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Institutions and Performance in Transition Economies

Hans Aage

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Economics and Democracy

Economics is concerned with institutions for coordination of decisions for resource allocation. Given individual preferences, technological possibilities and initial resources, the basic theoretical problem in economics is to analyse how the problem of optimal allocation is solved or not solved, when decisions are governed by incentives inherent in various types of institutions, i.e. patterns of behaviour regulated by formal and informal rules. By far the most extensively investigated economic institution is the market, but there are many others including enterprises, planned economies, corporations, labour unions, labour-managed firms, the family, the feudal economy, slavery.

As in economic theory, the point of departure for democracy is individual preferences – and conflicts between them. Generally speaking democracy means that the individual is able to influence his own life as well as social life and that institutions exist through which conflicts of interest can be confronted and mediated on terms of equality. This simple definition requires a few remarks. First, it does not imply admiration for narrow selfishness, let alone repudiation of morality or altruism, but it disregards a social interest above the individual as found in traditional societies. Second, any suppression of individual freedom of action requires justification, which is, however, often obvious as most actions influence the freedom of action for fellow members of society. Thus minority rights are essential for democracy as opposed to mob rule. Third, there is a close affinity between democracy and equality, the degree of which is a distinguishing feature of various democratic institutions.

One very potent mechanism of democracy is the market where preferences are expressed in terms of money. The demonstration of the optimality of individual market decisions under certain conditions is a major achievement of economics. As in principle nothing but quantity and price is bargained this leaves much freedom for the individual, also for the worker who sells his working power and therefore is:

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> "... frei in dem Doppelsinn, dass er als freie Person über seine Arbeitskraft als seine Ware verfügt, dass er andrerseits andre Waren nicht zu verkaufen hat, los und ledig, frei ist von allen zur Verwirklichung seiner Arbeitskraft nötigen Sachen." (Karl Marx, 1972:183)

Concerning equality of influence another democratic institution takes the lead, namely voting in the political process. Whenever the very strict conditions for market optimality are not met, the market will need the help of a visible, collective government hand.

Other mechanisms than rule by money and rule by people could be considered as well. A third type is self-management, which distributes power according to active participation, energy and talent. It is essential in libertarian socialism and anarchism, in Jugoslav social theory and in various contemporary proposals for economic democracy (Meyer et.al., 1981).

Finally, it is remarkable that democratic institutions sometimes renounce their power, not only concerning purely technical matters, but also in relation to decisions that involve political preferences. Instead power is entrusted to independent bodies which enjoy confidence and are subject to strict regulations. This professionalisation typically happens when short-sighted political decision makers are tempted to abuse their power and neglect long run harmful effects or when decisions are so painful that compromise is excluded. Examples are independent courts of justice and the power of the medical profession to decide the allocation of scarce resources. In the economic sphere the paramount example is the independence of monetary authorities.

The characteristics of these four democratic institutions can be summarized as follows:

market
: individual influence according to economic capacity;

government
: collective influence mediated by politicians through the political process and voting;

self-management
: influence depending upon active participation;

professionalisation
: legitimacy depends entirely upon confidence in the judgment and honesty of the body entrusted with decision making power.

The following sections review the economic development during six years of transition and examine the emerging statistical studies of institutional reform and its impact upon economic performance. The roles of various democratic institutions are evaluated, in particular the role of government, and finally the prospects for long-term economic growth and democracy are discussed.

Transition trends

Concurrently with far-reaching institutional changes and progress towards marketisation (cf. table 1) the countries in Central and Eastern Europe and the former Soviet republics have experienced a historically exceptional, deep depression. Output declined by 17-60% during the years after 1990. Poland hit the bottom in 1991 and other Central and Eastern European countries in 1993–1994, but in 1995 none of them had regained the level of 1989, which, however happened in Poland in 1996 (cf. table 2). In several former Soviet republics GDPs continue the decline and have in some cases dropped considerably below 50% of the 1989-levels. In 1995 GDP in Russia amounted to 55% of the 1989-level, in the Ukraine 40%. There are still heavy macro-economic imbalances (cf. table 3), but also in this respect large differences between countries prevail, and generally the situation is much more comfortable in Central and Eastern Europe than in the former Soviet republics.

The number of people living below the poverty line of 120 1990-dollars a month has increased from 8 million (3% of the population of 320 million in Central and Eastern Europe) in 1987–1988 to 58 million (18%) in 1992-93 (Milanovic, 1994; UNICEF, 1994). The reason is first and foremost the depression of production rather than the simultaneous escalation of inequality, especially in the former Soviet republics where a wealthy new elite has emerged swiftly (Rimashevskaja, 1996; Eatwell et.al., 1995:72). The reported Russian Gini-coefficient has increased from .26 in 1991 to .41 in 1994, a very conspicuous change, as the two values approximately correspond to the values in the most equal and most unequal western countries, respectively (Kosmarskij and Maleva, 1995:14; Hedlund and Sundström, 1996:164). Poverty is not extreme because of a functioning social security net, and in the former Soviet republics the private plots, which were also important in the Soviet era, contribute increasingly to the survival of the population. But mortality has increased in many countries, most in Russia by no less than 35% from 1989 to 1993 which has caused a "surplus mortality" during the years 1990–1993 of at least 600.000 people who would not have died if the age specific mortality rates of 1989 had been preserved (UNICEF, 1994:35, 43; Eatwell et.al., 1995:59, 80; Ellman, 1994).

