Sixteen years after the fall of the Berlin Wall, the transition has brought about mixed results, through radical political changes and wide-ranging economic reforms. A genuine laboratory for an investigation into the way the reforms have influenced the relation between politics and the economy. Hence some Central and Eastern European countries, and the Baltic States, have managed to get into the European Union and combine Market and Democracy, but as for the majority of the former Communist countries....

The trap of partial reforms and incomplete democracy

by Fabrizio Coricelli

Many former Soviet republics, particularly Russia and Ukraine, are facing a dilemma, i.e. the choice between making the leap towards the construction of democratic States and market economies or remaining illiberal States dominated by political and economic oligarchies. One corollary of this dilemma concerns the relationship between democracy and the market economy. These questions are relevant not only for the former USSR countries but for China as well.
Transition countries have been a laboratory for investigating the relationship between the politics and the economics of reforms. Transition countries went through, and some are still going, a process of radical political change accompanied by far-reaching economic reforms on the way to building market economies. After 16 years since the fall of the Berlin Wall, transition has brought mixed results. While countries of Central-Eastern Europe and the Baltic States have completed their transition culminating in their entry in the European Union, most countries of the former Soviet Union have neither built a well-functioning market economy, nor a democratic and free society. Using existing, albeit imperfect, indicators of economic reforms and political regimes we discuss the interplay between politics and the pace of economic reform, its durability and possibly reversal. Transition countries confirm the view that a market economy is a necessary but not sufficient condition for democracy. Although examples of market economies with authoritarian regimes have been observed in history, in transition countries a democratic regime has been a powerful engine for economic reform, which in turn has been an important factor in consolidating democracy. We find that partial political and economic reforms expose countries to backlash and reversal of reforms. The problem is that once trapped in an equilibrium of partial reforms governments have weak incentives to move towards a fully-fledged democracy. At the same time, contrary to the views of several optimistic observers, the demand of powerful lobbies (the "oligarchs" in Russia) for the imposition of the rule of law has turned out to be practically inexistent. In such a context an external anchor for democratic reforms, similar to the role played by entry in the European Union, could be crucial.

The "trap" of partial reforms

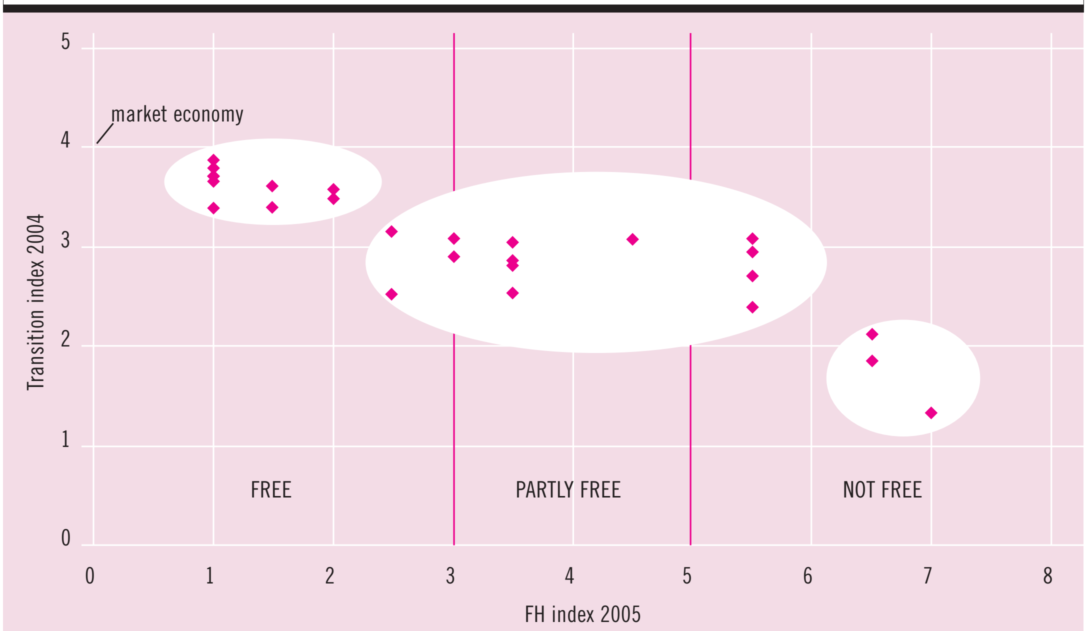
We use the EBRD transition indices as a proxy for economic progress towards a market economy, and the Freedom House indices as a proxy for democracy. The latest available indicators (2004 and 2005) clearly indicate that democracy and economic reforms are correlated. However, there is an interesting grey area in the middle, showing that gains in terms of economic reforms are very small for not free or partly free countries. Moving from authoritarian regimes to partly free regimes, in fact, does not lead to more ambitious economic reforms. One simple inference from this stylized fact is that to achieve a market economy one needs a large-scale democratization.

