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**THE ROLE OF POLITICAL
CONSTRAINTS IN TRANSITION
STRATEGIES**

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INTERNATIONAL MACROECONOMICS



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ABSTRACT

The Role of Political Constraints in Transition Strategies*

This paper tries to clarify the political economy arguments underlying the big bang and the gradualist approach to economic transition. The big bang approach emphasizes the importance of windows of opportunity when *ex ante* political constraints are less binding, whereas gradualist programmes are defended because of their higher *ex ante* political feasibility. Both approaches aim at achieving irreversibility, but through different means. The big bang approach emphasizes how speed in reforms may constrain a successor government, whereas the gradualist approach tries to design the sequencing of reforms so as to build, at each stage of transition, constituencies for further reform.

JEL classification: H89, P50

Keywords: transition, sequencing, political economy, Eastern Europe

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NON-TECHNICAL SUMMARY

This paper examines the role of political constraints in transition strategies in Eastern Europe. *Ex ante* political constraints are feasibility constraints that block decision-making. *Ex post* political constraints refer to the danger of backlash and reversal after decisions have been taken and outcomes observed. *Ex ante* and *ex post* political constraints must be dealt with differently. *Ex ante* constraints imply either that compromises must be made on reform plans or that decisions on radical programmes have to be delayed. *Ex post* political constraints are dealt with by trying to create irreversibility.

Advocates of the big bang approach are less concerned with *ex ante* than with *ex post* political constraints. With respect to *ex ante* political constraints, the basic idea is that there is a *window of opportunity*, a grace period. *Ex ante* political constraints do not exist today, but may be present tomorrow. It is therefore necessary to be quick and decisive in making all the major decisions on transition. *Ex post* political constraints are dealt with by a strategy of *fait accompli*: to constrain a successor government by increasing the costs of reversing policies adopted today. The main instrument for achieving this goal is a reduction in the size and wealth of government. By lifting price controls and disbanding administration, one makes it more costly to reinstate price controls. By distributing freely state assets to the population and to workers, one runs down government wealth and makes it more costly to renationalize or to expand government expenditures. This is a form of 'scorched earth' politics. An important assumption in this line of reasoning is that there is an exogenous probability of losing power.

Gradualism is directly concerned with *ex ante* feasibility constraints. It also deals with *ex post* political constraints by focusing on the importance of building constituencies. Gradualism alleviates *ex ante* feasibility constraints by reducing the reversal cost of early reforms. This reduces the cost of experimentation in the presence of aggregate uncertainty. Not only may gradualism increase the feasibility of reforms, but it may also create irreversibility by building constituencies to get unpopular reforms adopted at a later stage of transition. When uncertainty is large, people are more willing to engage in the reform process once they know that initial reforms have been successful for them. People who become successful entrepreneurs may have been reluctant to support reforms when they were still workers or ordinary employees.

In order to build constituencies at early stages of reform to push decisions at later stages of reform, it is important to avoid sequencing mistakes.

1) It is better to start first with reforms having a higher expected outcome than with reforms having a lower expected outcome.

2) Under a democratic framework, it is always better to start first with reforms that are advantageous for a majority.

3) Between two reforms having an equivalent expected outcome, it is better to start first with the more risky reform.

Sequencing not only allows reformers to take advantage of the partial resolution of uncertainty to build constituencies, it may also use 'divide and rule' tactics to get reforms adopted.

1. INTRODUCTION.

Political constraints play an important role in the transition process in Eastern Europe. Recent election results in Poland, and especially in Russia, remind us that it is not very realistic to devise transition programmes that do not take these constraints into account.

In debates on transition, political economy arguments have often been put forward either to justify a fast or a slower speed of transition. In this article, we try to clarify these various arguments. There are also important economic arguments favouring either a fast or a slower speed of transition (see e.g. Kornai, 1990; Murrell, 1990; Murphy, Shleifer and Vishny, 1992; Aghion and Blanchard, 1993; Burda, 1993; Bertocchi and Spagat, 1993; Gates, Milgrom and Roberts, 1993). We will not discuss these arguments in this paper. However, economic and political economic arguments about speed are often related. Indeed, the speed of reform that is optimal from the point of view of aggregate social welfare may also be less likely to violate political constraints.

The aim of this paper is to propose a framework based on recent economic theory for analyzing the role of political constraints in transition and their effects on the speed and sequencing of reform. We will compare the political argument for fast speed or big bang reforms and the political argument for gradualism implying a lower speed and a given sequencing of reforms. This typology is clearly oversimplistic. In theory and in practice, one may view transition programmes as a mixture of the big bang and the gradualist approach. It is however useful to discuss both the arguments in favour of both approaches as well as their limitations. Our purpose is not to exhaustively enumerate the pro's and con's of big bang and gradualism but rather to present a consistent view of both arguments by referring

to the underlying economic theories. This will help to clarify the assumptions and reasoning in one of the most important debates on transition. Economic policy positions are often a matter of judgement, but it is important to have a common language to understand and evaluate various policy choices.

