



# **The transition of China and Ussr: A political economy perspective**

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# **THE TRANSITION OF CHINA AND USSR:**

## **A Political Economy Perspective**

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### **I. INTRODUCTION**

Communism and the transition to market based systems have been called the two great economic experiments of the twentieth century (Stiglitz and Pleskovic, 2000). When comparing the Eastern Europe and Former Soviet Union (EEFSU) nations transition of the early 1990s with that of East Asian experience in the late 1970s to early 1980s, the consensus appears to be that China undertook a highly successful transition, whilst EEFSU was a mixed bag.

The main debate through the transitions was whether to take a fast (big bang) or slow (gradualist) approach to reform. Given that both approaches were taken in EEFSU with similar net results, great emphasis needs to be put on other elements such the role of institutions, privatization, and unique conditions within the nation.

With the collapse of the Soviet Union in 1991, it was clear that successor states would move to a market based systems. A series of reforms based around somewhat called the “Washington Concensus”, which primarily focused on liberalization, privatization, and stabilization were generally accepted. Pomfret (2002) argued that with western support in the form of “econolobbyists”, it is not hard to see why these reforms were accepted.

Whether there was debate over the reforms which centered around social support as one of standout successes of socialist nations was their “cradle to the grave” support. Primarily, the debate was to what pace should and in what sequence the transformation should take place. In line with this argument, Pomfret (2002) later proved that sequencing did not play a big role as some reforms needed to occur before others. However, it is clear that from the Russian experience sequencing is very important, which is particularly the case with privatization.

### **II. LITERATURE REVIEW**

#### **2.1 The Political Economy Approach**

The Big Bang or shock therapy approach was one taken in Poland, Slovenia, Czech Republic, Estonia, and Russia. It involved undertaking all the reforms to a market based economy in the shortest amount of time possible. It is believed that there was a limited window of opportunity to carry out the reforms and to achieve a new market based, the old soviet institutions would need to be torn down before they had a chance to reestablish (Pomfret, 2002).

Countries which used shock therapy have been categorized as incurring a deeper recession than nations which took a gradualist approach, however, the formers have experienced in faster growth than the latter. Poland is good example of this where there was an economic downturn

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in real GDP from 10% in 1989 to 7% in 1991 but after that, they enjoyed growth of between 3% and 7% (Pomfret, 2002).

Several arguments have been proposed to endorse a big-bang approach to various types of reforms. First, in the context of privatization, a big-bang approach provides a critical scale of privatized sector in the economy so that the privatized firms will be efficient (Roland and Verdier, 1994). Second, a big-bang may increase the credibility of reform (Lipton and Sachs, 1990). Third, the gradualist alternative gives time to reform opponents to organize themselves and thus invites a formidable resistance (Krueger, 1993). Fourth, in the context of price reforms, gradual reform seems to be undesirable based on the fact that it potentially generate an intertemporal speculation (van Wijnbergen, 1992). Fifth, sequential plans did not work if any reform program needs approval consensus such that it induces time-inconsistency problem. Finally, a big-bang approach brings the benefit more quickly (World Bank, 1991).

Despite the economic success of shock therapy, it was never of political success in which the shock therapy governments thrown out after one term (Marangos, 2003). However, Stiglitz and Pleskovic (2000) argued that reformers relied too much on simplistic “textbook economics”. Advocates of shock therapy insisted that post transition in shock therapy was never undertaken as they prescribed (Marangos, 2003). It would now appear that shock therapy was not a success with who undertook this process getting the worst of the shock without solid institutions.

In the proponent view, Stiglitz *et al* (2007) pointed out that the irony of it all is that the modern critique of utopian social engineering was based on the Bolshevik approach to the transition from capitalism to communism, and the shock therapy approach tried to use many of the same principles for the reverse transition. With the right textbooks in their briefcases, “the market Bolsheviks” would be able to fly into post socialist countries and use a peaceful version of Lenin’s methods to make the opposite transition.