The production structure has changed, as the production decline is most pronounced in industry. This was partly intentional, because large parts of industry had a negative value added at international prices. Presumably, this applied to 20-24% of industrial production in Poland, Hungary and Czechoslovakia in 1989 and even more in Russia (Aage, 1994a:210). It has proved difficult for industry to recover, while service production, which was very low under communist rule, has increased. Industrial investments are very low in many of the countries, partly because of depression and uncertain political environments, partly because of scarcity of investment finance due to capital flight to western countries and opportunities for fast profits through trade and financial tranactions. In the former Soviet republics the decline has been particularly deep for investment in machinery and equipment, and investment in technological development has virtually disappeared in many countries (ECE, 1996:77-81).

But in the Czech Republic, in Hungary and especially in Poland industrial production and investment is growing. In Russia, however, the decline continues, and particularly the technologically advanced industry suffers because of lack of competitiveness. For example, the Russian aviation industry can not even count on Aeroflot to buy its aircraft.[2] Also the Russian consumer and food industries have been hit, as production in the first half of 1996 had dropped to 18% and 50%, respectively of the production in the first half of 1990 so that more than 50% of consumption is imported (Sato, 1996:2). It is reported that 70% of

2. Eatwell et.al. (1995:117-119); The Economist (5 October 1996, p 83).

Table 1
Production and institutional reform in the transition economies 1989–1995

	GDP per capita 1989 USA=100		Institutional reform EBRD	EIU		IBRD	Private GDP-share 1995 percent	change 1989-95 pct-points
Slovenia	48	4.0	2.9	3.4	4	3.3	45	37
Czech Republic	44	3.6	3.3	3.3	4	3.1	70	59
Estonia	37	3.0	2.9	3.0	3	2.6	65	55
Latvia	35	2.8	2.4	2.6	3	2.3	60	50
Hungary	34	2.8	3.3	3.3	4	3.3	60	45
Lithuania	32	2.6	2.5	2.5	3	2.5	55	45
Russia	31	2.5	2.3	2.3	2	1.9	55	50
Croatia(*)	30	2.4	2.5	2.3	4	3.2	45	30
Poland	29	2.3	3.1	3.3	4	3.3	60	45
Slovak Republic	28	2.2	3.0	2.7	4	2.9	60	50
Belarus	26	2.0	1.8	1.4	1	1.4	15	10
Bulgaria	25	2.0	2.3	2.2	3	2.5	45	30
Ukraine	25	2.0	1.9	1.8	1	1.4	35	30
Romania	23	1.8	2.2	2.2	3	2.2	40	27
Kazakhstan	23	1.8	1.8	1.9	2	1.5	25	10
Georgia(*)	23	1.8	1.7	1.7	2	1.5	30	12
Armenia(*)	23	1.8	1.8	1.9	2	1.6	45	37
Moldova	20	1.5	2.3	2.1	2	1.8	30	25
Albania	20	1.5	2.0	2.1	3	2.2	60	55
Azerbaijan(*)	20	1.5	1.3	1.6	1	1.3	25	20
Kyrgyz Republic	20	1.5	2.5	1.8	2	2.0	40	35
Turkmenistan	20	1.5	0.8	1.4	1	1.0	15	10
Uzbekistan	17	1.2	2.0	1.5	1	1.4	30	25
FYR Macedonia(*)	15	1.1	2.1	2.1	4	3.1	40	30
Tajikistan(*)	15	1.1	1.3	1.2	1	1.2	15	10

Notes: Figures for GDP per capita in 1989 are an attempt to rank countries using different and contradicting computations of GDP in purchasing power parities. In the second column the figures are scaled in order to match the following columns which indicate various indices for degree of institutional reform computed by the EBRD, EIU and IBRD (cf. the text). The last two columns indicate private sector share of GDP in 1995 and its change since 1989. Countries severely affected by regional tensions, marked by asterisks, are excluded from the statistical analysis.

Sources: Kekic (1996); Aage (1994a:15, 178); EIU Country Reports og Country Profiles; World Bank (1996:188-189); UNDP (1992:127); IMF, IBRD, OECD & EBRD (1991(vol. 1):231; Riishøj, 1996:103); Hedlund & Sundström (1996:134-136).

Table 2
Economic growth in transition economies 1989–1996

	Smallest GDP year	1989 =100	GDP 1995 1989=100	GDP growth percent 1994	1995	1996	1997	1998
Slovenia	1993	77	85	6	5	3	4	5
Czech Republic	1993	80	86	3	5	4	1	3
Estonia	1994	64	66	-3	4	4	7	3
Latvia	1993	52	54	2	1	3	3	5
Hungary	1993	81	86	3	2	1	3	4
Lithuania	1993	39	41	2	3	4	5	6
Russia	1995	55	55	-13	-4	-5	1	3
Croatia(*)	1995	68	68	1	-2	4	5	5
Poland	1991	82	99	6	7	6	6	5
Slovak Republic	1993	77	85	5	7	7	5	3
Belarus	1995	54	54	-20	-12	-3	3	3
Bulgaria	1993	73	75	1	3	-11	-7	3
Ukraine	1995	40	40	-23	-12	-10	-3	2
Romania	1992	74	84	4	7	4	-2	2
Kazakhstan	1995	45	45	-25	-9	1	2	4
Georgia(*)	1995	17	17	-35	-5	11	11	10
Armenia(*)	1993	34	38	5	7	6	6	5
Moldova	1995	39	39	-31	-3	-8	-2	3
Albania	1992	58	74	7	7	8	-15	10
Azerbaijan(*)	1995	34	34	-21	-17	1	5	9
Kyrgyz Republic	1995	42	42	-27	-6	6	6	5
Turkmenistan	1995	63	63	-20	-5	-3	-15	8
Uzbekistan	1995	83	83	-4	-2	2	1	3
FYR Macedonia(*)	1995	53	53	-4	-4	1	2	5
Tajikistan(*)	1995	40	40	-21	-12	-7	-3	0

Notes: The two first columns indicate year and size of the smallest GDP in the years 1989-1995. The figures are disputed, but presumably not completely unrealistic with a few exceptions, including the figure for Georgia, where production allegedly dropped to 17% of the 1989 level. The last five columns indicate growth rates for recent years; figures for 1997 and 1998 are preliminaryor forecasts.

