CENTER FOR GLOBAL LIBERTY & PROSPERITY
DEVELOPMENT POLICY ANALYSIS

NOVEMBER 9, 2007 • NO. 4

Fifteen Years of Transformation in the Post-Communist World

Rapid Reformers Outperformed Gradualists

by Oleh Havrylyshyn

Executive Summary

The collapse of the Soviet empire freed hundreds of millions of people from communism. In most of the post-communist world, political freedom was followed by economic liberalization. The transition from central planning to the free market was uneven, however.

In the early days after the fall of communism, two schools of thought about economic reform emerged. Some economists argued for a rapid break with the past, whereas others favored a more gradual approach. With the passage of time, it is now clear that rapid reforms were on the whole better than gradual reforms. Countries that adopted far-reaching reforms tended to experience higher growth rates and lower inflation and received more foreign investment. Inequality increased less among rapid reformers than among gradual reformers. The same is true with respect to poverty rates.

Importantly, rapid reformers developed better institutions than countries that opted for gradualism. In fact, all of the rapid reformers developed into liberal democracies, whereas in many of the gradual reformers, such as Russia, small groups of super-wealthy oligarchs captured the state and dominated its economic decisionmaking. The efficiency of large-scale privatizations was not dependent on the speed but on the transparency and honesty of the process.

Future reformers should not be afraid of adopting rapid reforms. To gain maximum benefits from economic reforms, however, they need to ensure that the privatization process is more transparent than it has been in the past.

In countries where the state has been captured by a small clique of oligarchs, rapid reforms may be politically impossible in the short run. Still, liberalization of the business environment, especially with regard to small and medium-sized enterprises, could stimulate the economy without being seen as a threat by the ruling oligarchy.

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Introduction

On November 9, 1989, the Berlin Wall fell, marking the end of the communist experiment and the beginning of the end of the Soviet empire. That momentous historical event has come to symbolize the end of the Cold War, the freeing of millions of people from an authoritarian state that had kept them closed off from the rest of the world, and the liberalization of national economies from the constraints of socialist central planning.

The euphoria of the moment was widely shared, not only by the citizens of the socialist countries, but by many others around the globe. Unsurprisingly that euphoria was accompanied by high hopes of quickly achieving the same degree of democratic freedom and economic well-being enjoyed by the advanced West. Equally unsurprising, those unrealistic expectations were not quickly fulfilled, and by the mid-1990s disillusionment began to replace euphoria in many, but not all, former communist countries.

Analysts understand that economic miracles do not happen in a few years. They all expected output to fall before picking up again.[1] But the extent of the output decline was larger in most countries than most economists had expected, and the initial social impact of the transition was unquestionably painful. Did that decline justify the many alarm calls of the mid-90s, typified by the United Nations Development Programme's statement that the transition in the post-communist world had brought about "the most acute poverty and welfare reversal in the world?"[2]

In particular, was it right to attribute the worst effects of transition to the application of "shock-therapy," as many writers did in the case of the Russian reforms? This paper shows that such assessments were at best premature, often exaggerated, and not applicable to many better-performing countries—even at the beginning of the transition process. Most importantly, social costs were greatest in gradual, not rapid, reformers.

It was natural for scholars to undertake a mid-term review of the transformation process. However, given that an initial reduction of output was widely recognized as unavoidable, some of the reviews were less than honest about qualifying their preliminary results and overly eager to conclude that the transition had been a failure. It is now possible to review the transition experience over 15 years for which we have data—a period long enough to capture not only negative impacts of the early demise of central planning, but also the positive effects of the transition to a market economy.

The transition process was marked by a wide divergence in economic performance among the former communist countries.[3] Some countries have prospered, while others have stagnated. That divergence raises a crucial question for future reformers elsewhere in the world: What type of reform strategy leads to superior outcomes?

With the passage of time, it is now possible to conclude that rapid reforms were on the whole better than gradual reforms, the effectiveness of large-scale privatization was not dependent on the speed but on the transparency and honesty of the process, and the best path for institutional development was *not* to delay liberalization. In fact, countries that moved early and fast on macroeconomic stabilization and liberalization also built better institutions such as independent judiciaries that protect private property rights.

Reform Strategies: Theory and Practice

A popular refrain in the early 1990s said that "there is no precedent for moving from socialism to capitalism." That refrain was used legitimately to emphasize the difficulties in finding the optimal path of transition, but it was also used by the opponents of reform to try to slow down the pace of economic liberalization. To say that there was no precedent is not to say there were no road maps. In fact, plenty of road maps were produced inside the former Soviet empire and outside.

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).

Table 1, for example, shows the main aspects of the so-called Washington Consensus. The Washington Consensus refers to the broadly shared views on transition policies held by the international financial institutions (IFIs) such as the World Bank and the International Monetary Fund and by the proponents of the 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.[4] Big-bangers worried that going too slow would create large opportunities for rent-seeking by both old and new industries, and thus create vested interests opposed to liberalization. It was better to use the short "honeymoon" period of the post-communist euphoria, they reasoned, to quickly put in place the new liberal regime and prevent reform reversals. To deal with unemployment, big-bangers proposed social safety nets that were to be implemented immediately.

The Washington Consensus has become a straw man for those who favored gradual reforms and the "institutions-first" approach to transformation from communism to capitalism. Early gradualists, including Philippe Aghion of Harvard University and Olivier Blanchard of MIT, argued that the magnitude of dislocations would be very large given the huge inefficiencies of the socialist economy. To avoid those dislocations, they argued that the changes should be gradual, allowing time for new industries and jobs to be created as old ones were closed or restructured.[5] Both schools of thought recognized the importance of institutions, but it was undoubtedly more central to the thinking of the gradualists, who argued for delaying liberalization until better institutions were put in place.[6]

Going beyond that broad summary, the differences become nuanced especially when it comes to the sequencing of reforms. In the case of the Washington Consensus, of the 10 dimensions of reform, 5 were to be early and rapid. Those 5 were macroeconomic stabilization, market liberalization, trade liberalization, legal reforms, and (notably) unemployment compensation. The rest, including large-scale privatization, were to start later and take a long time.

Gradualists accepted the need for a rapid macroeconomic stabilization and in many cases saw the value of early privatization of small-scale entities as well as the freedom to start new businesses.[7] In the early debates, the gradualists wanted institutions to develop

Countries that adopted far-reaching reforms tended to experience higher growth rates and lower inflation and received more foreign investment.

before any liberalization took place, and by the mid-1990s they criticized the Washington Consensus for paying lip service to institutions-building.[8] In fact, the building of institutions lagged far behind other reforms, including large-scale privatization. The infamous loans-for-shares privatization in Russia, for example, has become a lightning rod for the gradualist and institutionalist criticism of the big-bangers.[9]

The key differences between the two views can thus be summarized as follows:

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 institutions 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 institutions come before liberalization and privatization to ensure maximum efficiency gains.

