Markets, States, and Democracy

The Political Economy of Post-Communist Transformation

edited by
Beverly Crawford

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Foreword

DIETER DETTKE

This publication is a critical evaluation of the post-communist economic transformation process in Eastern Europe and of Western aid programs. By focusing on (but not limiting ourselves to) the political economy in Eastern Europe, major difficulties and deficiencies both of reform programs in individual Eastern European countries and of Western aid became apparent.

The changes that were necessary after the revolution of 1989–1990 amounted de facto to the erection of an entirely new economy and at the same time the creation of new democratic institutions, all juxtaposed against the virtual absence of a tradition of functioning institutions of civil society. Therefore, the term "transformation" is almost a euphemism in view of the magnitude of the task that the new post-communist governments had to shoulder.

The term "revolution," too, needs qualification and interpretation, because the events of 1989–1990 were less the result of an overthrow of communist regimes than of a massive implosion of a system that failed miserably to meet the social, political, and economic expectations that it had created. Although there is no lack of victory theories to assert that capitalism—as a result of the triumph of the West in the competition of the two systems—defeated communism, the true story of the demise of communism looks more like a process of self-shackling and finally self-destruction, perhaps best described by Sir Karl Popper:

> The road to serfdom leads to the disappearance of free and rational discussion; or, if you prefer, of the free market of ideas. But this has the most devastating effect on everybody, the so-called leaders included. It leads to a society in which empty verbiage rules the day; verbiage consisting very largely of lies issued by the leaders mainly for no purpose other than self-confirmation and self-glorification. But this marks the end of their ability to think. They themselves become the slaves of their lies, like everybody else. It is also the end of their ability to rule. They disappear, even as despots. (Sir Karl Popper, "Address Before the American Economic Association," New Orleans, January 4, 1992)

Acknowledgments

BEVERLY CRAWFORD

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PART ONE

Overview and Historical Legacies

1

Post-Communist Political Economy: A Framework for the Analysis of Reform

BEVERLY CRAWFORD

After the revolutions of 1989 in Eastern Europe and the last gasp of the Communist party's power in Russia, most post-communist regimes embarked on a course of self-proclaimed economic and democratic shock therapy to transform their societies, economies, and political systems. These new regimes' immediate external and internal mandate was the simultaneous introduction of markets and democracy and the dismantling of the discredited socialist state. Under what conditions will they succeed, and why will some fail?

The task faced by the new leaders was unprecedented. Liberalizing reforms were launched in the absence of strong civil societies, a prosperous middle class, and widespread liberal values. New regimes struggled to revive economies that plummeted faster, farther, and longer than anyone anticipated, and these economies entered the international economy with uncompetitive exports in a period of fierce global market competition in which no external power or group of powers appeared to be willing and able to underwrite the costs of liberalization. In other regions of the world and in previous historical periods, new democracies had failed to put down roots under conditions of economic crisis, and successful market reform in the post-war period has most often taken place under authoritarian regimes that sometimes engage in brutal repression to stabilize and develop their economies. The only successful recent *simultaneous* introduction of markets and democracy has occurred when these institutions were "installed" by an external hegemonic power, as in the case of post–World War II Germany and Japan (and experts disagree as to just how "liberal" these countries are).

The current intellectual debate on the "sequencing" of economic and political liberalization suggests that the simultaneous effort to introduce markets and democracy will fail in the post-communist world. Democratic rule has historically not been a necessary condition for establishing a functioning market economy (Comisso, 1991). For "late developers," the chances for economic growth are best under a strong "developmental" state that is insulated from social pressures and is a recipient of generous external support. The conventional wisdom gleaned from the experience of the East Asian Newly Industrializing Countries (NICs), Chile, and China is to hold back democracy until market reforms are consolidated. Simultaneous economic and political liberalization triggers too many demands on resources precisely during the period in which development has been delayed and a rapid accumulation of capital is required. Weak democracies will impede the project of economic liberalization, because society will not accept the painful effects of price reform, a reduction in welfare benefits, and the inevitable massive social dislocation. Liberal democracies find consolidated political support only after successful market reforms have spawned a middle class, a civic culture, and pluralistic societies (Rustow, 1970; Huntington, 1984; and Johnson, 1988).

