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## How Capitalism Was Built: A World Transformed

by Anders Åslund\*

In 1989, the Soviet Bloc – from Berlin to Vladivostok – was struck by one of the greatest liberal revolutions of all times.[1] Since then, society has changed profoundly. A complete ideological, political, economic, and social system passed away, and some 400 million people had to choose a new system. The rejection of socialism was unequivocal. A broad consensus aspired to build democracy and a market economy based on private ownership and the rule of law, while opposition to these goals was concealed in disagreement on how to accomplish them.

At the collapse of communism, liberal revolutionaries seized the political initiative. They aspired to build a “normal society” and to “return to Europe.” The petrified communist dictatorships had to give way to democracy and individual freedom, the state-controlled economy to markets, and public ownership to private property. Communism had rejected the rule of law, which should now be established. A total transformation was needed, and nobody thought it would be easy.

Communists always feared the return of capitalism. They planted many poison pills to secure the destruction of capitalism, such as the comprehensive nationalization of property, the annihilation of civil society, the elimination of markets, and the suppression of law. Communism was dead as an ideology, unable to resist the liberal revolution, but its poison pills were alive. They bred a rent-seeking state and that was the

actual alternative to free market capitalism. The main struggle of postcommunist transformation stood between radical market reformers, who desired a swift and complete transition, and rent seekers, whose desire was to make money on a prolonged period of market distortions.

Perspectives change over time. As often happens during revolutions, people's expectations become exaggerated and then people become disappointed. The institutional changes have been immense, but even so the legacies of the old society remain palpable, as Alexis de Tocqueville [1856] noted so accurately in *The Old Regime and the French Revolution*. Some institutions have been much more successfully reformed than others.

The outcomes of postcommunist transition have been remarkably diverse. The results have depended on early policy choices, which were influenced by the conditions prevailing in each country. The Central Europeans swiftly shifted to normal market economies and privatized. They adopted West European social welfare system with high taxes, large social transfers, and excessive labor market regulation, which have impeded their economic dynamism, but they have also become impeccable democracies and corruption is relatively limited.

Nine Commonwealth of Independent States (CIS) reformers also developed market economies, but of a more East Asian type with low taxes, limited social trans-

fers, and liberal labor markets. The low taxes are a major cause of their recent high growth rates. Low flat income taxes, decreasing corporate profit taxes, and the liberalization of labor markets are proliferating from the East into the EU. Alas, they are at best semi-democratic and mostly authoritarian states, with pervasive corruption.

The Baltics cleverly chose the best of both of these worlds, adopting full-fledged market economies with limited public sectors and high economic growth. They also enjoy democracy and limited corruption. South-East Europe straddles a middle ground be-

tween the social democratic Central European model and the liberal Baltic model. It is still too early to say what eventual choice they will make.

Three CIS countries are completely non-reformed, Belarus, Turkmenistan, and Uzbekistan. They are true tyrannies, and they maintain a state-dominated, Soviet-style system. Through their very example, these three countries show that the success of market economic reform was never a given. If no attempt was undertaken, no achievement was recorded.

*The building of capitalism included four main elements:*  
*a) deregulation of prices and trade,*  
*b) subsequently necessary inflation control,*  
*c) large-scale privatization,*  
*d) expected massive social dislocation requiring a new social safety net.*

## **Radical Market Economic Reform Worked Best**

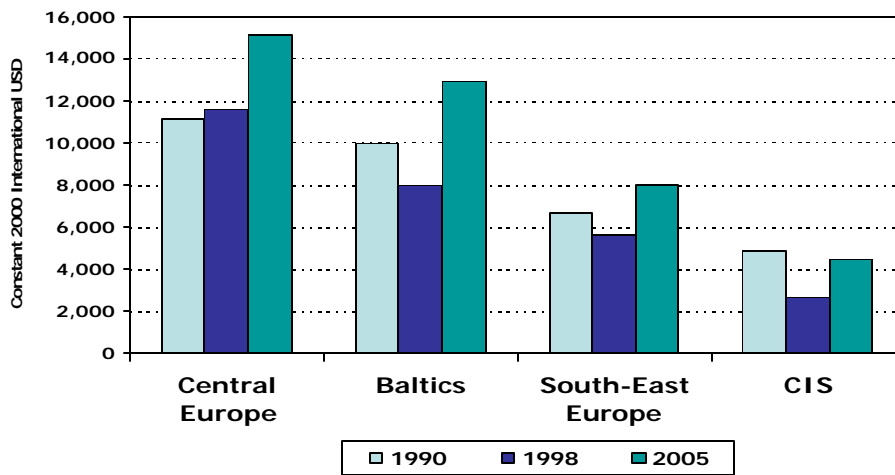
The building of capitalism was widely seen as comprising four key elements. The first and most fundamental step was to deregulate prices and trade so that a market could be formed. Second, when prices were freed, they inevitably rose because of shortages caused by excess demand, and inflation had to be brought under control by many means. Third, the nominally public enterprises lacked real masters, and the only plausible principals to be were private owners, which required large-scale privatization. Fourth, everybody understood that postcommunist transformation would involve massive social dislocation, and all acknowledged the need for a new social safety net.