As will be shown below, the evidence suggests that the big-bangers were right to argue that rent-seeking blossoms with too much delay in reforms. They were also right to argue that institutions could come slightly later than reforms. The gradualists, on the other hand, were wrong to argue that moving too fast would cause greater social costs than moving more slowly, but they were right to argue that institutions enhance efficiency gains.

Inequality increased less among rapid reformers than among gradual reformers. The same is true with respect to poverty rates.

Related to the debate about the efficacy of the economic reforms was the debate about the effect of economic reforms on democratization. For example, Adam Przeworski of New York University hypothesized that in a democracy the pain of reforms would result in a new anti-reform or populist government winning the next elections and reversing the reforms.[10] Thus, he worried that market liberalization and democratic liberalization are not compatible. This paper provides empirical evidence that contradicts Przeworski's thesis.

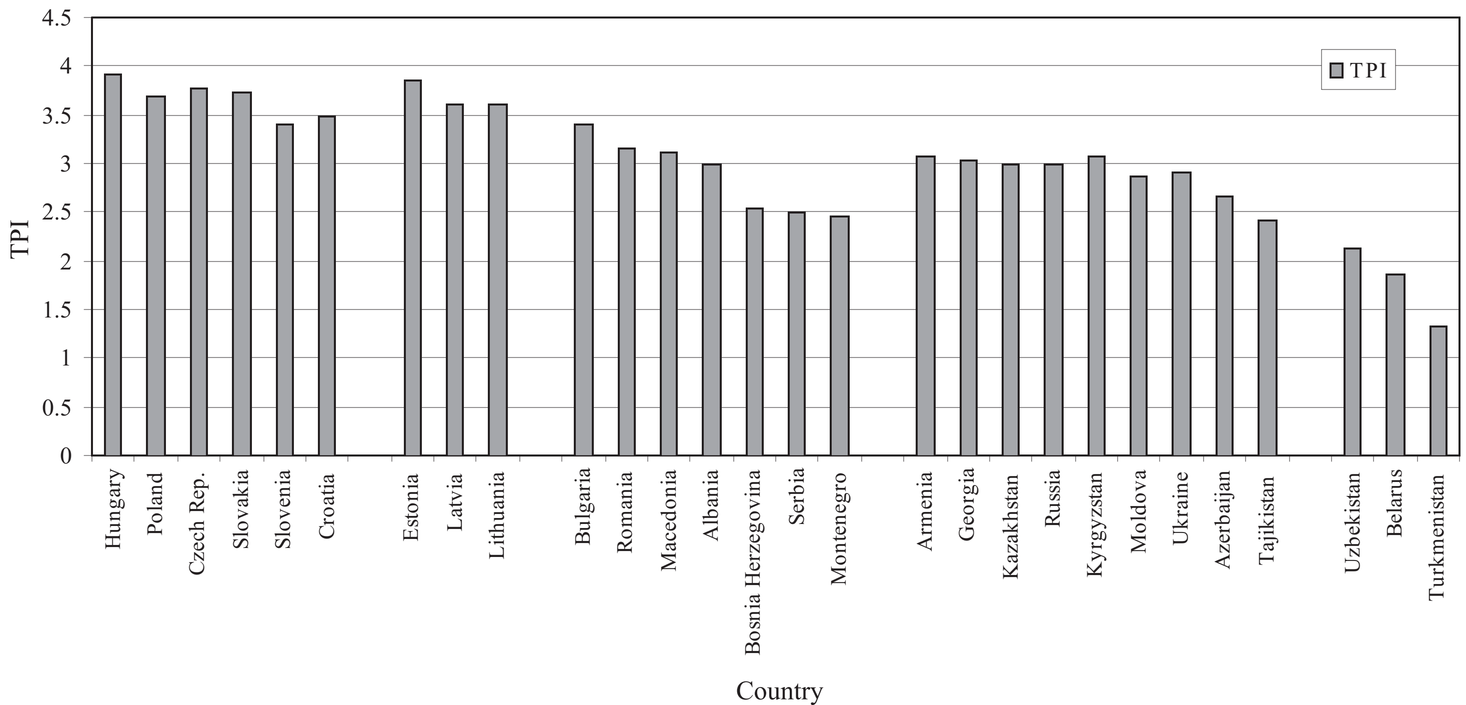
Defining the Big-Bang and Gradualism

Transition in most countries has gone so far that the debate over the speed of transition may seem to be only of historical interest. However, the debate still persists, with gradualists "showing" results confirming their point of view and big-bangers "showing" results confirming theirs.[11] Part of the difficulty is that classifying particular reformers as rapid or gradual has been somewhat arbitrary. That arbitrary classification was possible because the transition process involved many dimensions, leaving room for labeling the same country fast or slow.

After 1989, for example, Poland was considered a rapid transformer. Beginning in 1992, Russia was also designated as a rapid reformer by some analysts, though not all. Two very influential studies, one by Peter Reddaway from George Washington University and Dmitri Glinski from Columbia University and the other by Joseph Stiglitz also from Columbia University, critiqued shock-therapy's failures by focusing on the Russian example. They argued that rapid liberalization and privatization resulted in great social, economic, and political damage.[12] Neither study had much to say about Poland, which, by the time those two studies came out, was widely considered a success.[13]

Stiglitz's critics argued that the Russian reforms of 1992 were not a proper example of a big-bang approach to reform, because they stalled and were, to some extent, reversed, and important macroeconomic stabilization was not achieved until 1999. In response to that criticism, Stiglitz now seems to have redefined transition speed as pertaining only to large-scale privatization and on that narrow measure, Stiglitz labels Russia as an unsuccessful big-bang case and Poland a successful gradualist case.[14] But Stiglitz's focus on large-scale privatization as a defining difference between big-bang countries and gradualist countries is

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.

surely too selective. Except for large-scale privatization, Poland undertook all the relevant reforms fairly rapidly.

To get a better sense of the uneven pace of reforms in different countries, consider the most widely used index of transition in the post-communist world, the Transition Progress Indicator, which is estimated annually by the European Bank for Reconstruction and Development. The TPI measures the degree of a country's market-orientation on a scale from 1 to 4.5, with 1 denoting a centrally planned regime and 4.5 denoting a fully functioning market. 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.