Gradualist on the other hand preferred a slower approach to economic reform, fearing political ramifications of economic reform could lead to the new governments being thrown out and a return of central planning (Pomfret, 2002). Concern was also raised that good institutions and legal systems take time. Beside, rushing into a new structure without carefully considering the ramifications could be potentially disastrous. It is expected that appropriate sequencing of reforms would provide demonstrated successes to build upon, and thus creating constituencies for further reforms (Wei, 1997). Countries that took the gradualist approach included Romania, Ukraine, Hungary, and China.

There are several proponent arguments in favor of a gradualist approach to reform. First, a gradualist approach may avoid excessive cost, especially for the government budget (Nielsen, 1993). Second, it avoids an excessive reduction in standard of living at the start of a reform (Wang, 1992). Third, it allows trial and error and mid-course adjustment (World Bank, 1991). Finally, it helps a government to gain incremental credibility (Fang, 1992).

In the context of the political economy of the choice of reform strategies, it is possible that gradualism is politically preferred to the big-bang. Dewatripont and Roland (1992) argue that under the political constraints that a program needs a unanimous support, a gradualist approach imposes less pressure on government budget than a big-bang based on an assumption that there

is asymmetric information between the government and workers with respect to workers' ability. In contrast, by assuming individual uncertainty on transition costs in which the government and workers have the same ex-ante information, Wei (1997) concludes that a gradualist approach may not always be better than a big bang. This idea comes from the fact that as long as a big bang is politically preferred to no reform, it is preferred to gradualism both in terms of political support and in terms of economic efficiency.

Another possibility that gradualism is politically preferred to the big-bang is when the outcomes of reforms are uncertain to individuals in which a gradual or sequential approach splits the resistance force and thus boosts the programs' chance of surviving attacks by special interests groups. In his preliminary paper, Rodrik (1990) emphasizes the importance of a sustainability policy environment for an eventual success of structural adjustment programs. In a separate view, Rodrik (1993) concludes that an explicit understanding of political economy forces in a reform process is as important as the content of the reform package itself for its success.

However, there is political economy argument against gradualism in terms of the distributive consequences of reform. By widening the scope of efficiency in improving reforms, Martinelli and Tommasi (1993) argue that the government is more likely to gain the support of larger segments of the population, particularly if the losers of each particular measure are benefited by other measures. If the government needs to pass a threshold of popular support at each step, a gradual process risks stop at the each stage by the hurt group at that point. Therefore, the government may need to implement all reforms simultaneously even if this entails some aggregate costs so that credibility and political sustainability can be intertwined.

While most gradualist countries have been described as having slow growth in GDP, China defied this and has grown at almost 10%. Therefore, many studies attempt to compare China with EEFSU (see McMillan, 2004; Sachs, 1996; Pomfret, 2000). By taking a gradual approach, institutions could be allowed to develop naturally taking into account unique domestic politics and needs.

## 2.2 The Political Economy of Transition Reforms

The literature on the political economy of reforms identifies two broad strands: normative and positive. On the one hand, the decision-making problem of reformers subject to political constraints is a main priority of the normative political economy of reforms. The use of the "agenda-setting hypothesis" in this models capture which the executive branch of government that has monopoly power over the design and sequencing of reform packages to vote in the legislature or in a popular referendum (Roland, 2002).

Reformers are assumed to face two types of political constraints (Roland, 1994). Firstly, ex ante political constraints, that can deter decision making and can prevent reforms from being accepted. Secondly, ex post political constraints which are related to backlash and policy reversal after reforms have been implemented and outcomes observed.

The concept of ex ante and ex post political constraints will be effectively the same, aside from the presence of uncertainty and reversal costs (Fernandez and Rodrik, 1991). In terms of

uncertainty, a majority may oppose particular reforms before being implemented, although those same reforms would end up benefiting the majority and would not be reversed if implemented. Thus, uncertainty along the reform path plays an important role in designing a politically feasible sequence of reforms. In contrary, reversal costs typically make it harder to enact a reform and hence, turning back will be costly. Thus, reversal costs increase the *ex ante* constraints on reform but reduce the *ex post* constraints.

In the transition context, the positive analysis of reforms has been somewhat less developed than the normative analysis (Roland, 2002). The positive political economy of reform seeks to explain differences in the extent of rent seeking and how special interests may effectively capture regulatory bodies. Such differences may be insightful in many countries where the political and legal institutions have been existed for a long time and can be viewed as exogenous variables. But in the specific context of transition economies, the institutions themselves are a product of the transition process and must be seen as an endogenous variable.