Extensive multi-country regression analyses over the years have passed a surprisingly unanimous verdict. The virtuous reformers in Central Europe and the Baltics undertook all these reforms radically and early on. The leader in Central Europe was Poland and in the Baltics Estonia. They deregulated, privatized and brought inflation under control. Poland was the first country to return to growth, and soon the whole of Central

Europe was growing soundly. Since 1995, the Baltics have grown impressively. Most CIS countries launched later and more gradual reforms, which generated extraordinary corrupt revenues for old and new elites. As a result, corruption became much greater in these countries; the output decline was much greater; and they returned to economic growth much later. All reforms, including privatization, had a positive impact on early economic growth.

Postcommunist transformation has been an intense battle. On one side of the barricades stood radical reformers, who wanted to build a normal society. Their main opponents were rent seekers, not old communists. The rent seekers' goal was plain: to make as much money as possible on transitional market distortions. Their endeavors led to a great misallocation of resources and slumping output. Their hunger for state subsidies and subsidized credits boosted inflation, disorganizing the whole economy. All their successes skewed income and wealth distribution in their favor.

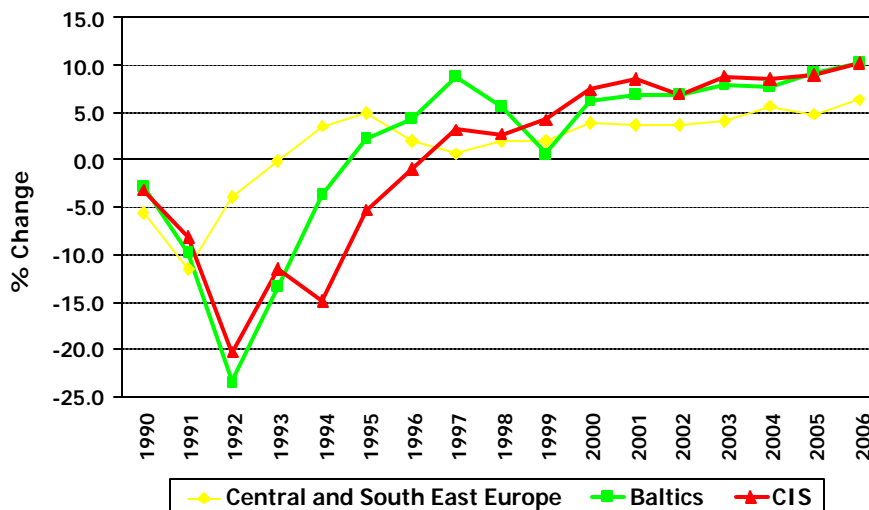
*Graph 1: GDP per Capita in PPP for 1990, 1998, and 2005*



*In spite of all hardship, most socialist economies have swiftly become ordinary market economies.*

*Graph 2: Official GDP Growth -*

*1. Collapse Bred Misery and 2. Capitalism Brought Growth*



In spite of all hardship, most socialist economies have swiftly become ordinary market economies. Of the twenty-one countries studied here,[2] all but three - Belarus, Turkmenistan, and Uzbekistan - have been successfully transformed. Transactions are monetary, reasonably free and carried out on markets. In almost all of these countries, inflation has fallen to single digits and nearly two-thirds of the national output is produced in privately-owned enterprises. The

international community knew how to build a market economy. Predominantly, it advocated a radical market economic reform with deregulation, macroeconomic stabilization, privatization, and the formation of a new social safety net. To a reasonable degree, this policy was implemented, but mostly with delays. To build a market economy was a political choice that most, but not all, governments made.