Figure 1 shows the TPI ratings for 28 former communist countries in 2004. The countries are grouped into six categories: Central Europe (CE), the Baltics, South-East Europe (SEE), members of the Commonwealth of Independent States (CIS) with a moderate degree of reforms (CISM), and three CIS members with very limited reforms (CISL).

The speed and the scope of reforms in the first few years after the end of the communist rule are essential to distinguishing between the two approaches. Therefore, I have defined as rapid reformers those countries that saw their TPI score increase by 1 point or more over a period of three years.

I made two adjustments. First, some countries, such as Hungary and two former Yugoslav republics, which started off with advanced initial TPI values (well above 1.0) undertook economic reforms at a slower pace than the main big-bang countries, such as Poland and the then-Czechoslovakia, but attained similar TPI values after 3 or 4 years. I have labeled them as Advanced Start/Steady Progress countries. Second, some countries made a big initial leap in the TPI ratings, but did not sustain the pace

Table 2
Transition Countries Grouped by Early Reform Strategies

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

Note: Slovakia underwent rapid economic reforms between 1990 and 1992, when it was a part of the Czechoslovak federation.

All of the rapid reformers developed into liberal democracies.

of reform. Typically, countries where inflation exceeded 5 percent per month also reversed some of their early liberal economic reforms. Those I labeled as Aborted Big-Bang countries.[15]

Table 2 shows that only six countries can truly be called Sustained Big-Bang reformers. Those countries made a big leap toward liberalization in the first few years after the end of communist rule. They have achieved and sustained low inflation, and steadily increased their TPI scores through the present. The Advance Start/Steady Progress countries moved more slowly at first—perhaps because of their advanced starting position—but progressed steadily to TPI levels enjoyed by the Sustained Big-Bang countries by the mid-1990s. Aborted Big-Bang countries saw large TPI increases in the first few years, but their pace of reform was not sustained and/or inflation returned. Since the big-bang approach to reform in those countries was aborted, the third category in effect falls into a gradualist grouping. The countries in Gradual Reforms category adopted gradualism from early on. In those countries, macroeconomic stabilization and meaningful liberalization were delayed for at least two to three years and, in some cases, longer. Finally, the Limited Reforms category is comprised of countries that have made very limited progress from a Soviet-like economy.[16]

Different Strategies and Different Outcomes

The TPI reflects not only price and trade liberalization, but also the evolution of market-related institutions, including improvements in the climate of open competition and corporate governance. It is thus widely used as an overall indicator of progress toward the market economy. But some critics of the big-bang approach to reform note some serious shortcomings of the TPI, most importantly its inability to reflect the concentration of economic and political power in the hands of a few very wealthy "oligarchs" as in Russia and Ukraine.[17] That shortcoming raises the question as to the "quality" of the market economy that the TPI represents. It is thus important to look at more direct measures of performance or outcomes of the transition.

In the discussion below, I evaluate the five groups of former communist countries as categorized by the TPI according to their performance on a variety of indicators, including institutional development, economic performance and dislocation that accompanied the reform process. With a few exceptions, coun-

Table 3
Sequence of Economic Liberalization and Institutional Development

Countries	Index	1994	1999	2005
Central Europe	LIB	3.7	4.2	4.3
	INST	2.7	3.1	3.3
Baltics	LIB	3.7	4.1	4.3
	INST	2.3	2.9	3.2
South-East Europe	LIB	3.0	4.0	4.1
	INST	1.7	2.2	2.5
CISM	LIB	2.2	3.7	3.9
	INST	1.4	2.1	2.2
CISL	LIB	1.9	2.0	2.3
	INST	1.4	1.6	1.5

Source: Based on EBRD's 2000 and 2005 *Transition Report* country tables, http://www.ebrd.com/pubs/econo/series/tr.htm.
Notes: Liberalization (LIB) is the average of the following indicators: price liberalization, foreign exchange and trade liberalization, and small-scale privatization. Institutional reform (INST) is the average of the following indicators: corporate governance and restructuring, large-scale privatization, competition policy, banking reforms and other financial sector reforms.

tries that started their reforms early and resolutely achieved the best results.

Early Liberalizers Moved Fastest on Institutions

Although many indicators of institutional development now exist for all countries, including those in transition, I return to the EBRD's because it provides a more consistent time series for the former communist countries than do other estimates, and it also allows direct comparison with other indicators of liberalization.[18] Table 3 breaks down the TPI data into those dealing with market liberalization (LIB) and those dealing with institutional development (INST). Based on the evidence, several very important conclusions can be drawn. First, in all former communist countries institutional development lagged far behind economic liberalization. Second, those countries that moved early and rapidly on liberalization also moved fastest on institutional development. Third, in no country, including the gradualist countries, did institutional development precede liberalization.

In CISL countries, political leaders often claimed that they were moving gradually on reforms in order to avoid the mistakes of Russia's "shock therapy." They also claimed that they were building a social-market economy by preparing the institutional base before undertaking economic liberalization. Table 3 suggests the opposite. The CISL countries not only lag on economic liberalization, they also lag on institutional development. The CISM countries have progressed slightly farther on institutions but lag well behind the CE and Baltic leaders. Only SEE, where some countries still suffer from conflict or post-conflict problems, is comparable to CISM.

Consequently, it is possible to argue that the theory of gradualism was abused by political leaders in the less liberalized countries. Those leaders were not interested in real economic and institutional reforms but used the gradualist arguments to delay reforms, which, as shown below, resulted in large rent-seeking and state capture. Conversely, it may be argued that the leadership committed to firm progress on economic liberalization was also committed to progress on institutional development.

In many of the gradual reformers, small groups of super-wealthy oligarchs captured the state.

Table 4
Economic Performance Indicators in 2003

	GDP Index (1989=100)	GDP Index (Aslund Adjustment)	2003–2004 Median Annual Inflation, %	Cumulative FDI Per Capita, $US
Central Europe	115	139	2.5	2,305
Baltics	90	112	0.9	1,641
SEE	82	86	8.8	465
CISM	67	84	9.7	339
CISL	104	n.a.	13.3	168

Source: All data are from EBRD *Transition Report 2004*, except column 3, which is taken from Oleh Havrylyshyn, *Divergent Paths in Post-Communist Transformation: Capitalism for All or Capitalism for the Few?* (New York: Palgrave MacMillan, 2006), chap. 3.