Sources: Economics of Transition 4 (May 1996, No. 1:282); EIU Country Reports og Country Profiles; Hedlund & Sundström (1996: 134-163); EERD Transition Report 1997.

Table 3
Indicators of macroeconomic imbalances in transition economies 1994–1995

	Inflation percent		Unemployment percent		Balance of payments percent of GDP		Fiscal surplus percent of GDP	
	1994	1995	1994	1995	1994	1995	1994	1995
Slovenia	20	13	14	14	3	0	0	0
Czech Republic	10	9	3	3	0	-5	1	1
Estonia	48	29	5	5	-8	-8	0	0
Latvia	36	25	7	6	6	4	-4	-4
Hungary	19	28	10	10	-9	-6	-8	-7
Lithuania	72	40	5	6	-2	2	-1	-2
Russsia	309	197	7	8	4	4	-10	-4
Croatia(*)	98	2	17	17	1	-11	1	0
Poland	32	28	16	15	-1	-3	-2	-2
Slovak Republic	13	10	15	13	6	6	-1	0
Belarus	2221	709	2	3	13	3	-3	-3
Bulgaria	87	63	13	11	0	3	-7	-7
Ukraine	891	377	0	1	-3	-4	-17	-8
Romania	137	32	11	10	-1	-4	-3	-4
Kazakhstan	1878	176	1	2	-3	-3	-7	-2
Georgia(*)	18916	183	4	3	-36	-32	-7	-6
Armenia(*)	4962	176	6	7	-35	-28	-24	-11
Moldova	486	30	1	1	-8	-9	-8	-5
Albania	23	10	18	17	-10	-2	-12	-7
Azerbaijan(*)	1644	412	1	1	-8	-10	-20	-7
Kyrgyz Republic	278	52	1	2	9	-7	-7	-13
Turkmenistan	2714	2500	0	0	-5	-2	-3	-2
Uzbekistan	1550	320	2	3	-5	2	-4	-4
FYR Macedonia(*)	122	17	33	36	-11	-8	-3	-4
Tajikistan(*)	350	443	2	2	0	2	-11	-11

Notes: Several figures are preliminary, estimated and not comparable, particularly unemployment figures, as there is considerable hidden as well as unreported unemployment in many countries, notably in the former Soviet republics. Inflation figures are the most reliable ones.

Sources: Economics of Transition 4 (May 1996, No. 1:283); ECE (1996:88, 96, 130); EIU Country Reports og Country Profiles; DØS (1996a:105-107); World Bank (1996:190).

food consumption in Moscow and St. Petersburg was imported in 1994 (Eatwell et.al., 1995:103).

Privatisation has progressed rapidly everywhere with few exceptions, notably Belarus and other former Soviet republics (cf. table 1). Concerning small enterprises the problems have been practicable, and a large number of new firms have been created. Some large enterprises have been privatised as well, and the Central European countries have to some extent succeeded in dispersing ownership rights and in improving corporate governance. But in Russia the "forced privatisation" has been chaotic. Enterprises were simply handed over to insiders, namely employees and particularly the former directors, to whom a disproportionate number of shares have been transfered, either for free or at very favourable prices. Estimates show that on average 65–70% of the shares ended up in the hands of insiders; 9–17% went directly to the old directors, and furthermore they subsequently gained control over a considerable part of the remainder. Everywhere in Eastern Europe, with the Czech Republic as a possible exception, the outcome of this privatisation – in popular parlance entitled *prikhvatizatsija* (from the Russian prikhvatit', to grab) – has been that members of the former elite has gained a degree of control over the wealth of society that they did not even dream of during the former regime. The *nomenklatura* has transformed itself into a *kleptoklatura.*[3] Privatisation has been a fertile soil for corruption and, particularly in Russia, in addition for extensive, organized and most violent criminality. Reportedly, 70–80% of private business is controlled by the Russian mafia-like organizations (Sato, 1996:2; Lotspeich, 1995; Handleman, 1994).

These trends have caused widespread popular despondency concerning current conditions. Interview surveys show that the economic situation in the past is evaluated as better then the present. This is much more pronounced in Russia than in Central Europe, and a further striking difference is that in Russia, in contrast to Central Europe, the past is also evaluated as better than the expected future, although some improvement is expected as compared to the present in Russia too. In Russia the share of positive evaluations was 80% concerning the past, 20% concerning the present and 40% concerning the future. The same trend is found concerning appraisals of political developments in Russia, but not in Eastern Europe, where the communist regime is evaluated most negatively (World Bank, 1996:12).

The market economy is not becoming more popular. Since 1990 support for the market economy has declined all over Russia and Eastern Europe (with the exception of Romania), although in Eastern Europe there are still majorities of 10–20% supporting the market economy. But in Russia the majority of 8% in 1991 in favour of the market economy has been replaced by a majority of 44% against the market economy in 1994 (22% in favour of the market economy, 63% opposed to it). However, at the same time a majority of 12% holds that economic reforms are progressing too slowly in Russia (Eurobarometer, 1995:1, 8-18, Annex figure 4).

3. Sutela (1994); Hedlund and Sundström (1996:117); Frydman, Murphy and Rapaczynski (1996:6); Frydman, Pistor and Rapaczynski (1996:582).