## Has Privatization Been Overdone?

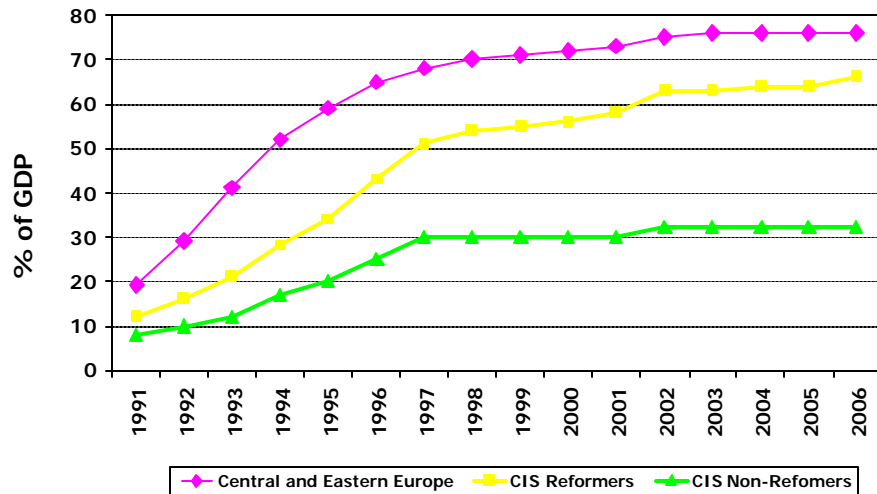
No, the predominance of private enterprise has been a precondition of both market economy and democracy. Private enterprises have generated virtually all economic growth. The price paid for an enterprise at its privatization was not very important because successful privatized firms often pay annual taxes exceeding the highest price imaginable of the original asset. As private companies generally do better than public enterprises, it is more important that enter-

prises are privatized early than how they are privatized. The later the privatization, the greater the destruction of both physical and human capital was.

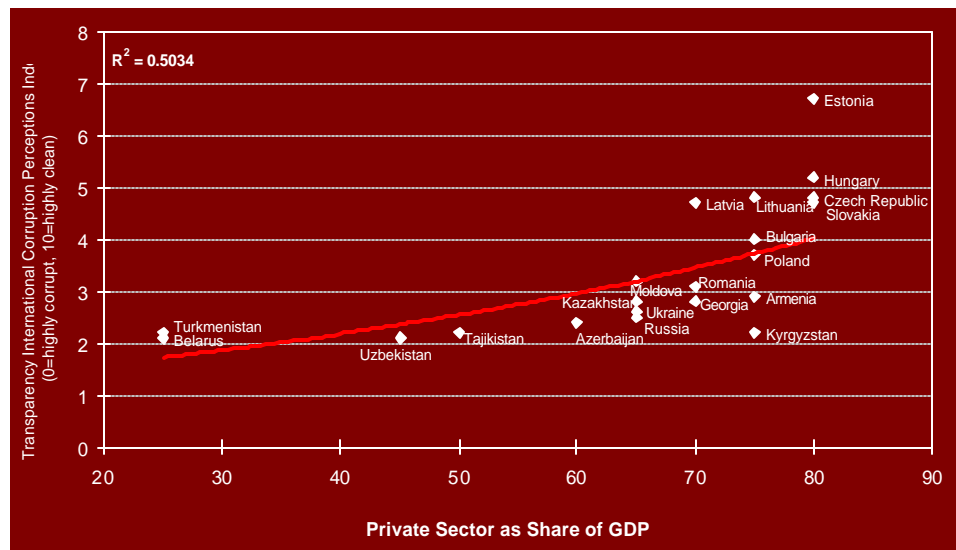
Since virtually any privatization is better than no privatization, the most important is that privatizations are politically accepted so that property rights become strong. Beside corruption, renationalization is the worst threat both to economic performance and political freedom in the

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*Graph 3: Early Privatization—Early Growth of Private Sector as % of GDP*



*Graph 4: More Privatization = Less Corruption, 2006*



CIS countries as so vividly illustrated by Putin's second term in Russia. It is vital that a privatization is perceived as legitimate, so that the resulting property rights are politically recognized. Restitution, mass privatization, and sales to insiders have been more

easily accepted than initial sales to outsiders, although the latter have been economically successful. The countries with the most far-reaching privatization are also the most democratic. The more privatization, the less corruption there is.