Sonin (1999) has built a very insightful model of rent seeking that sheds light on many of the processes observed in transition countries. In the transition context, rich agents like the Russian oligarchs gain benefit from low security of property rights which allows them to convert corporate and social assets to their private use. Therefore, they seek to capture government decision making to prevent reforms that would enhance security of property right so that they can exploit economies of scale in rent seeking. For political economy reasons, a high initial level of inequality in wealth and power can lead to long-lasting insecurity of property rights.

The initial distribution of wealth and power is a primary concern amongst reformers. A country with high concentration of wealth and power (e.g. Russia) is the result of the mass privatization policy chosen favoring the insiders (Polishchuk, 1999). However, the choice of the mass privatization policy itself can also be seen as a result of prior rent-seeking activities, which raises the question of why this form of mass privatization was deployed in Russia and the Czech Republic, but rejected in Poland and Hungary (Roland, 1996).

One hypothesis that has not been explored is the cross-country difference in the extent of preexisting civil society before transition (Putnam et al., 1993). In this context, there is a strong contrast between the situation of Poland and that of Russia. Poland had powerful social networks, including the Catholic Church and the Solidarity trade union. But in Russia and other countries of the former Soviet Union, any social networks hardly existed to be independent of the Communist Party, and there is no dissident activity as it would be repressed by the government. Thus, it is important to have a better understanding of the social and political initial conditions of reforms, which should reach beyond the economic initial conditions.

### **III. The Transition Models**

#### **3.1 The Soviet Model**

After Vladimir Lenin's death in 1924, Joseph Stalin created what was known as the soviet model for centrally planned economies and was replicated around the world by other communist states. The key aspects of the model included as follows (Ericson, 1991): First, a strong hierarchical authority structure; Second, rigid central plans for resource allocation;

Third, a goal of resource maximization rather than efficiency; Fourth, formal rationing of goods; Fifth, inflexible centrally fixed prices instead of reflective of the true value of the goods or services; Sixth, slow response systems with no alternative to assign work; Seventh, absolute power exercised by superiors and incentives to meet plans without recognizing economic costs. By the 1980s GDP had slumped and people were growing restless. Inefficiency in the Soviet economy was often summarized by the saying “the workers pretend to work and the state pretend to pay them” (Pomfret, 2002).

### **3.1.1 Mikhail Gorbachev’s Reforms**

Under the leadership of Mikhail Gorbachev, the USSR attempted two final reforms which are Glasnost and Perestroika before the collapse of the Union in 1991. In the former reform, Glasnost was a policy to increase transparency and accountability undertaken by Gorbachev. Citizens who had been repressed and censored for sixty years now could speak up their minds. Parliament was now televised and the government is under intense scrutiny as the atrocities were reported in the free press. Thus, a centrally planned economy could not be sustained in a new era of political economy.

Meanwhile, in the latter reform, Perestroika brought about decentralization of power and economic decision making whilst maintaining a non market environment with price controls and state orders (Krueger, 1993). In 1987, the Supreme Soviet passed the Law of Enterprises, beginning the process of Perestroika or economic restructuring. Under the new law, enterprises were to become self financing in a bid to loosen central control and to increase efficiency. However, at the time prices were still fixed and as such could not make the best decisions leading to large deficits. With this condition, enterprises did not have the incentives to reduce their reliance on state order. Sachs (1996) believed that Perestroika was Gorbachev’s attempt to follow in the Chinese footsteps but was unsuccessful because of the differing initial conditions.

### **3.1.2 EEFSU Transition**

When undertaking economic reform, there was little debate as to the direction in which the successor states should take, but rather the focus was on the speed at which the reforms should be conducted (Pomfret, 2002). A transition to market economy relies on the pillars of market prices, enterprise reform, removal of trade barriers and financial reform. However, geopolitical factors are quite important factor in transition while economists often view transition as an ideological shift toward democracy and the market (Roland and Verdier, 1999). In geopolitical terms, transition represents the shift of Eastern Europe and the Baltic states toward Western Europe. Indeed, the single most significant factor about transition is the change from the status of a satellite country of the Soviet empire to that of a country belonging to the Western bloc. Transition represents a unique historical opportunity for several nations like Eastern Europe and the Baltic state to join the European Union. In addition, the prospect of this connection gives credibility to the political and economic process of transition in a sense that the adoption of the political and economic system of the West is useful to undergo the cost of transition.