"Liberalization has indeed been a good investment"

Summarizing the described trends during six years of transition the World Bank concludes that "liberalization has indeed been a good investment" (World Bank, 1996:29). How could this be possible? The explanation is some peculiarities in the analysis. First, the analysis exclusively considers differences between transition economies themselves, in accordance with the principle that all things are relative. Or the presumption is that without liberalisation things would have turned out even worse; in any case the yardstick is not expectations at the outset of transition. Second, one heavy-handed interpretation of empirical information is chosen with careful negligence of all other possibilities. Thirdly, it has conceivably contributed that "the public must constantly be reminded of the reasons for change and informed about the progress to date", as declared in the report (World Bank, 1996:11, cf. pp 4, 111).

The procedure is to rank countries according to degree of liberalisation in various areas, namely domestic transactions (prices, abolition of state monopolies), external transactions (export controls, import duties, convertibility), and entry of new firms (privatisation, private sector development). A weighted average of these three dimensions constitutes a general liberalisation index for each of the years 1989–1995, and an average for the whole period is computed. The countries are classified into four groups according to degree of average liberalisation, and this classification is found in the first of the two IBRD-columns in table 1, where 4 indicates the highest degree of liberalisation in order to obtain comparability with the EIU and EBRD indices. In the World Bank report and in figures 1 and 2 below the numeration is the reverse, so that 1 indicates the highest degree of liberalisation. The second IBRD-column shows the index values which have been transformed linearly, so that the range corresponds to the two other indices (World Bank, 1996:14).

The analysis disregards countries severely affected by regional tensions, including Croatia and FYR Macedonia which according to the IBRD index belong to group 4 of highly liberalized countries where they substantially would affect results. This omission is contestable but is retained below. Both countries are, however, ranked slightly lower according to the two other reform indices shown in table 1.

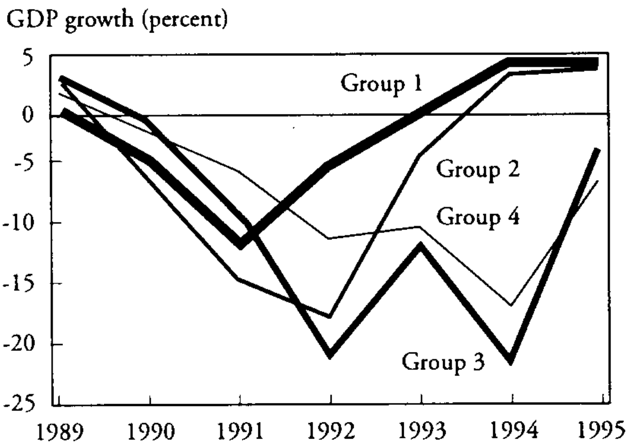
The EBRD index was constructed by the European Bank for Reconstruction and Development based on assessment of progress in nine areas: large- and small-scale privatisation, enterprise restructuring, price liberalisation, competition, liberalisation of foreign trade and foreign exchange, and financial reform. The EIU index was constructed be the Economist Intelligence Unit based on a poll of thirty experts who were asked to rate economic institutional development in transition countries in relation to average EU standards on a scale from 1 to 4. Ratings according to the three indices coincide fairly well with each other. The World Bank classification would be very close to the other two, if Croatia and FYR Macedonia were moved down from group 4 to group 3, Estonia up from 3 to 4, Russia up from 2 to 3, and Ukraine up from 1 to 2.

Finally the World Bank report computes unweighted averages for the four groups of countries, so that variation within groups is neglected, and then the following striking conclusion appears in figures 1 and 2 from the World Bank report.

The validity of these conclusions can be evaluated from various points of view. Firstly,

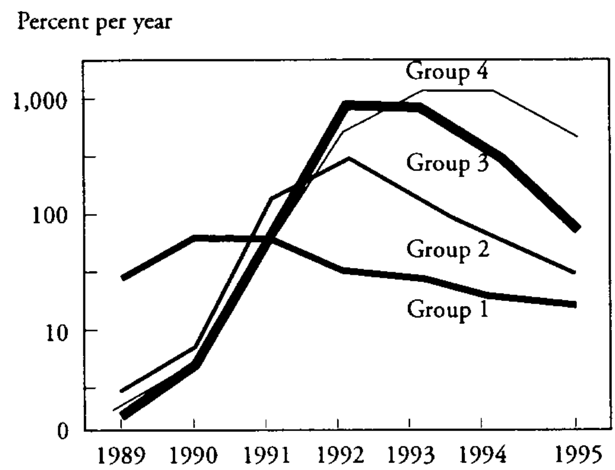
"Countries that liberalize rapidly and extensively turn around more quickly."

Figur 1. Time profiles of output decline and recovery by country group



"Progress with liberalization brings down inflation."

Figur 2. Time profiles of inflation by country group



Note: The classification into country groups is shown in the left IBRD-column in table 1, where, however, the numeration was reversed. In the figures the countries in group 1 are the most liberalized. Countries severely affected by regional tensions are excluded.

Source: World Bank, 1996:29, 39.

there exist as shown in table 1 other classifications of countries according to institutional reform. Table 4 compares results obtained by using two different reform classifications, the World Bank classification (IBRD-column) and the European Investment Bank classification (EBRD-column). Four measures of economic performance are considered: the year with the smallest GDP, the size of GDP in 1995 (1989=100), and the growth rate and inflation in 1994, where most figures are fairly reliable and where furthermore differences between country groups are rather pronounced according to figures 1 and 2. As compared to the IBRD classification, the EBRD classification predicts economic development less accurately, as rankorders and linear trends for year for smallest GDP, GDP in 1995, and GDP growth in 1994 all become less clear. Both classifications are, however, strongly correlated with inflation in 1994. Although the two reform indices are rather closely correlated, as apparent from table 1, and both are correleated in broadly the same way with the four measures of economic performance, the choice of reform index nevertheless influences clarity and persuasive power of the results considerably.