## Democracy Building: Intellectual Lacuna

The building of democracy and the establishment of the rule of law have been much less successful. Out of our twenty-one postcommunist only eleven are ranked as free or democratic by authoritative Freedom House. Those eleven are the new EU members plus Ukraine that has not persistently been assessed as democratic. Thus, no less than eleven out of twelve CIS countries are dictatorships.

Frequent complaints are that too much attention and resources were devoted to economic reform and too little to political and legal reforms. This may be true, but more striking is that in these spheres no viable theory predominated and the policy advice was often too vague and diverse to be helpful. National leaders had no clear idea or program to follow. As a consequence, only the EU accession countries, which adopted all the EU institutions, were successful in building democracy. The promotion of the rule of law has been even more unsatisfactory.

Mainstream economists have a clear idea of what is needed to build a market economy, while political scientists are at loss to state what is needed to build a democracy, as distinct from how to define a democracy. During the early transition, leading political scientists were more preoccupied with the need for social benefits than with the building of the institutions for democracy. They had no clear answer on whether old commu-

nist constitutions or the need for early founding elections after a democratic breakthrough was more important. Nor could they tell whether a parliamentary system or a presidential system was better. Were proportional elections to prefer or majority elections in one-man constituencies? Most preferred political stability over effective checks and balances.

The empirical conclusion today is that early founding elections were vital. Only parliamentary systems have stayed democratic. Proportional elections with a reasonable hurdle of 3-5 percent of the votes cast have best supported the building of a normal party system. The most short-lived governments have been recorded in the Baltic states, which have also been the most successful. The political scientists did not have any relevant normative advice to offer. Nor did they try to do so. As a consequence of the absence of clear ideas, few concrete actions of democracy building were undertaken, and only the adoption of *acquis communautaire* has secured democratic breakthroughs. This intellectual lacuna needs to be urgently amended.

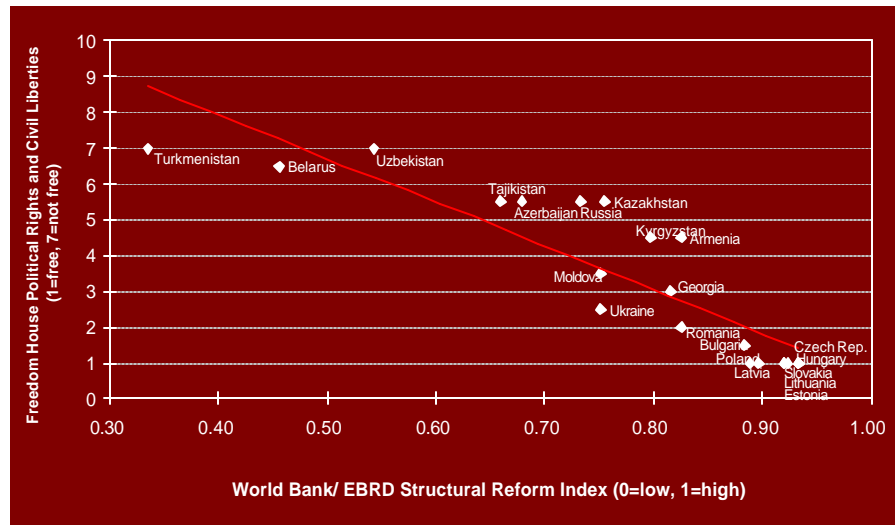
Democracy has had a positive impact on economic reforms and growth because democracy served to control the abuses of rent seekers who wanted to make money on state subsidies rather than on productive activities. The positive correlation between