Theories of collective action suggest that market reforms must precede democratic consolidation if liberalization is to succeed. Assuming that the benefits of economic liberalization are diffuse, aggregate, and long term and that the costs are concentrated, particular, and short term, economic liberalization will create more opponents than supporters. Consider, for example, the privatization process in Poland (Lenway, Mann, and Utter, 1993). The benefits of privatization (in the form of vouchers) were widely distributed throughout the population, but the costs (downsizing and unemployment) fell on the highly organized labor sector. As plants in declining industrial sectors were shut down, those whose livelihoods and political power were threatened agitated against privatization.

Collective action approaches suggest that most organized social groups and the mass electorate are rent-seeking actors who work to inhibit the efficient market allocation of economic resources through the political process. Under democratic regimes, these groups have access to government, and they lobby, bribe, strike, and vote to persuade governments to allocate resources to them. Politicians need resources to distribute in exchange for their support or they will be punished by being ousted in the next election. They have a higher incentive to distribute particular benefits to important supporters *now* than to implement general policies that are likely to lead to overall economic growth in the future (Buchanan and Tollison, 1972; Olson, 1982). Politicians prefer to reward concentrated, well-organized pressure groups such as producers over diffuse and less-organized groups such as consumers (Schattschneider, 1963). Politicians also prefer to reward party activists who mobilize social support for them over external constituencies for whom the rewards may be delayed and whose support is not ensured (Geddes, 1991). Rewards to party activists are especially important in post-communist societies where the social base of political parties is particularly thin, shifting, or altogether nonexistent. Under these conditions, politicians are tempted to hold back markets and perpetuate state intervention in the economy to tap those resources and exchange them for support. It follows that only those regimes that are insulated from these pressures will have the courage to cut state expenditures, sell public enterprises, reduce public employment, and create market allocation of resources to ensure economic growth.

These claims notwithstanding, new democracies, or "polyarchies," can initiate and implement policies of economic liberalization under three conditions: first, if the net benefits of liberalizing reform are not altogether diffuse but accrue to powerful groups that have formed dominant coalitions in the political system to provide support to liberalizing politicians; second, if these politicians are insulated from punishment by those who bear the costs of reform—that is, if the costs fall on groups that are unable to translate their opposition to reform into demands that are represented in the political process; and third, if politicians are able to make side payments to losers, via economywide tax and transfer policies or via discrete channels and linkages between state agencies and various social and economic sectors. Side payments are intended to mitigate some costs *now* in exchange for support and to impose other costs later.

Clearly, the second of these conditions—the insulation of reformers from punishment by those who bear the costs—means the undermining or delay of *liberal* democracy but may be initially possible in post-communist societies where—as discussed by the contributions by Hall (Chapter 4) and Ost (Chapter 8) in this volume—social groups are not well organized politically. The third condition—side payments to losers—can take place in more open political systems but may be difficult under conditions of economic crisis and may discourage or even destroy economic incentives necessary for reform. Certainly there are tradeoffs in economic and political liberalization, but it is not at all certain that markets and democracy cannot be introduced simultaneously. If the above logic holds, simultaneous economic and political liberalization is possible in post-communist regimes. To explore the connection and predict the odds of success, we must first identify the conditions that either support or undermine liberalizers in the political process. That is, we must examine how the costs and benefits of economic liberalization are distributed throughout society. Further, we must identify the particular kinds of institutions that structure political participation in ways that permit either liberalizers or their opponents to achieve dominant or at least influential positions in the policy process. In this volume, we focus primarily on the first set of tasks. In this Introduction, I construct a framework to analyze forces that facilitate support for liberalization and forces that create opposition to such reform. Subsequent chapters explore these forces in specific issue areas.