Note: The three indicators in Table 4 have not been updated beyond 2003 in part because of the strong influence of the boom in the energy sector on the economic performance of the CIS countries. Also, it is important to note that Aslund calculated his adjustment only up to the year 2000. Projecting his calculations three years ahead, as Table 4 does, may be reasonable, but extending those projections by another three years would be methodologically questionable. Still, even when 2006 values are used, the relative ranking of the country groups remains the same.

To gain maximum benefits from economic reforms, reformers need to ensure that the privatization process is more transparent than it has been in the past.

Early Reformers Had Best Economic Performance

Table 4 compares the five categories of former communist countries with three different indicators of economic performance between 1989 and 2003. The first column shows the index of GDP relative to 1989—the year that is commonly used as when transition began. That column shows that, with the exception of the CISL countries, states with more advanced market reforms have achieved stronger recovery from the recessions that followed the collapse of communism.

Some scholars, including Anders Aslund of the Peter G. Peterson Institute for International Economics, have argued that evaluation of the reform process with 1989 as the base year overstates the decline of output during the years of recession, because communist statistics overstated output by including production of zero or negative value and not reflecting negative value of shortages and queues. For countries outside CE, the 1989 benchmark also overstates the decline attributable to transition, which did not begin in many countries until 1992 and, in some cases, even later.

Aslund has taken into account some of the above effects on GDP and has calculated new estimates. The second column of Table 4 shows economic performance in post-communist countries adjusted—conservatively—for only half of Aslund's estimates. Even those adjustments strengthen my conclusions: broader and more rapid reforms resulted in earlier and stronger GDP recovery. Still, the CISL performance remains a puzzle. That may be partly because of the overstatement of GDP growth rates in those still very Soviet-like economies and because the economic downturn, though ultimately unavoidable, was temporarily postponed as were reforms. It is also notable that the good output record of the CISL countries is not entirely consistent with the indicators of wellbeing that I discuss later. (In the case of Belarus, for example, the high GDP growth rate is related to a significant Russian energy subsidy.)

Median inflation values for each group are shown in column 3. They too correlate with the degree of reforms. The CISL countries, for example, have the highest inflation rates in the region—suggesting that Soviet-era policies of

providing cheap credit to inefficient industries continue. The dramatic differences seen in cumulative foreign direct investment per capita figures in column 4 speak for themselves.

The superior performance of the big-bang countries is explained not only by the degree of market reforms. A detailed econometric analysis also concludes that the greater the degree of market reforms in the first decade, the better the economic performance.[19]

Gradual Reformers Suffered More Social Pain, Not Less

A key motivation for gradualism was the concern that rapid reforms would impose too great a social cost in the form of unemployment, income deterioration and poverty. In practice, the opposite has occurred.

Critics of the big-bang approach point out that GDP growth ignores the distributional effects—including the rise in inequality—on different segments of the population. To capture those and other social costs of transition, I use indicators of social wellbeing produced annually by the United Nations Development Programme. The UNDP's Human Development Index is a measure of well-being encompassing not only per-capita incomes, but their distribution, the extent of poverty, and access to basic needs such as housing, health, and education.

When one looks at the HDI values for the transition countries from 1990 to 2000 a different picture emerges from that painted by the gradualists. In fact the HDI values for Central Europe did not decline at all but saw a steady increase, especially after 1995.[20] Those for the Baltics did fall significantly but more than fully recovered by 2000, whereas those for both CIS groups declined most dramatically and by 2005 had not yet recovered their 1990 values. The clear conclusion is that more radical reforms led to *less* social pain, not more.

Why are those results so different from those found in many studies from the late-1990s, such as the UNDP's 1998 report *Poverty in Transition*? First, earlier studies only had data up until 1995 and 1996, covering the recession period, and were bound to show a more negative picture of the transitions. Recent studies confirm that significant turnaround in social indicators for all the groups started in the mid 1990s.[21] Second, even when it comes to the early period, the majority of the studies focused on the worst cases in the CIS countries and did not adequately reflect what was happening in, for example, Central Europe.[22]

The effectiveness of large-scale privatization was dependent on the transparency and honesty of the process.

Table 5
Approximate Gini Coefficient Values during Transition

Countries		1988–92	1993–96	2002–03
Central Europe		22	29	28
Baltics		25	35	36
SE Europe (3)		21	27	33
CISM		27	42	38
CISL		25	NA	33
OECD	Lowest = Denmark			25
	Highest =USA			40
Developing	Lowest = Indonesia			30
	Highest =Colombia			49
China				Rural = 36
				Urban = 32

Source: Author's calculations based on United Nations Development Programme, *Poverty in Transition* (New York: UNDP Regional Bureau for Europe and the CIS, 1998) and World Bank, *Growth, Poverty, and Inequality: Eastern Europe and the Former Soviet Union* (Washington: World Bank, 2005).

The theory of gradualism was abused by political leaders in the less liberalized countries.

The turnaround and the superior performance of advanced reformers can also be seen in the patterns for the World Bank's Gini coefficient, which measures inequality and poverty ratios (Table 5). The Gini coefficient is usually calculated on a scale from 0 to 1, where 0 represents perfect income equality and 1 represents complete income inequality. I have multiplied the Gini coefficient values by 100 and averaged them for each country group. It is important to emphasize that while changes in the poverty ratio can be described normatively as "deterioration" or "improvement," the same cannot be said for income distribution measures such as the Gini coefficient. In the transition process some widening of income distribution was not only to be expected as private ownership and the market replaced socialism, but it was also, at least to some extent, desirable. In the free market system, growing incomes serve as an incentive to increasing productivity and entrepreneurship.

Before 1989, the Gini coefficient was arguably too low in socialist economies. It could also be argued that extremely high income disparities are "bad," partly due to efficiency reasons. Very high Gini coefficient values reflect societies in which there may be huge political tensions between lower and upper income groups, with resulting instability, poor incentives for labor, and inferior growth performance. This paper does not attempt to pass a judgment on what the right Gini coefficient should be after 15 years of transition, but only compares former communist countries to one another and gives some benchmark references from other countries.

As expected, income distribution widened in all countries. In most cases, however, it narrowed again after the mid-1990s. I have analyzed the Gini coefficient values for 2002 and 2003 and found that they ranged from 28 to 36 in the more advanced reformers of Central Europe and the Baltics, and somewhat higher in the CIS countries. Some studies show values in the CIS countries that are much higher—40 or more in Russia, Georgia, Uzbekistan—but given the wide variation of results, precision on this issue is impossible. Nevertheless it appears the trend for the Gini coefficient has been a rise to the late nineties, then somewhat of a decline and stabilization.