The evidence in *figure 1* could certainly be interpreted as indicating an opposite direction of causality, namely from economic reform to democracy. We share Kornai's view (more in line with Hayek than with Schumpeter) that a market, capitalist, economy is a necessary, though not sufficient, condition for democracy. However, we wish to stress the interactions and the two-way relationship between economic reform and democracy. Political change fosters economic reform, which in turn affects political change. In the case of Central-Eastern European countries such interaction has worked as a self-reinforcing mechanism. Political change, introduction of freedom, has created consensus and tolerance for radical economic reforms. These, in turn, have paved the way for economic growth in the medium run and for sizable foreign direct investments. Positive economic results have helped to maintain democratic regimes, even though reformist governments have often been overthrown in elections by the opposition. During the period 1989-2004 there have been 38 elections in the new members of the EU; in 30 of them elections led to a dismissal of the government. By contrast, in countries of the FSU political change has been partial, economic performance poor and foreign direct investment very small. These disappointing results have in turn reduced the pressure for political change and in some cases have led to a backlash both in the political and in the economic area.

Figure 2 illustrates the idea of "trap" of partial economic reforms and partial political liberalization. Although democracies display better outcomes in terms of cumulative growth since the start of reforms, the worst performance is associated with intermediate regimes. For authoritarian regimes there could therefore be the possibility of more political freedom and additional reforms producing a deterioration of the economic situation, which could in turn create dissent with and opposition to governments.

These results are consistent with the idea

1. DEMOCRACY AND ECONOMIC REFORM

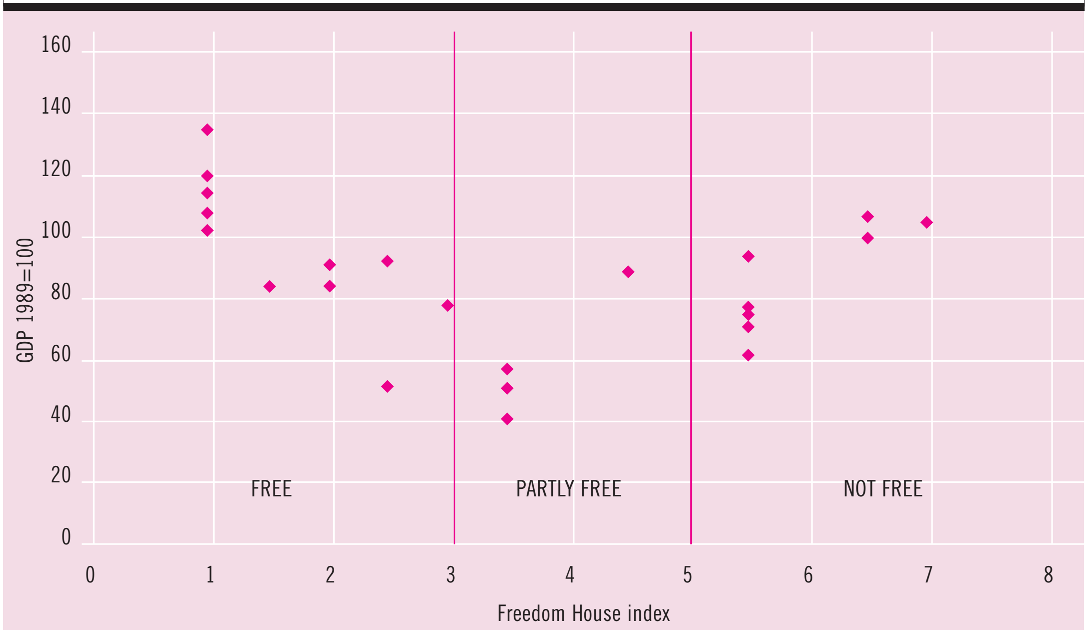


that economic reform has a negative effect on growth on impact. Only over time the effect turns positive. The benefits of reforms are not immediate. Myopic governments would tend to be discouraged to implement reforms to avoid the loss of support by citizens adversely affected by reforms. Countries of Central-Eastern Europe benefited from two main factors and were thus able to avoid the trap of partial reforms. As freedom can be considered a value per se, citizens of Central-Eastern Europe gained from the introduction of democracy at the very start of reforms. This allowed reformist governments to carry out radical economic reforms as the potential economic costs of such reforms were weighed against the benefits of freedom (see Kornai, J., *The Great Transformation of Central Eastern Europe: Success and Disappointment*, Presidential Address, International Economic Association, 14^{th} World Congress, 2005).