Secondly, there are other differences between countries than progress of liberalisation and reform, including differences concerning their point of departure, and as a simple proxy for this GDP per capita in 1989 has been used as the basis for the classification in the GDP89-column i table 4 actually it gives a reasonable explanation of the four measures, especially if compared to the

Table 4

Averages of GDP growth and inflation for groups of countries, classified according to degree of institutional reform and according to GDP per capita in 1989

	Country group	Classification of countries according to reform level and GDP per capita in 1989 IBRD	EBRD	GDP89
	4	92.6	92.8	93.2
Year for	3	92.8	94.0	93.0
smallest GDP	2	95.0	93.0	94.0
	1	95.0	95.0	94.4
analysis of variance, v^2		19.94	3.94	1.27
regression coefficient	-1.36	-1.11	-0.59	
t-statistic		-4.80	-2.60	-1.52
correlation, r^2		.58	.28	.12
	4	88.2	84.5	75.4
GDP 1995	3	65.7	51.0	70.0
1989=100	2	45.3	80.3	59.6
	1	60.0	50.5	60.2
analysis of variance, v^2		8.65	13.43	0.74
regression coefficient		16.88	14.78	7.77
t-stastistic		3.31	2.19	1.30
correlation, r^2		.39	.22	.09
	4	4.6	3.3	2.2
GDP-growth	3	2.2	-11.0	0.0
1994	2	-24.0	2.3	-12.6
	1	-16.8	-22.0	-15.0
analyais of variance, v^2		29.04	7.40	2.62
regression coefficient		13.72	11.93	8.73
t-statistic		4.61	2.76	2.34
correlation, r^2		.56	.31	.24
	4	18.8	23.7	26.6
inflation	3	67.2	211.3	106.5
1994	2	737.8	570.0	1042.8
	1	1844.0	1926.0	1010.2
analysis of variance, v^2		13.16	14.65	2.49
regression coefficient		-951.68	-1114.50	-555.27
t-statistic		-5.49	-5.55	-2.29
correlation, r^2		.64	.64	.24

Notes:
The three classifications of countries are based upon table 1: IBRD: as the classification in the IBRD-column. EBRD: according to the EBRD-reform index: group 4: 3.3-2.9, group 3: 2.5-2.3, group 2: 2.2-2.0, group 1: 1.9-0.8. BNP89: according to GDP per capita in 1989: group 4: 48-34, group 3: 32-28, group 2: 26-23, group 1: 20-17. For each of the four measures of economic performance, the table gives the average value for four groups of countries according to the three classifications. Averages for country groups are unweighted. Countries severely affected by regional tensions are excluded, cf. table 1. The analysis of variance statistic, v^2, shows the ratio of the variation between groups to the variation inside groups. The regression coefficient, the t-statistic and the square of the correlation coefficient are computed from the ungrouped data.

Sources: Tables 1, 2 og 3.

EBRD classification. While seemingly GDP per capita in 1989 predicts the economic development almost as well as the two reform indices, this is however not the case, because there is so much variation within country groups as compared to variation between groups that most differences between the groups are – in contrast to the reform index classifictions – insignificant, cf. v^2 in table 4.

The relationships can be a little further illustrated by means of regression analyses which convey the same impression. The uniformly scaled variables in table 1 have been used (columns 2, 3, and 6), so that regression coefficients are roughly comparable. Predictions are best for the IBRD index, somewhat poorer for the EBRD index and weakest for GDP per capita in 1989, which gives only two significant t-statistics.

The closest correlation is obtained for inflation in 1994. This is also the result of a regression analysis carried out by Fischer, Sahay & Végh (1996:230), but here the interpretation is quite different. Instead of considering liberalisation as a cause of low rates of inflation as in the World Bank report, low inflation is regarded as one – important – determinant of economic growth among others, including degree of liberalisation, fiscal surplus, and foreign assistance.

In an investigation by Laza Kekic (1996) more features of the initial situation are incorperated: proximity to Western Europe, size of countries, earlier dependence on CMEA trade, mineral wealth, economic structure, prior reform experience as well as foreign assistance. This changes the conclusions concerning the determinants of economic achievements in the years 1989–1995 completely: "Findings on the influence of institutional reform are at variance with optimistic assessments of the impact of rapid change. No specifications yield a positive impact. The results in fact suggest that the pace of reform had a negative impact, once other factors were taken into account".[4]

The World Bank conclusions in relation to figures 1 and 2 above seem rather partial, as the firmness of expression is not matched by a corresponding firmness of substantiation. But one can not be too careful when it comes to avoiding any manifestation of "indoctrinating citizens with antimarket propaganda" (World Bank, 1996:4).

Market, government, and economic growth

Proximity to Western Europe is among the explaning factors in Laza Kekic' analysis, and a glance at tables 1–3 immediately reveals that differences between countries concerning institutional reform, stabilisation and recovery are rather closely associated with the geographical distance between the respective capitals and Brussels. Probably this indicates the importance of two other determinants, besides liberalisation reforms, namely economic and political tradition and culture, and economic policy.

The close association between low inflation and economic recovery points to the importance of stabilization policy. The most successful transition countries in Eastern Europe also had the most active and consistent *economic policies*, and not only stabilisation policies. In the Czech Republic the extreme liberalism is more rhetorical than real; certainly, health care, education and public transport have been partly privatized (with rather disastrous consequences), but

4. Kekic (1996); cf. also Gerner, Hedlund and Sundström (1995:148).

spending on social policy is still large, the housing market has not been liberalized, and the government protects big enterprises from bankruptcy, which contributes to the remarkably low rate of unemployment (cf. table 3) (Eatwell et.al., 1995:48-50, 64). In Poland state enterprises accounted for 64% of the booming investments in 1995 (ECE, 1996:78). In Russia, on the other hand, the government finances a declining share (23% in 1995, ECE, 1996:79) of the shrinking total amount of investments.