From an international comparison, it is clear that the most recent Gini coefficient values in the post-communist world are not greatly out of step with other market economies. The lowest Gini coefficient values are similar to the lowest in developed countries, such as Denmark, and the highest are comparable to the top end, such as the United States. In comparison with the developing countries, the transition group looks more like Asia rather than Latin America, which has very high Gini coefficient values. In the mid-1990s, which is to say before the significant recovery in the CIS countries, some countries, including Russia, did appear to be reaching Latin American Gini coefficient values. But economic growth has narrowed income distribution. It is of interest that China, which is often cited as an example of a successful gradualism, experienced a rise in the Gini coefficient to well above 30—higher than most of the post-communist countries.

Poverty rates show a similar trend (Table 6).[23] Pre-transition socialist economies had a low incidence of poverty. However, it is notable that many Soviet republics had poverty rates similar to those of low-income developing countries—even during the communist period. As transition started, poverty rates rose sharply in most countries and then they slowly declined. Recent poverty rates have, in many cases, returned to the pre-transition levels. However, the more gradual reformers of the CISM not only saw a much greater worsening of poverty up to the mid-1990s, but also continued to experience poverty rates far higher than those found in the CE and Baltic countries. Even more telling is the trend in CISL. The CISL governments rejected economic reforms because of the accompanying deterioration in some indicators of social well being. But, they too experienced an early jump in their poverty ratios and, in recent years, have seen at best a partial correction that was certainly far smaller than the correction experienced by advanced reformers.

Table 6
Range of Poverty Ratios by Country Group (percent)

	Pre-transition	Mid-transition	Most recent
Central Europe	0–13	1–25	0–7
Baltics	1–2	22–46	3–5
SEE	2–6	15–45	4–24
CISM	2–30		
(Tajikistan = 50)	12–70		
(Tajikistan = 96)	1–54		
(Tajikistan = 74)			
CISL	1–24	22–63	2–47

Source: Author's calculations based on United Nations Development Programme, *Poverty in Transition* (New York: UNDP Regional Bureau for Europe and the CIS, 1998) and World Bank, *Growth, Poverty, and Inequality:Eastern Europe and the Former Soviet Union* (Washington: World Bank, 2005).

Again, the message is clear: early and rapid reformers did not avoid an increase in poverty altogether, but they suffered much less of it and more than fully recovered by the end of the decade.

Overall, the evidence on economic performance and social costs seems to contradict the first hypothesis of the gradualists, who argued that gradual reforms would smooth and minimize adjustment costs.

Did the Privatization Experience Vindicate Both Schools of Thought?

The second hypothesis advanced by the gradualists states that privatization will not yield the expected efficiencies unless the proper institutional environment of a competitive market is in place. A comprehensive test of that hypothesis can be found in econometric studies which concluded that privatization without good institutions does not result in significant efficiency gains, but, accompanied by the discipline of a competitive environment, the gains can be considerable.[24] Gradualists contend that such studies confirm their views and in a narrow sense they are right—better institutions lead to better overall results.[25] But in a lager sense, as Table 3 shows, the only countries that experienced considerable institutional development were the rapid liberalizers—not the gradual reformers.

The problem of assessing privatization is closely linked to the problem of distinguishing between countries that followed gradual reforms and countries that followed rapid reforms. Is it justifiable to call Poland a gradual case, because the Polish government moved very late to privatize large state-owned enterprises? Compared to what and whom? Poland was far ahead of most former communist countries on small-scale privatization, on market liberalization, and on developing institutions. Does Poland's experience with late large-scale privatization confirm that gradualism achieves better results than rapid reforms? That is only true if the comparison is with the Russian experience. Others who privatized their large-scale enterprises more rapidly than Poland, including Estonia and Hungary, have surely achieved results as good, and perhaps better, than Poland, not to mention Russia.[26] Even the Czech Republic, which was much criticized for its too-rapid large-scale privatization, cannot be compared with Russia in terms of today's outcomes. On the other hand, slow privatizers, such as Ukraine, show outcomes on most dimensions inferior to Poland's and more like Russia's. Privatization is only one part of an overall reform strategy and cannot be used as the sole criterion distinguishing the gradual and the rapid reformers.

Liberal markets and liberal politics went hand in hand in former communist countries.

Table 7
The World Bank's Index of State Capture (1999)

	Index Value
Central Europe	0.20
Baltics	0.18
SEE	0.35
CISM	0.38
CISL	0.10

Source: Oleh Havrylyshyn, *Divergent Paths in Post-Communist Transformation: Capitalism for All or Capitalism for the Few?* (New York: Palgrave MacMillan, 2006), p. 192.
Note: The scale of the state capture index is from 0 to 1, with higher numbers denoting higher degrees of state capture.

Only the competitive discipline of a free market under the rule of law can ensure the maximum benefits of a market order.

Finally, consider Przeworski's worry that in democracies rapid reforms would lose political support and lead to the reversal of reforms or, to put it differently, that liberal markets and liberal polities were in conflict. In the broader literature on this issue, the evidence remains mixed, but for the former communist countries, the evidence is very clear. There is a strong and statistically significant correlation between economic liberalization and political liberalization.[27] Contrary to Przeworski's thesis, in other words, liberal markets and liberal politics went hand in hand in former communist countries.

Gradualist Theory Was Not Wrong, but It Was Abused in Practice

No countries followed the prescriptions of the pure gradualist model, but many politicians used gradualist arguments to justify delays in reform, allowing political insiders to benefit from large rents, accumulate considerable wealth in the hyperinflation period, and gain privileged access to the large-scale-privatization process.

One of the major theorists of gradualism, Gerard Roland of University of California, Berkeley, notes that "Insufficient attention has been given so far to this issue of partial reforms and the conditions under which it creates momentum, or on the contrary, creates vested interests that block further reform."[28] The actual evidence from ex-communist countries spanning 15 years suggests that the latter is the case. Partial and/or delayed reforms, which often also meant delayed macroeconomic stabilization, have initiated a vicious circle, in which rent-seeking opportunities were created, great wealth was accumulated by those with inside connections, and an oligarchy evolved. That oligarchy, in turn, "captured the state" and used its influence to block competition, transparency, and even-handed application of law, thus freezing both market transition and democratic development.