This geopolitical factor may be strong enough to explain why countries from Eastern Europe did not suffer from the type of government collapse, anarchy and general diffusion

of criminality, inside and outside government that Russia and other countries from the former Soviet Union have been facing (Roland and Verdier, 1999). The ability to enforce the law and to protect property rights seems to be a key reason why Eastern Europe recovered from its fall in output, while Russia and other countries not facing the prospect of entry to the European Union experienced a much more prolonged decline of output.

Geopolitical considerations also play a role in explaining why a version of China's dual-track approach was not tried in Eastern Europe, at least at the level of trade across countries (Roland, 2002). Essentially, the plans to introduce some form of a dual-track approach, which would facilitate in maintaining existing trade contracts, were unsuccessful. One possible explanation is that reformist governments wanted to use their window of opportunity to create irreversibility by disentangling the planning system.

If the dual-track approach had been tried in a country like Russia, it would probably have failed because of the government collapse in 1991. Such a collapse would have made any contract enforcement difficult to achieve, given the weakness of the state and the corruption of the justice system and government administration. Thus, it is clear that the resistance to transition proved much harder in the former Soviet Union than in Eastern Europe, as witnessed by the greater difficulties in requiring enterprises to face their own losses and in adopting macroeconomic stabilization measures (Roland, 2002).

### **3.2 The China Model**

#### **3.2.1 The Initial Reforms**

China started experimenting after the death of Mao in 1974. However, reform was never going to go far with leader Hua Guofeng who advocates a policy known as the “Two Whatevers” in a sense that whatever policy Chairman Mao devised, all officials would resolutely support and whatever directives Chairman Mao laid down, all officials would forever observe (Schram, 1984).

This strict adherence to the former leaders approach could not be sustained as the economic machinery of the centrally planned economy started to become less and less responsive. Guofeng tried to turn this around by importing factories directly from Japan. This was a risky strategy as China was paying for these imports on the back of oil. Ironically, as its economic efficiency dried up and new sites could not be found, this strategy was abandoned which lead to the downfall of Guofeng’s leadership.

Deng Xiaoping swept to power in 1976 after ousting conservative Maoist Hua Guafeng. Deng ushered in a new era of reform towards a market based economy, ironically called “socialism with Chinese characteristics”. The two main foundations of Deng’s reforms centered around agriculture and foreign investment. Deng’s manner was more pragmatic than his predecessors saying “it does not matter if the cat is black or white as long as it catches mice”. In other words, whatever the policy should be applied must focus on growth and prosperity for the people.

#### **3.2.2 Deng Xiaoping’s Reforms**

Agrarian reform was the corner stone of the new Chinese economy. After the complete failure of the Great Leap Forward resulting in the greatest famine, it was clear that the agriculture sector, which made up 80% of the workforce, needed reforming.

Farmers were receiving very low wages and did not receive the “iron rice bowl” social support of those who lived in the urban areas (Sachs, 1996).

The crux of the reform was to dismantle the rigid plans for the farms under a commune system and increase individual responsibility (Sachs, 1996). Under the new system, communes still existed as a formal organizational unit, but each farmer was allocated a state owned plot. Any output above pertaining to what the central plan required was retained by the farmer who could then consume or sell it into the market.

Critically decisions about the farming techniques and output mix were left to the individual. The new system was providing incentives at the margin to nearly the whole sector by 1984 (Naughton, 1995). By creating a set of choices in the system of household responsibility, the reform has been seen as a bottom up of reform and this is contrast to the approach taken in EEFSU.

One interesting Chinese institution from the political economy point of view is that China chose to liberalize prices in 1984 through a dual-track system (Roland, 2002). For planned output, planned prices were maintained and planned contracts for supplies and deliveries were kept frozen at a preexisting level and were enforced. Farming communes are given a state order which they sell at the state (lower) price and any excess output can be sold at the higher market price.