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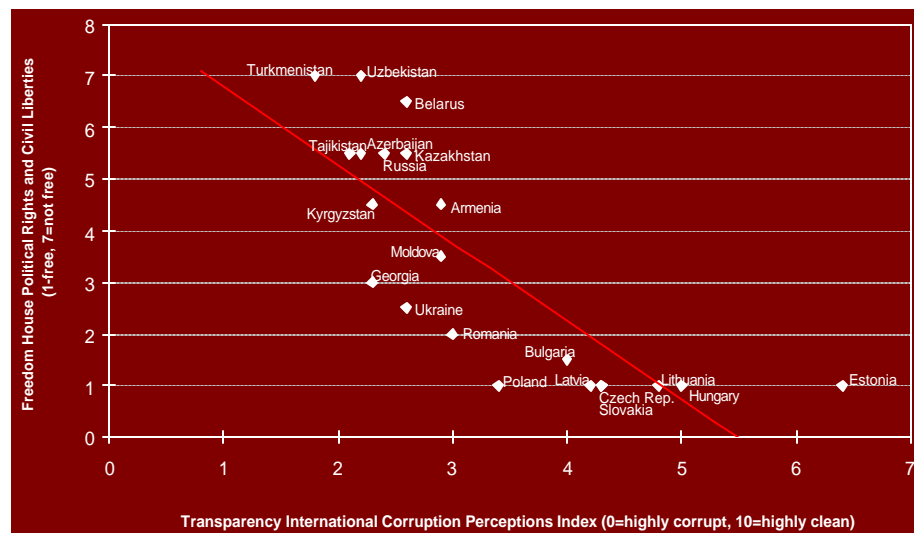
democracy and market reform is very strong, and more democracy also leads to less corruption.

*Graph 5: Democracy and Market Reform go together, 2005*

*The positive correlation between democracy and market reform is very strong, and more democracy also leads to less corruption.*



*Graph 6: More Democracy = Less Corruption, 2005*



### Has Western Aid Been Excessive?

No, Western assistance to the postcommunist countries has been small by any standard. The total grant assistance to the region was a couple of billion dollars a year, which is tiny. By contrast, the US peace dividend, that is, the reduction in US military expenditures that became possible be-

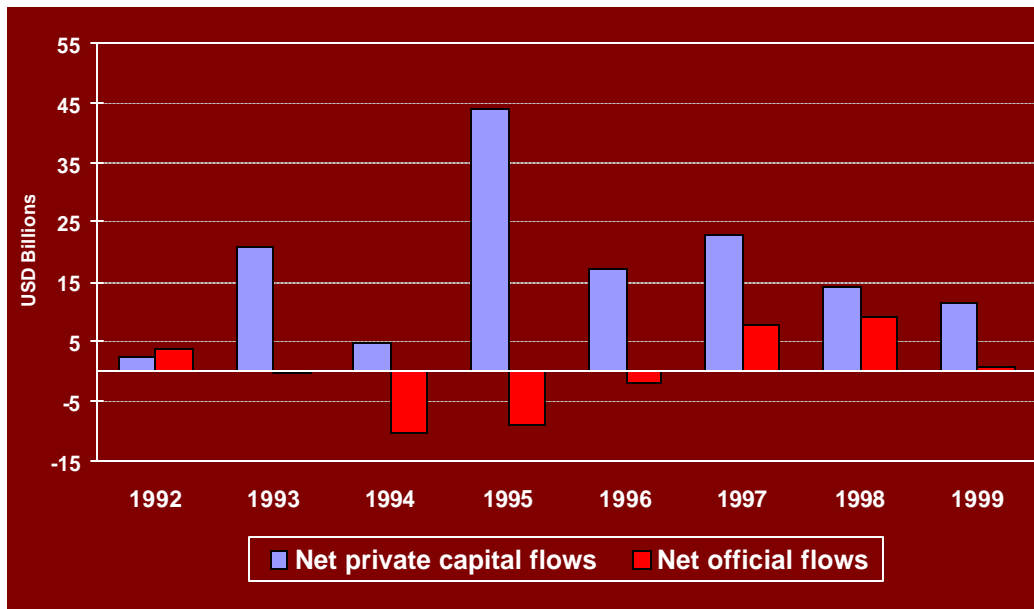
cause of the end of the Cold War amounted to a stunning \$1.4 trillion in the 1990s, or as much as 3 percent of the US GDP in 1999.

Amazingly, according to IMF statistics, Western governments received more in debt service on old communist loans than

they gave in both loans and grants to the postcommunist countries from 1993 to 1996. The Western negligence to make a

serious effort at assistance in the early transition is disturbing.

*Graph 7: Countries in Transition: Net Capital Flows, 1992-1999*



*East Germany stands out as a complete exception [...] [West Germany's] huge financial inflow has greatly exceeded that region's absorption capacity. East Germany has been priced out of the market by this giant financial flow that has formed an insurmountable social welfare trap.*

East Germany stands out as a complete exception. It has suffered from the opposite problem. Since 1990, West Germany has poured over \$80 billion a year into its new Laender – initially about half its GDP and twice the global assistance to developing countries. This huge financial inflow has

greatly exceeded that region's absorption capacity. East Germany has been priced out of the market by this giant financial flow that has formed an insurmountable social welfare trap. Strangely, this harmful wastage of public resources is continuing unabated.