I begin here with a general discussion of the liberal ideal—its adherents and detractors. I then examine the conditions that bolster and undermine liberalizers at four levels: (1) social legacies, (2) state structures, (3) international aid and trade, and (4) economic policy choice. After establishing this framework, I suggest four hypotheses about how these forces might interact, the political coalitions that each of these hypotheses support, and the potential expected outcomes. These outcomes are expressed in the form of four scenarios: (1) the liberal utopia, (2) the region as a new global "periphery," open to the international economy, where weak democracies persist because their political institutions are required as a condition for international aid and because they provide benefits to rent-seeking domestic groups, (3) the successful state-led transition to economic development and political liberalization, and (4) the failure of liberalization and a return to despotism.

A Framework for Analysis of Post-Communist Transformation

The Liberal Ideal

Economic and political liberalization have at their root the drive for individual freedom. Liberals seek to build institutions that foster and protect the individual's right to enter into contracts, own property, buy and sell, speak and practice religion freely, choose government officials, and be protected in those rights from the state and from others in society who would thwart them (Holmes, 1991). Two institutions are crucial in this quest for freedom: markets and liberal democracy. Economic liberalization means the creation of labor markets, capital markets, and financial markets and the removal of barriers to the creation of those markets in order to efficiently allocate scarce resources in the hope of achieving economic growth. For economic liberals, the creation of markets does not ensure growth, and it does mean that inequalities in income and wealth are likely to characterize social relations. Inequality, however, is tolerated in private economic relations because the growth that should ensue from the efficient allocation of resources will make everyone better off than they would have been in the absence of markets, and economic inequality is offset by equality of citizenship and representation in the political process.

Liberalizing politics in new democracies involves the creation of institutions that ensure representative government and universal citizenship. Under Leninist regimes, political power was vested in a small group of people rather than in a set of impersonal rules. Political liberalization demands that new rules of political contestation be formulated and implemented to remove the *certainty* of power for any one political elite and to permit new contenders for political power to enter the competition. In Chapter 3 in this volume, Stephen Holmes shows how this transformation occurred throughout Eastern Europe and much of the Soviet Union through the process of constitutional reform. He shows how the clause in every Soviet-era constitution stipulating the leading role of the Communist party was deleted and how constitutional amendments represented a legal and "wholly non-Bolshevik" method for "reacting to and promoting social change."

New political institutions would have to be strong enough to resist the intervention of one or another political actor who might wish to reverse the outcomes of the political process (Przeworski, 1991). Old institutions vested power in a single party that prohibited opposition; new institutions would have to be created that encourage a "loyal opposition" and block any incentives on the part of losers to reverse the outcome by force (Hall, 1987). Old institutions concentrated political power; new institutions would have to diffuse it, and they would have to replace regime-coerced political activity with measures that structured the preferences of voters to enhance political participation rather than subvert political institutions. Finally, as Haggard and Kaufman (1992) have noted, party systems would have to be created with the strength to effectively channel the inevitable social struggles over distribution of scarce resources. To ensure the creation of *liberal* democracies, politicians would have to construct and enforce a complex web of legal relationships that affirm equality before the law, protect individual rights and freedoms, guarantee political accountability, and ensure free, fair, and competitive elections.

According to the liberal ideal, these institutions create loyalty to the democratic model and provide a noncoercive form of social mobilization for the state while restricting its control over the population. The success of liberal democracy depends on universal citizenship. If universal citizenship is not ensured, loyalty to the state is undermined and illiberal democracies emerge. Illiberal democracies exhibit many attributes of polyarchy, like fair voting, freedom of speech, freedom of movement, freedom of association, and freedom of religion; however, illiberal democracies are unable or unwilling to protect their citizens from powerful social groups who would thwart those freedoms (Dahl, 1990; O'Donnell, 1992).