Normally, such a price disparity would provide an opportunity for enterprising individuals to partake in arbitrage and make profits between the price differences. However, this was not as prevalent as one might assume due to the creation of economic crimes, punishable by death. Dual pricing propped up the state sector, as the state paid the lower price while at the same time allowed an expansion of a new non state sector. Therefore, China’s dual track system has created a system with no losers (Naughton, 1995).

China’s approach to reform has been described as “growing out of the plan” (Naughton, 1995). By maintaining the state sector with a fixed order, but creating incentives at the margin for growth, over time the size of the state sector will diminish as a proportion of the economy. In other words, the plan was growing out rather than wholesale destruction of the state.

With a more efficient agricultural sector, households now had excess labour and higher incomes from additional output sold at the market price, leading to the creation of new Township and Village Enterprises (TVEs). This new sector became substantially deregulated as towns began a race to the bottom, to attract more of these new enterprises. However, Sachs and Woo (2000) argued that TVEs’ density statistics can be misleading as the definition of what a TVE is can vary, with some private “red cap” enterprises registering as TVEs. Thus, new non sector provided substantial growth but not at the expense of the state sector.

### **3.2.3 China Transition**

Analysis of China’s transition broadly falls within two schools of thought, experimental and convergence (Sachs and Woo, 2000). Experimentalists argue that China’s incremental and experimental approach to reform was the key to its success (Naughton, 1995). They contend that this strategy can be applied to other economies in transition. On

the other hand, the convergence school of thought believes that China's success was despite the gradual approach to reform, but rather convergence with other market based economies. They argue that these reforms cannot be transplanted and put a greater emphasis on initial conditions (De Melo *et al*, 1999).

While in retrospect the Chinese gradualist approach to economic reform appears to have been highly successful, there was no clear plan that the leaders appeared to follow at the time. Naughton (1995) believes that despite the official version of events presents Deng as a leader with a determination to seek truth from facts, evidence shows that there was no grand design but a series of experiments.

In principle, the dual-track system has other properties that are relevant in the transition context. The continued enforcement of the plan contracts can reduce the disorganization effects of price liberalization (Roland and Verdier, 1999), thereby preventing the output fall otherwise generally observed in transition economies. Finally, dual-track system helped prevent the collapse of existing government structures because government kept a direct control over economic resources without having to depend solely on fiscal revenues to finance essential activities like law enforcement, which are crucial to efficient tax collection and many other purposes (Roland and Verdier, 1999).

### 3.3 Sequencing

The sequence of reforms in transition economies are roughly in line with political economy theory, which suggests that reforms expected to be more popular should start first (Roland, 2002). For example, in all Eastern Europe, democratic reforms preceded economic reforms. Apart from political reforms, certain other institutional changes can be decided at an early stage of reforms. Fingleton *et al.* (1996) have argued that the establishment of institutions for competition policy should be among the first reforms to be implemented in transition economies, a particularly important reform given the monopolistic structure of industry inherited from central planning. In practice, competition laws have generally been passed rather early in the transition process, in line with the theory. This example also emphasizes the danger that can be associated with a wrong sequencing.

Another important early step in the sequence of transition reforms is encouraging the development of a small private sector prior to more comprehensive reforms. Liberalizing the small private sector is often a popular early measure that provides a supply response in emerging markets. In China, the nonstate sector's share of industrial output was already 22 percent in 1978, thus providing a basis for its growth to 47 percent in 1991 as liberalization occurred (Qian and Xu, 1993).

Sequencing arguments have been applied to privatization. In transition economies, the best firms tend to be privatized first Gatsios (1992). The result of privatizing more profitable firms first is to create political support and goodwill for further privatization and other reforms. Prior to implementing privatization policies, debates concerned mostly on the efficiency of various privatization schemes. However, a major effect of privatization policies in some countries is the disengaging in the amount of asset which were largely anticipated and has been associated with privatization processes and the ensuing consequences, like increases in rent-seeking activities and state capture, and political instability (Roland, 2002).