In Russia the state has not retreated generally from economic life, as the political elite and the new economic elite are intertwined (Hedlund and Sundström, 1996:123). But the absence of responsible government policy for economic and social development is striking. Driven by powerlessness and the economic interests of the new elite the government has left society to immature market forces (Nuti, 1996:11; Sato, 1996:3). Ideology presumably also played an active role through the adoption of what Stiglitz labels a widespread western "folk theorem", namely that "anything the government can do the private sector can do as well or better" (Stiglitz, 1995:31; cf. World Bank, 1996:110).

In a remarkable article in the Russian newspaper Nezavisimaja Gazeta a number of distinguished Russian and American economists, including three Nobel Laureates, called for a much more active government policy (Klein et.al., 1996). They critize the IMF and the World Bank for "tying the governments hands concerning action to overcome depression and capital flight" in return to relatively small amounts of finance.

There are very strong arguments in favour of improved government intervention in the economy. The large state enterprises need ownership control which means government control, as it is impossible to privatise all of them fast; social institutions and law and order must be restored, and in particular, an efficient tax collection is of utmost importance; infrastructure investments must be carried out by the government;[5] management of natural resources and environmental policy is only possible under government guidance; and restructuring and growth requires deliberate industrial policy. A very difficult dilemma is how to prevent the closing down and subsequent rapid erosion of technologically advanced industry without permanent subsidies (Eatwell et.al., 1995:115-120; Dewatripont and Roland, 1996:20-21).

The association between proximity to Western Europe and active economic policy is in part no coincidence, as EU membership aspirations might have supported the political practicability of stabilization.

But in part it might also reflect *cultural differences*. The simplistic view prevailing in 1989, on the eve of the period of transition, among large parts of the economics profession, was that the planned economy was a perversion of economic life, the elimination of which was not only a necessary, but also a sufficient condition for returning to the natural state of economic life, namely a well-functioning, democratic market economy.[6]

Subsequent events have modified this complacent view, and a broader geographical and historical perspective proves that the

5. Sachs and Warner (1996:3); "the obvious answer", according to The Economist (9 November 1996, p 108) is to deregulate public utilities.
6. Sachs (1993:12); cf. Portes (1994:1178); Islam and Mandelbaum (1993).

well-functioning market economy is the exception rather than the rule. It is not an original, natural state of economic life, but requires a complex system of legal, political and social structures which are not easy or quick to establish. Thus, from the tender years in thirteenth century Northern Italy, it took 500 years for Western European capitalism to develop, and it required another 200 years to become civilized into a socially acceptable system, as described in the institutional approach to economic history (Gerner, Hedlund and Sundström, 1995:136).

Several recent journal articles have a more cautious tune. Instead of shock-therapy a gradual approach to transition is recommended as the only possible one as well as the most efficient for empirical as well as theoretical reasons, and historical preconditions are pointed out as decisive determinants for speed and success of transition programmes.[7] Most economists agree that habits and mentalities, learned during the long period of Soviet rule, are adverse to transition particularly in Russia, namely authoritarianism, egalitarianism, reliance upon and alienation from the state at the same time, traditionalism, and a general lack of initiative, rationality and responsibility (Aage, 1991). Some would go further back in history than to 1917 in order to unveil the roots of this anti-market Russian cultural tradition, to the Congress in 1903 and the disunion of the Russian social democrats between mensheviks and bolsheviks, to the attack by the mongols in 1237, the schism between Catholicism and Orthodoxy in 1054, or even to the partition of the Roman empire in 395 (Gerner, Hedlund and Sundström, 1995:104-118).

The concept of culture is, however, imprecise and cultural explanations correspondingly ambiguous.[8] Empirical attempts to distinguish between situational factors and the cultural heritage are inconclusive (Shiller, Boycko and Korobov, 1992). Historically, however, a strong, efficient and uncorrupted government is a characteristic which is associated with economic growth (Reynolds, 1983:976). Furthermore, historically there is not a very pronounced correlation between marketisation of the economy and economic growth. It should be recalled that just a few years ago two outstanding American textbooks on comparative economic systems concluded from a comparison of planned economies and western market economies that the "... dynamic efficiency of the two systems appears similar. ... The important differences in growth rates appear not between the systems but rather among the nations within the same economic system."[9]

But particularly on the last point a large part of the economics profession is changing its mind rapidly. The upsurge of theoretical and empirical research concerning long-term growth and determinants for catching-up and convergence has provoked new disputes.[10] A number of recent studies, including the World Bank report, point to economic freedom as the key determinant for growth,[11] with low levels of public spending as an important aspect (Sachs & Warner,

7. Murrell (1995); Dewatripont and Roland (1996); Hedlund and Sundström (1996:48, 54); cf. also the articles by Roland, Blanchard, and Portes (1994) in The Economic Journal, September 1994.
8. For a critical reveiw of some recent attempts, cf. The Economist (9 November 1996, pp 25-32).
9. Pryor (1985:101); cf. Gregory & Stuart (1989:414).
10. Maddison (1995); Barro and Sala-i-Martin (1995); Baumol (1986); DeLong (1988).
11. Gwartney et.al. (1995); The Economist (13 January 1996, pp 21-23; 25 May 1996, pp 23-29; 12 October 1996, p 93).