Table 7 shows the 1999 values from the World Bank's Index of State Capture for each of the five groups of former communist countries.[29] (State capture is a term denoting a situation where a group of economically powerful interests is able not only successfully to lobby the government in order to gain economic benefits, but also has an overpowering influence on election outcomes and the general direction of government policy.) The values, which were estimated on the basis of extensive surveys of business managers, were lowest among the more rapid and advanced reformers, and highest among the partial reformers.[30] (Moreover, there is a significant negative correlation between economic liberalization and state capture. In other words, vested interests, once entrenched, block further reforms.[31])

So where did gradualism go wrong? It is widely, though not universally, believed that the theoretical models and theoretical conclusions of the gradualist model were correct. In practice, gradualism was hijacked by politi-

cians who acted in their self-interest. The most successful countries had committed leaders with the interests of the nation in mind. They could have followed a gradual strategy, but for reasons that many of them have described in their writings, they did not. Those reasons included concerns that partial reforms would result in rent-seeking and political self-interest, the realization that liberalization could be done quickly, and the belief that the necessary institutional changes would follow.[32]

Policy Recommendations

For the country groups at the two extremes of the spectrum, policy recommendations are straightforward. Central Europe and the Baltics have mostly completed their transitions, except for institutional development, and no longer face problems associated with transitional economies. Rather, they face problems associated with other emerging market economies that include attracting capital inflows without inflation and overheating, and maintaining fiscal prudence in the face of democratic pressure.

Belarus, Uzbekistan, and Turkmenistan are caught in the political and economic grip of a Soviet-like regime. When a new opportunity arises for transformation of those three countries into market democracies, the lessons from Central Europe and the Baltics will be of great relevance. The order of the day should be speedy liberalization, opening of markets to small business, transparency in privatization—be it rapid or gradual—and parallel institutional development. Unfortunately, those countries face a big risk of falling into a trap created by the mismanagement of transition in the captured states. In captured states, citizens have come to equate "capitalism" with private ownership without appreciating the need for competition as a mechanism for ensuring market outcomes.

Incidentally, this "trap" has global relevance. A great deal of the resentment against globalization arises from the same mistaken understanding that private ownership alone is all there is to capitalism. Economists must do a much better job of clarifying publicly that capitalism without free markets is not a true capitalism and that only the competitive discipline of a free market under the rule of law can ensure the maximum benefits of a market order.

In the middle of the spectrum, the countries of SEE remain far from having genuinely free markets. The most advanced countries, including Bulgaria, Croatia and Romania, score high on the EBRD liberalization index, but lag on institutions. For those countries that have not yet become member states of the European Union, such as Croatia and Macedonia, the best strategy is to meet the conditions for the EU accession, which proved to be a powerful disciplining force for Central Europe and the Baltics. The extensive requirements of the EU legislation, the so-called "acquis communautaire," in effect required former communist countries to undergo substantial market liberalization, transparency, and establishment of democratic and open institutions.

In the other Balkan countries, much more is needed. Late starters, such as Serbia and "noncountries" like Kosovo, are a case in point. Though they are not on a formal EU accession path, the carrot of an eventual membership could provide a powerful incentive to move forward with reforms. Given their small size, the Balkan countries can learn from Hong Kong and Singapore, whose open and liberal economies performed much better than countries that tried to nurture their domestic industries. Montenegro, for example, began to apply free-market and free-trade policies even before it became independent.

The toughest nut to crack is the CISM group of countries. The first constraint on their development is the harsh reality that policymakers in captured states are, almost by definition, unable or unwilling to apply policies that will reverse state capture. The entrenchment of economic elites with a vested interest in a frozen transition means that popular election victories as seen in the color revolutions in Georgia, Ukraine, and Kyrgyzstan, do not by themselves unseat the oligarchs.[33]

Foreign firms bring with them business practices which tend to be more professional and transparent than the business practices in former communist countries.

Private sector players from industrial countries should insist—first and foremost—on transparency.

But there is room for action. At least some of the newly rich are likely to see institutional development, including greater protection of property rights, as the best way to legitimize their newly acquired wealth and status. They may therefore be prepared to agree to policies that will in the long run liberalize the economy and the political space.

What are some of the policies that CISM countries should adopt? First and foremost is the liberalization of the business environment with respect to small and medium-sized enterprises (SME). In most of the CISM countries, the SME sector is vibrant and growing, but still very small. Its growth is limited by bureaucratic barriers, arbitrary inspections, and high taxation.[34]

While the oligarchs may not like the idea of future competition, they stand to benefit from growing middle class demand. Moreover, it is difficult for oligarchs to claim that "we are just good businessmen" and then oppose SME development. Also, CISM countries should allow greater external competition, especially in the form of foreign investment. Foreign firms bring with them business practices from their home countries, which tend to be more professional and transparent than the business practices in former communist countries. In the same vein, it is essential to create more transparency in budget, tax collection, licensing, and regulatory procedures. It is important to achieve not only simplification of rules, but also evenhandedness—a level playing field for large and small firms and entrepreneurs.

There are also some measures that have to be avoided. The promotion of SMEs by grants and tax privileges is not a good idea. Government subsidies remain a part of the psychology of firms and entrepreneurs in many former communist countries. But government support does not lead to the development of an efficient small-business sector. More likely, it leads to the continued reliance on government handouts, shoddy service and high prices. The best way to promote SMEs in those countries is for the government bureaucrats to stop harassing those businesses.

Anti-corruption campaigns are also of dubious usefulness. The powerful business elites in the captured states do not fear them. In fact, they find them useful, because anti-corruption campaigns usually end up targeting less powerful small businesses and thus undermine their competitors. Anti-corruption campaigns also provide politicians with a useful vehicle to claim, both domestically and internationally, that they are fighting corruption. Another policy to avoid, even if the political opportunity arises, is renationalizing enterprises that were privatized in a corrupt way and starting all over again. While a handful of egregious cases of privatization at bargain prices can be reversed without serious damage to investor confidence, a large number of renationalizations would be disastrous.[35] It would send all the wrong signals to investors, both large and small; it would tie up the courts for years; and it would likely lead to taking assets away from political opponents and giving them to new political favorites.[36]

In their push to promote good government and transparency, the international financial institutions should exercise great caution in supporting anti-corruption campaigns. As I have noted, those campaigns are all too often used as a façade aimed not at tackling of big corruption, rent-seeking and state capture, but at small businesses, which are then forced underground and thereby destined to remain corrupt.[37]

Finally, private sector players from industrial countries with potential business interests in former-communist countries should also insist—first and foremost—on transparency. Of course, private sector players should be promoting better institutions in general, but transparency is perhaps the most important dimension of better institutions. Episodic promotion of transparency is relatively easy—as when an international oil company wishes to bid on a Russian oil facility or oil exploration rights. But the collective voice of all foreign investors would be much more effective. There is a risk, of course, that a call for better rule of law by foreign companies will seem hollow if at the same time those companies yield to the temptation of accepting special privileges. Many countries,

after all, attract foreign investors by offering them tax holidays, duty free zones and so on. It is surely not in the long-term interest of either the host country or the foreign investors that foreign companies enjoy special privileges not available to local firms. Such price distortions are no better than discrimination between favored domestic firms and others.