Privatization took many different forms in EEFSU from auctions to handovers to vouchers. China opted not to privatize their SOEs but instead focus on creating a new private sector rather than on the state expense. Russian privatization is often cited as poorly executed and amplifying inequality through the creation of Russian business oligarchs of former government officials. This has led some critics to describe the process as privatization (Maltsev, 2006). In the beginning period of privatization, it was popular with the public perception. However, by 1995 this had drastically changed into rejection (Appel, 1997).

In the first phase of privatization dubbed as “the people’s privatization”, a voucher process was used (Appel, 1997). These then were distributed to employees and managers within the enterprise with the rest going to the general public. A key difference between the Russian approach and that taken in other nations with voucher privatization was the right to sell the voucher (Appel, 1997). Shares in the new joint stock companies were granted to individuals rather than trade unions or other collectives.

Workers unsure of the true value of the vouchers were often convinced by management to sell them at a low price. Management influenced workers decisions on selling shares by withholding wages, setting up trusts with restrictions and physically restraining access to shares (Appel, 1997). With high inflation ranging between 152.6% in 1992 and 311% in 1994, the value of the vouchers in the eyes of the public had been all but wiped out (Pomfret, 2002). Citizens then sold their vouchers under the belief that they were now worthless.

The second phase of privatization became caught up in the loans for shares scandal. With large budget deficits, the Russian government sought to use the remaining state owned enterprises in terms of collateral against bank loans to pay for the deficit through an auction scheme with the loan contract being accepted by the highest bidder (Appel, 1997). Only a few banks were allowed to participate in the process, leading to low bids for significantly undervalued assets.

During the privatization process, little consideration was given to the question of whether privatization was a good idea in the first place (Pomfret, 2002). Russian privatization therefore put the concentration of the wealth in the hands of a few people, primarily those who have wealth came from large political power. Despite growing inequality and centralization of power related to the previous communist regime, it was argued that Coase's theorem applied and it did not matter who initially owned the enterprises, but that a market would develop and ownership would transfer to the most efficient usage (Pomfret, 2002).

In transition of a market economy, institutions play an important role in sustaining long-term economic growth. Some studies have attempted to analyze the quality of institutions (Pomfret, 2002). Some argued that privatization would encourage the establishment of the rule of law by creating a new private class who will lobby the government for protection of their rights and investments (Shleifer and Vishny, 1998).

However, in practice, the incentives for short term gains through asset stripping were more influential than in long term growth (Hoff and Stiglitz, 2002). Competition needs rules and a level of playing field to thrive. Thus, by creating institutions and a legal framework, players will be encouraged to take opportunities and invest in the economy.

In the opponent view, Pomfret (2002) insisted that institutions cannot just be imported and work without taking into account local conditions. Bankruptcy laws for example need to strike the right balance between protecting debtors and creditors and this will vary from country to country with different initial conditions, customs, politics, and stages of economic development.

#### **IV. Conclusion**

China's approach of early gradual economic reform without political reform appears to have been very successful in implementing a continually high growth. Experimenting with reforms rather than planning reforms has worked very well in China. McMillan (2004) pointed out that the honest approach to economic reform is to be deliberately experimental. Thus it is clear that prescribed reforms will not always be successful, including transplanting China's agricultural into EEFSU.

Sachs (1996) argued that China's gradualist approach cannot be compared with the EEFSU big bang approach as China's initial conditions were more favourable to the approach under Gorbachev's administer. The initial conditions do play a major role in determining the economic successes, however, they are just one factor amongst many and tend to play a minor role.

Hence, it is obvious that no model can apply equally to all transition of economies. Agrarian reforms which were highly successful in China did not work in Uzbekistan (Pomfret, 2000). The initial conditions and comparative advantages play a large role in the successes of transition strategies. While EEFSU was highly industrialized with a large urban population, China was largely agricultural and had a predominantly rural population (Sachs, 1996).

Another point made in relation with China and EEFSU is that of economic and political perspective, reform all run at once. China was very explicit that economic reform needs to come before political reform and this appears to have been successfully implemented. On the other hand, the USSR under Gorbachev's leadership attempted both simultaneously, which then have been directed as reason for the downfall of the Soviet Union.

However, it is dangerous to suggest that democracy and economic reform cannot go hand in hand. China was successful due to their gradual and experimental approach which provides more economic stability and less pain than shock therapy instead of political stability which was the key to its success.

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