Holmes's chapter here outlines the potential contradictions between liberalism and democracy as they are expressed in the amending formulas for liberal constitutions. He argues that a stringent amending formula suggests a bias for liberalism against democracy—that is, the constitution's provisions protecting liberal rights cannot easily be amended at the whim of parliament. On the one hand, if stringent amending formulas are adopted, parliaments faced with large social problems can simply deflect disapproval to the courts and escape democratic accountability. A looser amending formula, on the other hand, suggests the dominance of democratic procedure over the protection of rights. Constitutional amendments can be used as simply another technique for outmaneuvering one's current political enemies.

The Role of the State

The most important theoretical debate in literature on economic and political liberalization concerns the role of the state. There is little debate about the requirement for state strength: Liberals believe that strong states are needed to implement liberalizing reforms and to protect new institutions and individual rights from those who might wish to destroy them (Holmes, 1991; Poznanski, 1992). Liberals therefore caution against confusing state strength with authoritarian rule. The strength of the liberal state comes from its *legitimacy*—that reflects a diffusion of political power within civil society. The strength of the liberalizing state rests not on the concentration of its military or police power but on its constitutional authority and its ability to enforce the law. To protect liberal reforms, the state itself must be a liberal institution, governed by the rule of law. Only those states that have institutionalized a merit-based civil service, a system of "horizontal accountability" through a separation of powers, multilevel governments, and legal impartiality in the policy process can protect and foster liberal rights and principles in the broader society.

Liberals disagree, however, over the *role* that the state should play in both the economy and society. Should the state be a producer? A regulator? To what extent should it provide "safety nets"? For whom? Should it protect citizens from one another or simply restrain its own activity to protect citizens from the emergence of a new totalitarian regime? One group of liberals argues for a "minimal" state: The state must create a legal framework to ensure private property ownership, and it must be strong enough to enforce private contracts and adjudicate disputes. In its most extreme form, economic liberalism argues that markets are a form of "natural" spontaneous social order, requiring few (if any) regulating institutions. Others suggest that states are necessary to provide collective goods not supplied by the market. But even then, the state is clumsy and is less likely to provide collective goods than markets would be (Stigler, 1975). The central assumption of those who argue for a minimal state is that markets, not states, create the conditions for investment and capital accumulation, which, in turn, are the essential conditions for economic growth.

Others argue that the state must foster and protect investment, particularly in the case of "late developers." Alexander Gerschenkron (1962) was the first to make this argument, and it is supported by more recent research on the politics of development and by the previous discussion on rent-seeking behavior of social actors (Fishlow, 1990; Haggard and Kaufman, 1992). Autonomous and reform-oriented states are needed, the argument claims, to stimulate investment, to make markets work, and to support new market institutions. States can intervene by encouraging and promoting selected activities through the provision of low-cost credit to targeted industries, export and interest-rate subsidies, as well as technical assistance to those industries. They are also needed to create the infrastructure to support markets and may be needed to provide technical information not furnished by simple prices. For example, the privatization of public enterprises without infrastructure and information can undermine the market capabilities of new entrepreneurs, leading to the failure of newly privatized industries and thus the failure of the privatization project itself.

According to Alec Nove's argument in Chapter 10 in this volume, the state must play an "entrepreneurial role" if reforms are to be initiated and implemented. Economic crisis provides the credibility in new democracies for the state to play this role; sustained crisis, however, erodes government credibility and undermines political support. Therefore, to successfully push through liberalization policies, reformers in the state apparatus need to be insulated from social pressures by being granted discretion to operate either outside traditional bureaucratic channels (Waterbury, 1992) or by acting within internally cohesive and insulated bureaucracies (Evans, 1992). One way to insulate a reform-minded bureaucracy is to ensure the creation of a liberal state at the outset—that is, rule-based hiring and promotion within the bureaucracy itself—so that political actors are not able to use public employment as a political resource to be exchanged for support.