Later on, accession to the European Union provided a credible anchor and a unifying framework for reforms. The peculiarity of EU-accession was also that political and economic reforms were complementary, as the pre-requisites for entry into the EU were a democratic society and a well-functioning market economy. The countries of the former Soviet Union, with the exception of the Baltic States, lacked both the initial "honeymoon" and the external anchor of accession to the European Union. Right now only Ukraine has a chance, albeit small, to use accession to the EU as a driving force for implementing political and economic reforms.

In addition to aggregate effects of reforms and consequent support or opposition to reforms, it is important to analyze the distributive or asymmetric effects of reforms. Indeed, asymmetries in the effects may create opposition to reforms even when aggregate effects would be positive. A well-known argument in political economy of reforms is that negative effects are immediately visible while benefits are more diluted and less visible. As a result, even minority groups of losers may effectively oppose reforms, as there is uncertainty on those who would lose and those who would gain from reform. An interesting question is thus the relationship between democracy and inequality.

2. DEMOCRACY AND GROWTH HIGHLY NON-LINEAR RELATIONSHIP



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Democracy and income inequality

Empirical literature especially on developing countries finds that democratic regimes tend to be characterized by less inequality in income distribution. The experience of transition countries partially contradicts such view, as inequality increased with the movement towards more democratic societies.

Indeed, democracy may ultimately reduce inequality, but this takes time as initially the simultaneous introduction of democracy and market reforms tends to increase inequality, also because of the adverse initial effect on growth previously noted.

We look at the more recent data and find that democracy is associated with less inequality also in transition countries. However, the relationship between the change in inequality and democracy is highly non-linear. Again, we find that the middle ground of partial democracy leads to the worst outcome. Partial, limited democracy is indeed associated with more inequality than either full democracy or no-democracy.

It is important to note that the countries of Central and Eastern Europe have tackled the adverse effects of reforms on income inequality by building a social security net. Central-Eastern European countries spend almost twice as much in terms of GDP in social protection than countries of the former Soviet Union. This is an additional element in the partial reform trap that we identified earlier: more democracy and more reforms produce more inequality initially; this induces opposition to reforms and opposition to democracy by governments that want to ensure consensus.

Finally, there is an important effect of democracy on the probability of backlash or reversal of economic reforms.

Durability of reforms and return to the past

Using the EBRD transition indices we identify reversal in reforms as the negative change in the reform indicators. We found 27 cases of reversal. Reversals were affected by negative economic performance, such as slow growth of GDP and low inflow of foreign direct investments. However, it is remarkable that all reversals occurred in countries with incomplete democracy. This is consistent with the view that in less democratic regimes there is more uncertainty on the reform path.

The problem of incentives

The analysis identified a trap of partial reforms and partial democratization, in line with the view by Weingast (Weingast, B., *The Political Foundations of Democracy and the Rule of Law*, “The American Political Science Review”, 1997) on the stability of unconsolidated, thus incomplete, democracies. It is unclear how

_The former Soviet Union countries have lacked the incentive of entry into the EU. Ukraine alone has the possibility today of using entry into the EU as a driving force for political and economic reforms

a country can get out of such bad equilibrium. An implication is that it is hardly possible that democracy and the building of a well-functioning market economy will emerge gradually from authoritarian or partly free countries. Revolutions of different colours seem necessary: countries have to go through radical political change so as to introduce democratic political regimes. It is true that Russia may be more “normal” than we assume (see Shleifer, A. and D. Treisman, *A Normal Country*, NBER Working Paper 10057, 2003).
Many Western capitalist societies have wealth and power, control of the media, that are concentrated in a few hands. Nevertheless, there is still a long way before transition is completed in most FSU countries. How to get out of the partial democracy and partial reforms trap? The key issue is to create sufficient incentive for politicians to carry out reforms as well as sufficient popular support for such reforms. The development of a much stronger middle class is perhaps the key to ensure a process of democratization and market reforms. It is also important to have social security nets, not only for the poor but also for those segments of the middle class that risk falling into poverty. The rule of law should be strengthened. Governments cannot be hostage of the oligarchs, but at the same time government cannot arbitrarily confiscate private property. The attention of the international community should be more directed towards the respect of the rule of law, the inclusion through social security nets of large segments of the population and the defence of the democratic process. The dilemma, paraphrasing Kornai, is how to build a government that is not too strong to interfere excessively with the freedom of the economy and the citizens, but strong enough to enforce the rule of law and reduce the influence of power groups (oligarchs).