1996). Reducing the size of the state will also appear as one of the main recommendations in the World Bank's World Development Report for 1997.[12] On the other hand, liberalisation, economic freedom and neglect of social policy create not only incentives for economic activity, but also inequality and threats against political legitimacy which may have opposite effects for empirical as well as theoretical reasons.[13]

Transition and democracy

This raises the difficult issue of the interrelations between transition, economic growth, and the various mechanisms of democracy. Historically, there are no examples of planned economies with political democracy. On the other hand, rule of law in the sense of respect for human rights is not a necessary condition for growth. And democracy and economic growth are not closely correlated. Actually, in a study of 84 countries, which were ranked according to a democracy score and according to growth performance, the coefficient of democracy in a regression analysis of economic growth turned out to be exactly 0.00.[14] However, according to another study (Tavares and Wacziarg, 1996), part of the explanation for this lack of correlation is that beneficial effects of democracy are overruled by other influences. According to this study democracy is associated with stable government, low levels of public expenditure, trade openness and high levels of human capital formation, all of which generate economic growth. On the other hand democracy is also associated with low levels of public infrastructure investment and with income equality which is regarded as detrimental to growth in this study – contrary to other studies mentioned above. Thus in the light of available empirical evidence, strong effects of democracy upon growth cannot be expected.

But efficient decision-making is inescapable and preferably it should be democratic. There is a great danger that transition, particularly of the Russian type, may spoil the potential for *government* collective decisions without creating the necessary conditions for individual decisions in the *market* (Hedlund and Sundström, 1996:100).

Transition and liberalisation in Russia has reduced the decision-making power of government by creating strong, politically and criminally infected ownership interests. And without reconstruction of government the necessary conditions for individual decisions in the market can not be created, in particular price stability and contract enforcement by law.

According to Stiglitz, "the economic advantages of privatization are derived from the inability of the government to make certain commitments, in particular, the commitment to competition and the commitment not to subsidize" (Stiglitz, 1995:179). Thus privatisation alleviates the incentive problems of the planned economy related to the ratchet effect and the soft budget constraints (Dewatripont and Roland, 1996:14-20).

But this advantage is obtained at a cost that may prove detrimental, namely that the government also becomes incapable of

12. Transition 7 (September-October 1996, Nos. 9-10):16.
13. Eatwell et.al., (1995:63-64); Persson and Tabellini (1994); Bruno and Squire (1996); Hedlund and Sundström (1996:151,167); The Economist (19 October 1996, p 94; 26 October 1996, p 102).
14. Lane & Ersson (1990:220-221, 231, 242, 247, 249).

fulfilling its contract enforcement functions. Against this background there is an interesting trend to regard the emerging organised crime as an acceptabel phenomenon, as it provides the missing services of contract enforcement, although by unauthorized means, despite adverse effects like migration, low investment rates and capital flight.[15] It is argued that "legal reform should begin with the adoption of legal rules that the courts find usable and that private parties find cheaper to rely on than other methods of resolving disputes" (Hay, Shleifer and Vishny, 1996:562). Liberalisation and smaller government is regarded as an important anti-crime policy (Lotspeich, 1995:576, 580-581). And generally, because market failures cause difficulties concerning assessment of the effects of government action, it is often concluded, that "ironically, this dysfunction of the market turns out to be an argument for the state to do less, not more".[16] This trend is just another expression of a widespread view of society as driven by economic incentives which are considered the only possible ones, even the only permissible. The theoretical predilection for narrow, particularly economic incentives has a growing impact upon the social sciences, also outside economics.

Insider-privatisation was intended to buy the support of economic reforms from employees and directors (Dewatripont and Roland, 1996:9; Nuti, 1996:9, 12); maybe it was also intended to create some form of *self-management* democracy, but such effects did not materialize, and they would most likely not have contributed positively to the transition due to well known, empirically and theoretically documented problems related to self-management. On the contrary, the wide and partly spontaneous diffusion of employee ownership rights in several Eastern European countries during the 1980's was mainly a source of obstacles for restructuring and commercialisation (Frydman, Pistor and Rapaczynski, 1996:582, 586).

But privatisation has effectively eliminated political control by central planning and at the same time it endangers market control, because it threatens the collection of taxes and therefore also stabilisation (Hedlund and Sundström, 1996:65, 94-99).

Tax collection is essential to any economic system and to democracy as well. The old system had one important advantage, which is realized now when it is gone: it could collect taxes efficiently. Unfortunately, it did so by means of wage and price controls and the blocking of enterprise "account money" so that there was little codification of tax rules or administrations which could be carried over into the new system. Transition by necessity imposes severe strains upon public finances and impairs the government budget balance in two ways: the demands on public expenditure increase, and public revenues decrease.

Privatized firms lay off redundant workers, and they no longer fulfill their former social policy functions, like providing workers with cheap meals, housing, health care, leisure activities, holidays, and income, also for non-productive workers. The government must carry out some of these activities.

The recession also erodes the tax base. Tax payments from remaining state-owned enterprises decline; although this decline is partly offset by the elimination of government subsidies the sharp drop in

15. Cf. Lotspeich (1995:569, 575-578); Nuti (1996:12).
16. Åslund (1992:20, cf. also pp 12, 21-22).

output levels nevertheless reduce the tax paying ability of state-owned enterprises. Privatized firms deliberately avoid paying taxes, especially if the private sector is an unrecorded cash-economy, and success in privatisation means further erosion of the tax base (Hedlund and Sundström, 1996:120, 224-235).

If the simple solution of just cutting public expenditure to match the dwindling tax revenues is not possible (Sachs and Warner, 1996:3) the most important task, for stabilisation and for successful reform as well, is to establish effective taxation for the private sector, even if it entails adverse incentive effects for entrepreneurial activity. Otherwise, budget constraints could retard privatisation and restructuring and jeopardize its final outcome, because a slowing down of reform policy could be the only alternative way of reducing government social expenditures.