At the very least, many liberals argue, states play a role in the provision of "safety nets" for those who are dislocated in the transformation process. In centrally planned economies, the state provided health care, employment, and housing. Many liberalizers argue that these benefits must continue in some form as "side payments," particularly if the potential losers in the liberalization process can mobilize political support to oppose further reform. If the losers are diffuse and lack political organization, these safety nets are unlikely to be provided. Women and—as David Ost argues in Chapter 8 in this volume—labor in some sectors in post-communist societies are as yet diffuse and weakly organized. Those losers who are concentrated and politically mobilized—such as some industrialists and labor groups producing for the domestic market—are likely to pressure politicians for safety nets for themselves.

Conditions That Support and Undermine Liberalizers

There are three important conditions created by the fall of communism that support liberalizers in constructing liberal capitalist democracies. First, economic crisis had fully discredited the old regime and its supporters (Hall, 1987; Chirot, 1990; and Janos, 1991) and had destroyed the last ideological universalistic and cosmopolitan alternative to liberal capitalist democracy (Fukuyama, 1989; Jowitt, 1992). Having exhausted their capacity to produce economic growth, command economies were now seen as a fetter on the forces of production; new democratic regimes looked to market prescriptions to remedy their perennial problems of economic "backwardness" in relation to the West.

Paolo Guerrieri and Ivan Berend (in Chapters 5 and 6 of this volume, respectively) trace the legacy of this economic crisis, and their findings support the argument that the collapse of communism can in part be attributed to the fact that isolation from the international technological change "froze" socialist economies in a previous industrial era, triggering a decline in both living standards and in international competitiveness. Global technological change means that national competitiveness no longer rests on heavy industries that depend on relatively simple technology and a large unskilled labor force. Instead, prosperity depends on knowledge-based production, which relies on a cadre of highly trained engineers and a smaller, technologically sophisticated production workforce in all sectors of the economy.

Second, without ideological rivals, a "consensus" among foreign and domestic elites on simultaneous economic and political liberalization in the former communist states emerged, providing ideological legitimacy that could be used as a resource to muster support for reforms. As Berend argues in Chapter 6, elites throughout the region expressed a desire to again be part of "Europe" and knew they could only do so by rushing to adopt both democracy and markets. In Central Europe, particularly, the Left and the Right converged on the need for simultaneous economic and political liberalization. Ideological consensus on liberalization provided an attractive rhetoric for new political parties, especially in areas where the working class—a potential opponent of liberalization—was allergic to class-based political appeals providing alternatives to neoclassical reforms.

Finally, the relatively peaceful character of these revolutions, the communist legacy of civilian control over the military, and the failure of the halfhearted Soviet coup set a precedent against a resort to violence for regime transformation. The military was initially subordinated to civilian control and had little stake in opposing the economic reform policies of new democratic regimes.

These three conditions created initial widespread support for reform, and the benefits of having thrown off the old regime were perceived throughout the mass electorate to be greater than the potential costs of liberalization. Bolstered by these forces and sensitive to both international constraints and domestic public opinion, political elites perceived the need to demonstrate both success in their country's overall economic performance and their distance from Leninism by bringing in a merit-based civil service and institutionalizing procedures for transparency and accountability in government.

Indeed, the degree of initial support for reform contrasted sharply with the situation in many Latin American countries where the Right prefers radical market reform and the maintenance of authoritarian regimes—or the "gradual" introduction of democracy—whereas the Left and the more populist forces prefer the extension of democratic reforms while holding back market forces that could cause initial widespread deprivation in much of the population. In contrast, for most post-communist regimes, the question is not *whether* markets and democracy can be simultaneously introduced; democratic rhetoric—whether liberal or not—remains unchallenged, even if it has yet to be fully realized in practice. Rather, the debates revolve around the sequencing of *economic* reforms.[1] Liberalizers are divided between those who advocate radical and those who advocate gradual economic reform.

Two factors, however, worked in favor of the political opponents of liberalization. First, liberalizers have few resources to distribute in exchange for political support. The features of *liberal* democracy—rule-based behavior, transparency,