## Is the European Union the Best Solution?

Probably. The European Union has made impressive contributions to the transformation of the EU accession countries. It provided the standard of a normal society. Both through its demands and its transfer of institutions, it helped to reinforce democracy in the accession countries. From an early stage, the EU opened its vast market to them. In the accession process, the EU compelled the new members to adopt

80,000 pages of legal texts in the *acquis communautaire*. The great advantage was that the new members were forced to adopt a standard Western market economic and legal system.

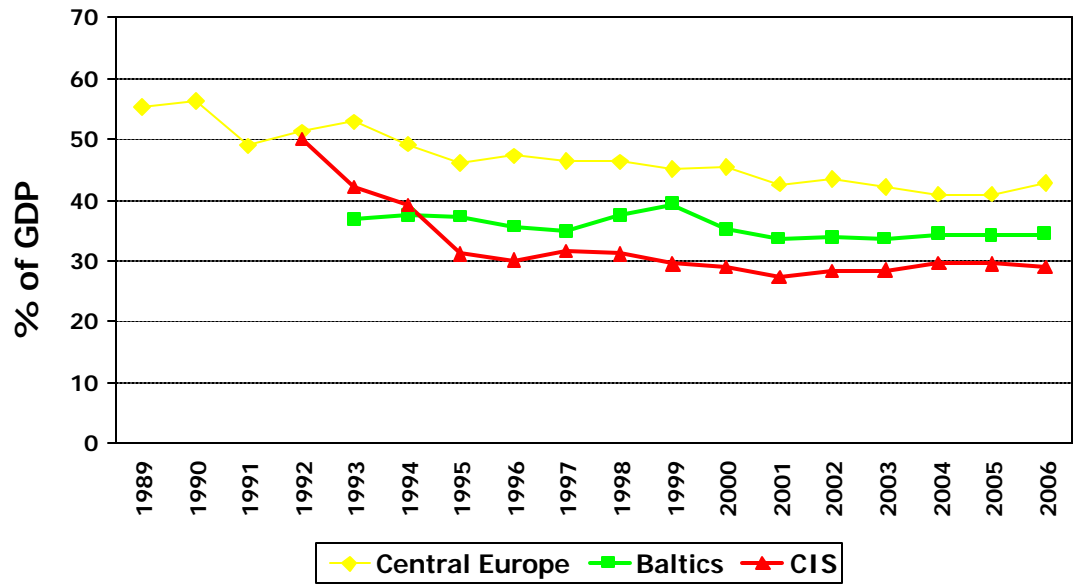
The drawback was that the new member states were induced to accept a West European social welfare model with high taxes, large social transfers, and various forms of over-regulation, notably of labor markets

and agriculture. That model is not conducive to high economic growth, which is one of these countries' greatest needs. In particular, the Central European countries have suffered from too high public expenditures, overregulated labor markets, and excessive

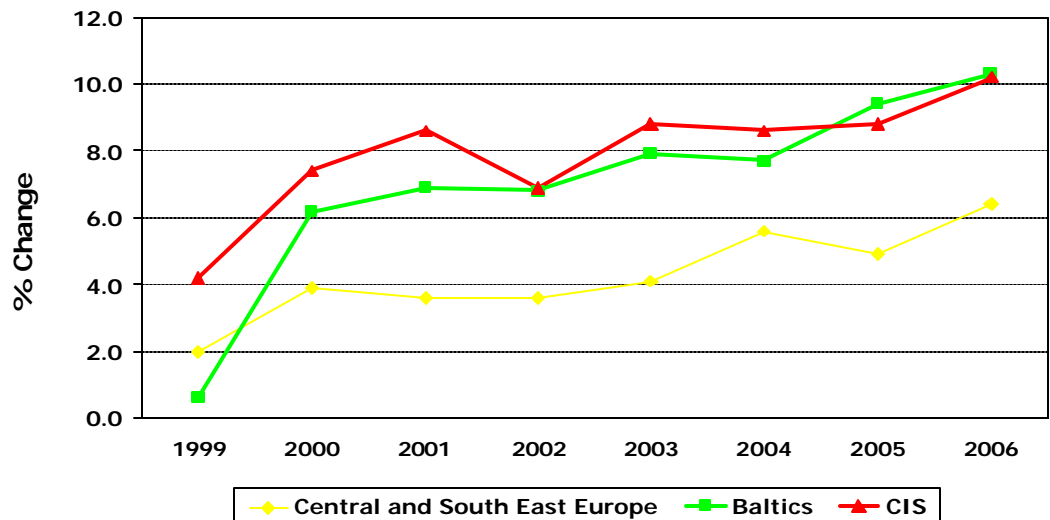
budget deficits in recent years, which have reduced their economic growth. This is an important explanation why economic growth has been much higher in the former Soviet Union than in Central Europe since 2000.