Statements about the need for transparency, a level playing field for SMEs and better rule of law, have more effect when they come from a CEO of a leading multinational, rather than when they come from World Bank or IMF officials. The promotion of transparency and equality before the law, though perhaps difficult to coordinate, would be a useful additional contribution of the private sector to the welfare of the post-communist world.

Notes

1. See Michael Bruno, "Stabilization and the Macroeconomics of Transition—How Different is Eastern Europe?" *Economics of Transition* 1, no.1 (1993): 5–19. Michael Bruno and others noted that this output U-curve occurred in all earlier reform and stabilization programs.

2. United Nations Development Programme, *Poverty in Transition* (New York: UNDP Regional Bureau for Europe and the CIS, 1998). This paper drew general conclusions from the worst cases in the former Soviet Union and ignored a very different picture that was emerging in Central Europe. See also World Bank, *Growth, Poverty, and Inequality: Eastern Europe and the Former Soviet Union* (Washington: World Bank, 2005). The World Bank showed that the UNDP's conclusions were premature, as even the worst cases of transition began to improve.

3. Some analysts, including the former U.S. national security advisor Zbigniew Brzezinski, predicted wide differences in the economic performance in the post-communist world. See Zbigniew Brzezinski, "The Great Transformation," *National Interest*, no. 3 (Fall 1993): 3–13.

4. The term "shock therapy" has become a rhetorical tool often used by its critics. In this paper I prefer to use more neutral terms, such as "big-bang" and "gradualism."

5. Philippe Aghion and Olivier Blanchard, "On the Speed of Transition in Central Europe," EBRD Working paper no. 6, July 1993. See also Mathias Dewatripont and Gerard Roland, "Transition as a Process of Large-Scale Institutional Change," *Economics of Transition* 4, no. 1 (1996): 1–30.

6. Table 1 makes it clear that the Washington Consensus did not ignore institutional development. The critics may be right, however, that in early years the World Bank and the IMF paid lip service to institutional development rather than making it a serious goal.

7. Joseph Stiglitz, "Whither Reform: Ten Years of Transition" in *Annual World Bank Conference on Economic Development*, ed. Boris Pleskovic and Joseph Stiglitz (Washington: World Bank, 2000), pp. 27–56.

8. Peter Murrell, "How Far Has the Transition Progressed?" *Journal of Economic Perspectives* 10, no. 2 (1996): 25–44. See also Luc Moers, "How Important are Institutions for Growth in Transition Countries?" Tinbergen Institute Discussion Paper no. 99-004/2, 1999.

9. In 1994, the newly privatized Russian banks offered to lend money to the government in Moscow to help it cover the government's huge budget deficit. The collateral was to be the shares in major state enterprises. As the government "failed" to meet its payment obligations, the banks took over majority shares of many large state enterprises. The critics allege that the government's failure to pay was planned from the beginning. The act of privatization itself, in other words, was more important to the reformers in Moscow than privatizing under transparent market conditions. Whatever history says about that particular episode, by the late 1990s, the proponents of the Washington Consensus began to give much more emphasis to building of proper institutions—the so-called "second-generation" reforms.

10. Adam Przeworski, *Democracy and the Market: Political and Economic Reforms in Eastern Europe and Latin America* (Cambridge: Cambridge University Press, 1991).

11. For the gradualist perspective see Sergio Godoy and Joseph Stiglitz, "Growth, Initial Conditions, Law and Speed of Privatization in Transition Countries: Eleven Years Later," NBER Working Paper no. 11992, 2006, and Gerard Roland, "Ten Years after . . . Transition and Economics," International Monetary Fund Staff Papers no. 8, 2001. For the big-bang perspective see Oleh Havrylyshyn, *Divergent Paths in Post-Communist Transformation: Capitalism for All or Capitalism for the Few?* (New York: Palgrave, 2006), and Stanley Fischer, "Ten Years of Transition: Looking Back and Looking Forward," International Monetary Fund Staff Papers no. 48, 2001.

12. See Peter Reddaway and Dmitri Glinski, *The Tragedy of Russia's Reforms: Market Bolshevism against Democracy* (Washington: United States Institute of Peace, 2001), and Stiglitz, "Whither Reform."

13. Gradualists, including Roland, Reddaway, and Glinski, agree with big bangers that Poland is a success story. The gradualists argue, however, that historical conditions made big-bang possible in Poland but not in Russia.

14. Godoy and Stiglitz.

15. Some observers might argue that those in-between categories define away the contrast between big-bang and gradualist approaches to economic reforms in the former communist countries. However, unlike most other authors, I have put forward transparent definitions of both rapid and gradual approaches to reform. My definitions recognize that between the two extremes of sustained reform efforts on one end and very gradual reforms on the other, there are other important categories. Countries that started higher on the index of transformation, progressed steadily, and kept up with the big-bangers are surely more like the rapid reformers. Countries that may have undertaken some big-bang reforms at the outset but for various reasons did not sustain or even reversed some of those reforms surely cannot be labeled rapid reformers. It is often those countries, especially Russia, that are used as evidence by the critics of Washington Consensus that the big-bang approach to reforms was a failure. Since the Washington Consensus policies were not in fact implemented in a sustained fashion it is wrong to conclude that they have failed. Such a conclusion would be akin to saying that a prescribed medicine did not work without mentioning that it was incompletely ingested. It is legitimate, of course, to argue that the political-economy environment was inimical to rapid reforms, but that, by itself, does not "prove" that an alternative strategy would have worked better.

16. Several SEE countries were excluded from my analysis, because political instability meant that the start of their transition only took place in the late 1990s. Those countries include Serbia, Montenegro, and Bosnia and Herzegovina.

17. Joseph Stiglitz, "Whither Reform."

18. The EBRD index is a good proxy for more sophisticated analysis as suggested by its high correlation of 0.945 with other measures of institutional development. See Beatrice Weder, "Institutional Reform in Transition Economies: How Far Have They Come?" International Monetary Fund Working Paper, 1999. See also Daniel Kaufmann, Aart Kraay, and Massimo Mastruzzi, "Governance Matters III: Governance Indicators for 1996–2002," *World Bank Policy Research Working Paper*, 2003.