The privatisation of the Russian gas monopoly, Gazprom, illustrates this whole complex of problems. The above-mentioned group of American and Russian economists calls attention to the necessity of exploiting the oil- and gas industry for improving the collection of taxes (Klein et.al., 1996). However, this proposal encounters the difficulty that prime minister Victor Chernomyrdin is affiliated with the management of Gazprom. The company is among the largest concentrations of wealth in the world with reserves of natural gas worth an estimated 700 billion dollars. When it was partly privatized about 1-5% of the shares were handed over to the management. Gazprom owns considerable parts of the Russian banking system and enjoys increasing economic power (Hedlund and Sundström, 1996:51, 167-168, 243; World Bank, 1996:119). The World Bank report mentions the problem of taxation of Gazprom without, however, questioning the appropriateness of withdrawing gas extraction – one of the few assets of Russian society – from political control through privatisation. Energy is a badly needed object for taxation; a 50% profit tax means 50% government ownership concerning the right of access to income; why not retain 100% government ownership?

Natural resources and the environment is an area where democracy can not rely on the market. Maybe it can not rely on government either because of the danger of short-sighted abuses at the expense of future generations. Thus, as in monetary policy, there is a case for delegating power by means of *professionalisation.* The extreme form for independence of monetary authorities is the system of "currency boards", as known in a number of former English colonies, and recently in Estonia, Lithuania, and Argentina (Eatwell et.al., 1995:179-181). A similar system of legal institutions could be necessary to manage resources and the environment, and various forms of "fisheries boards" and "environment boards" have been proposed (Aage, 1994c; Paldam, 1994:181-182).

Environmental policy has been relegated from the focus of attention, also in the World Bank report, where it is mentioned in the introduction as "important" and then altogether in five short remarks mostly in order to emphasize the beneficial effects of market forces.[17] If the great challenges of our time, i.e. the global environment and the global distribution are considered as interesting (Aage, 1994b; Aage, 1998), it is

17. World Bank (1996:iii, 4, 33, 54, 63, 110).

hardly sufficient to recommend that "the government must stop restricting and directly controlling private commercial activity" (World Bank, 1996:110). If not, a 50% decline in output should be a sufficient reason for, maybe not a planned economy, but in any case some plan in the economy which requires proper legal institutions.

It is repeated again and again that "there is no middle way between capitalism and communism",[18] and that furthermore "the great (and false) debate between state and market seems to be over for now".[19] The obvious truth is that there exists nothing but third ways; the problem of striking a balance between public sector involvement and private activity is a major problem in any economic system, or to put it in more tangible terms: the problem is how to collect taxes. Regulating legal institutions is a necessary condition for a well-functioning market, first of all a strong and uncorrupt government, and a functioning government needs the use of market-compartible incentives. The relationship between individual decisions in the market and collective decisions in the political process is complicated. Often the metaphor of a referee in a football game is invoked to describe the proper role of government in the economy, but maybe another metaphor would be more incisive. In a lecture on transition in Russia and Eastern Europe Wassily Leontief (1992) described the economy as a sailing-ship; the wind is the incentives of the market, and it gives the speed without which it is impossible to steer the ship. If the crew sets all sails, and then goes down to the cabin for drinks, the ship will certainly go fast, but in unknown direction. However, a clever government at the rudder could exploit the wind and the powers of the market to beat up against the wind and advance in the opposite and right direction.

What is worst, the disease or the cure ?

Contrary to previous revolutions the transition in Eastern Europe and the former Soviet republics apparently were not fuelled directly by requests for redistribution of power and wealth, but first of all by a desperate wish for economic growth. And the advice of economists has been asked to an unprecedented degree concerning account of symptoms, clarification of diagnosis, and prescription of medicine. The advice of economists are sometimes compared to medical treatment in the days of old (Krugman, 1994:9), and the comparison is particularly incisive for the transition economies, which have consulted western economists not only concerning details of economic policy, but also concerning transplantation of vital internal organs of society. The recommendations have been characterized by strong opinions in spite of theoretical perplexity, by general support to the prevailing view in spite of contemporary dissenting evaluations (Murrell, 1995; Portes, 1994; Dewatripont and Roland, 1996:1), and by willingness to radical treatment with harsh methods in spite of the admitted immediate relapse because of the economic bleeding. Thus the issue comes up, whether the disease or the treatment causes most harm.

All this is very much like medical treatment in the first half of the last century,

18. The Economist (28 October 1995, p 15).
19. Transition 7 (September-October 1996, Nos. 9-10):16.

before the great advances in medical science. At that time a strong health was required in order to survive removal to hospital, as it appears from the following account of the treatment of a "34 years old, hitherto fit civil servant" suffering from scarlet fever at The Royal Frederiks Hospital in Copenhagen in 1839: "The patient did not recover and had to be cured very actively. Several blood-lettings were performed, 36 leeches were applied, and "kalo-meal" (a mercury preparation) was given, together with castor oil and much more, and enema was performed. As this did not help sufficiently, the patient had his hair shaved in order to apply "ice in bladder". Spanish fly (a preparation of dry insects, strongly irritating for the skin) was applied on the neck where a wound developed with "good and abundant" flow of pus. During the cure the patient had blood in urine and faeces (mercury poisoning?), but finally he recovered" (Wulff, 1995:164). The treatment was *lege artis* at that time, and it was supervised by a distinguished physician who observed and described the case with exemplary scientific precision. The physician "had no doubt that the patient recuperated because of the cure, but with the knowledge of our time, one dare say that he recuperated in spite of the cure" (Wulff, 1995:164). It is quite understandable that the poor civil servant during the stay in hospital – as noted in the case sheet – now and then "screams vehemently and deliver political and godly speeches" (Wulff, 1989:24).

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