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*Graph 8: Public Expenditures: Too High But Lowest in CIS*



*Graph 9: Official GDP Growth, 1999-2006*





## Have the Postcommunist Countries Achieved Sustainable Economic Growth?

Probably. The Russian financial crash turned out to be the catharsis Russia needed to accomplish a full-fledged market economy with a critical mass of markets, macroeconomic stability and private enterprises. Its impact was felt throughout the post-Soviet region. Growth returned with a vengeance. It has been driven by sound macroeconomic policies, structural reforms, sharp cuts in public expenditures, low exchange rates, and a commodity boom. Since 2000, the huge former Soviet region from the Baltics to Kazakhstan has recorded an average growth of over 8 percent a year. The former Soviet Union has joined the growth belt that started in East Asia a few decades ago and has proliferated through China and India. Common features of all these economies are sound macroeconomic policies, low taxes, small social transfers and relatively liberal labor markets. In 2003, Goldman Sachs stunned the world with a paper about the BRICs (Brazil, Russia, India, and China), predicting that in 2028 Russia would overtake Germany and become the fifth biggest economy in the world after the U.S., China, Japan, and India.

If sustained high oil prices are added, Russia could become the fifth biggest economy in the world before 2020. Most of the former Soviet Union is growing even faster than Russia. Will this growth survive the current commodity boom? It probably will in the star performers – the Baltics, Armenia, Azerbaijan, and Kazakhstan, as they have undertaken considerable reforms. The main question mark is Russia, which has seriously aggravated its structural policies and re-

verted to re-nationalization.

Alas, approaching the European Union this dynamism fades away. Central Europe (Poland, the Czech Republic, Slovakia, and Hungary) got stuck with a growth rate of only 4 percent a year from 2000 to 2005. Admittedly, that is more than twice the EU rate, but these still poor countries need much faster growth, and at this rate they will not converge with the rest of the EU. In the last two years, however, growth rates also in Central Europe have risen to 6 percent a year, while the average growth rate in the former Soviet Union has reached 10 percent. It is naturally still early to say, but it appears as if enhanced economic integration of trade, capital and labor, tax competition, and regulatory competition all contribute to the enhanced growth rate, although the cyclical effect of a big economic boom in the whole world must not be ignored. The new member states have undoubtedly contributed to the economic revival of Europe, but they have benefited all the more themselves. Thanks to the Eastern enlargement of the European Union, the Union looks much more vibrant.

Latin America is a natural yardstick for achievements in the postcommunist region. Both before and after the collapse of communism, their economic level was similar. The postcommunist countries have caught up with Latin America by establishing a market economy and privatization. Latin America has been more successful in democratization, while the postcommunist region has achieved much higher growth rates, since its structural economic reforms

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are proceeding, while they have stalled in Latin America. The postcommunist countries are also much more ambitious in education than Latin America. At present, the

economic future of Eurasia looks bright, but the combination of authoritarian rule and the energy curse might take major countries in this region astray.

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## Footnotes

[1] This essay draws on my new book, *How Capitalism Was Built: The Transformation of Central And Eastern Europe, Russia, and Central Asia* (Cambridge University Press, 2007).

[2] They once formed the Soviet bloc in East-Central Europe and the Soviet Union. I call Poland, the Czech Republic, Slovakia, and Hungary “Central Europe,” and Bulgaria

and Romania “South-East Europe.” Estonia, Latvia, and Lithuania are the Baltic states. The rest of the region consists of the twelve countries belonging to the Commonwealth of Independent States (CIS), Russia, Belarus, Ukraine, Moldova, Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan.