19. For a review the econometric literature on growth in transition see Oleh Havrylyshyn, "Recovery and Growth in Transition: A Decade of Evidence," special issue, International Monetary Fund Staff Papers, vol.48, 2001.

20. Havrylyshyn, pp. 92–95.

21. World Bank, *Growth, Poverty, and Inequality*.

22. Branko Milanovic is an exception, recognizing that the poverty effects in Central Europe were far less severe than in the CIS. See Branko Milanovic, *Income Inequality and Poverty during the Transition from Planned to Market Economy* (Washington: World Bank, 1998).

23. Poverty rates denote the share of population below a certain level of income or threshold. The "threshold" level is often different in different studies, so variability of estimates for different countries is also quite large. As definitions vary by country, comparability is very imprecise and questionable—as the World Bank has repeatedly warned. For that reason, I do not show averages but rather rely on the range of poverty ratios experienced by different groups of countries.

24. Clifford Zinnes, Yair Eilat, and Jeffrey Sachs, "The Gains from Privatization in Transition Economies: Is Change of Ownership Enough?" International Monetary Fund Staff Papers no. 48 (2001).

25. Gerard Roland, "Ten Years After . . . Transition and Economics," p.46.

26. In "Ten Years After . . . Transition and Economics," Roland designates Hungary, like Poland, as a gradual privatizer. That designation is hard to square with the EBRD index of large privatization, which shows Poland at over 3 points out of 4.5 in 2006 and Hungary at 4 points in 1995 (on par with Estonia, the Czech Republic, and Slovakia). Russia, the gradualists' favorite rapid privatizer, had an index of 3 points by 1997 and stayed there until 2004. After 2004, the Russian index fell marginally due to some renationalization. Ibid.

27. Havrylyshyn, pp. 55–58.

28. Dewatripont and Roland, p. 42.

29. The only year available is 1999.

30. I have used the average of two concepts of state capture, pervasiveness, and concentration, as discussed in Joel Hellman and Mark Schankerman,

"Intervention, Corruption, and Capture," *Economics of Transition* 8, no. 3 (2000): 295–326. Hellman and Schankermann don't include 1999 values for some countries. Those values were calculated using an updated but revised definition in Joel Hellman, Geraint Jones, Daniel Kaufmann, "Seize the State, Seize the Day: State Capture, Corruption and Influence in Transition Economies," *Journal of Comparative Economics* 91 (2003): 751–773.

31. For the theoretical model of partial reforms and the vicious circle of rent-seeking, oligarchy, and state capture, see Oleh Havrylyshyn, *Divergent Paths in Post-Communist Transformation: Capitalism for All or Capitalism for the Few?* The book provides, among other evidence, a regression analysis showing that delayed reforms lead to a greater formation of vested interests.

32. Lezsek Balcerowicz, *Post-Communist Transition: Some Lessons* (London: Institute of Economic Affairs, 2002); Vaclav Klaus, "The Economic Transformation of the Czech Republic: Challenges Faced and Lessons Learned," Cato Institute Economic Development Bulletin no. 6, February 14, 2006.

33. Ukraine may serve as a case in point. The Orange Revolution has not chased powerful economic interests out of politics. The recent reimposition of grain quotas, for example, indicates a return of anti-reform lobbying by powerful vested interests.

34. For elaboration on the policies needed to stimulate SME development, see Anders Aslund and Simon Johnson, "Small Enterprises and Economic Policy," Carnegie Endowment for International Peace Working Paper no. 43, May 2004.

35. For example, Kryvorizhstal, Ukraine's largest steel complex, was sold in a 2003 insider-favored auction for $800 million. Its true worth, as indicated after renationalization in 2005 and resale in an open auction to a bidder who had been excluded in 2003, was nearly $5 billion. Further renationalizations, however, would probably be counterproductive.

36. A new and important debate has arisen between what I call the Transition Inevitable and Transition Frozen schools of thought. The TI position, based on the Coase theorem, argues that once private ownership is solidly established—regardless of the means by which assets were acquired—the new capitalists will want to have security of property rights and will use their influence to push for the proper rule-of-law institutions. In contrast, TF views point to history of entrenched elites who do not gladly embrace competitive markets, but resist new competition and loss of privileged influence. TF also notes that for the foreseeable future, "oligarchs" in the former communist countries can expect to continue obtaining various forms of rents and benefits of capture. They can also use their wealth and influence to buy property rights for themselves not only in the form of armed security guards but, more importantly, in the form of nontransparent privileged treatment by tax authorities in particular and the government agencies in general. A number of mathematical models have shown that when costs and benefits are accounted for, the outcome of the models depends on the following trade-off: as long as the benefits of holding the state captured are greater than the costs, such elites will not do as the TI theory predicts. Part of the TI argument is to compare the new oligarchs to the so-called "robber barons" in the United States, who gradually ceded their monopoly power and became satisfied with their already large wealth. Indeed, they began giving a lot of money to charity. But this argument can go in the opposite direction: "robber barons" did not give up their strong position immediately. Antitrust institutions, for example, took a long time to develop. More important, the comparison ignores a crucial difference. "Robber barons" first added value to the economy and only then began to use their influence. The oligarchs often acquired large assets though redistribution and are perceived by their respective publics to have done so immorally, if not illegally. Whether that is true or not, that perception is enough to make the oligarchs worry that they will be punished and lose their wealth and position in the future. Whatever the merits of the two views, the debate between TI and TF schools of thought will certainly go on for some time to come. See Konstantin Sonin, "Why the Rich May Favor Poor Protection of Property Rights," *Journal of Compar-ative Economics* 31, no. 4 (2004): 718–31; and Leonid Polischuk and Alexei Savvateev, "Spontaneous (Non)Emergence of Property Rights," *Economics of Transition* 12, no. 1 (2004): 103–27.

37. Let me also note that many good policies have been advocated by the IMF, World Bank and EBRD. Another important contribution that IFIs make is in the form of technical writing. Annual reports, working papers, monographs and so on contain valuable analysis of the problems facing SMEs, and the lack of transparency during privatizations. The very concept of state capture used here comes from World Bank researchers. Moreover, a recent World Bank memorandum details the process of oligarch development in Russia. It names the individuals, the companies and the value of assets held by the oligarchs as well as the economic consequences of such concentration of wealth in the hands of comparatively few people. See World Bank, *From Transition to Development: A Country Economic Memorandum for the Russian Federation*. (Washington: World Bank, April 2004).

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