Section 2 illustrates the importance of political constraints in economies in transition and discusses reasons for their importance. Section 3 and 4 give respectively the political economy argument in favour of the big bang and the gradualist approach to reform as well as their limitations. Section 5 discusses the role of institutional change in sequencing. Section 6 concludes.

2. HOW IMPORTANT ARE POLITICAL CONSTRAINTS ?

Political constraints appear to have played a major role in the actual transition process. In Russia, the former Parliament has blocked stabilization plans in 1992 and 1993. Prospects with the new Parliament are unfortunately not better, and important stalemate over key issues of reform is to be expected. Political constraints have played a major role in the design of the Russian privatization plan. Boycko, Shleifer and Vishny (1993) argue that the main justification for the give-away of state assets in Russia was not economic but political and that any other privatization plan than the present one would have been rejected by the political process.

In Poland, political constraints have played an important role with respect to privatization and restructuring. The Polish mass privatization plan, based on voucher privatization and the institution of mutual funds has been blocked for 3 years in Parliament and has only been adopted in April 1993 after numerous revisions, amendments and modifications. As yet this plan has not reached the implementation stage and it is not clear whether the new government will

implement it. Political constraints have also played an important role in blocking parts of the restructuring process. The intention of Balcerowicz to drastically cut subsidies to state-owned enterprises in 1990 could not materialize. Part of the fiscal subsidy cuts to firms were transformed into hidden subsidies taking the form of bank credit and interenterprise arrears. One has noted heavy worker resistance to closing inefficient state enterprises, as witnessed by the example of URSUS.

In Czechoslovakia, political constraints to privatization and restructuring were more geographically concentrated. They were much more important in Slovakia than in the Czech republic and this has played an important role in the break-up of the country.

In Hungary, one has observed political constraints with respect to privatization. The setting up of the State Privatization Agency was partly a reaction to fears of public opposition to spontaneous privatization (Dervis and Condon, 1992).

The above examples are not exhaustive and one can think of numerous other examples of political constraints in economies in transition.

Why may political constraints be important?

A first reason is related to the *redistributive consequences of transition*: not everyone will win from the transition process and there will be many losers¹. But if the transition to the market economy represents a Pareto improvement, isn't it possible to compensate the losers with the efficiency gains of reform? If this is the case, the goal of efficiency and the compensation of losers may perfectly be separated. Political constraints should therefore not influence transition programmes but only compensation schemes. So, if political constraints play a role in the design of programmes, this must be related to difficulties in compensating the losers. Let us mention three reasons: the distortionary costs of raising public

funds, asymmetric information and absence of government commitment. The first reason is evident and needs no further comment. If there is asymmetric information over welfare losses, individuals with smaller welfare losses can claim they suffer more than in reality. In the absence of screening mechanisms, governments may be obliged to concede rents to these individuals in order not to hurt those who will lose more. Moreover, absence of precommitment on compensation schemes may induce the government to renege on its promises in the future, thereby leading losers to accept reform only if compensation payments are equal to the net present value of future welfare losses. This sum may exceed the current efficiency gains, and the government may not be able to borrow enough abroad to finance these compensation payments. East European governments cannot even dream of borrowing abroad to pay transfers equivalent in height to those given to the East German population.

A second reason why political constraints may be important is related to the *aggregate uncertainty* in the transition process. Conventional wisdom about transition assumes that the end state of transition is relatively well known. Implicitly one has in mind a form of advanced capitalism as the German or the American model. If the end state is certain, the only question is how to get there. It is not certain that this is the correct view of transition. One assumes too easily that the worst scenario under transition will always be preferred to the best scenario under status quo in the socialist economy. Aggregate uncertainty may be very important. Will the outcome of transition be closer to the West German miracle after World War II or will it be closer to the Weimar republic, not to speak of Yugoslavia? Recent events in Eastern Europe exclude neither possibility. There are so many possible factors that may influence historical events in one or the other direction and there exists no established economic theory of transition. Economists don't understand the transition process very well and the possibility of aggregate uncertainty must be taken very seriously. Even if we believe that in the long run,

economic prosperity will prevail in these countries, the possibility of a protracted period of economic and political instability may make large segments of the population reluctant to engage in the reform process.

It is useful, when discussing political constraints, to distinguish between *ex ante* and *ex post* political constraints. *Ex ante* political constraints are feasibility constraints that block decision-making. *Ex post* political constraints refer to the danger of backlash and reversal after decisions have been taken and outcomes observed. *Ex ante* and *ex post* political constraints must be dealt with differently. *Ex ante* constraints imply either that compromises must be made on reform plans or that decisions on radical programmes have to be delayed. *Ex post* political constraints are dealt with by trying to create irreversibility.

3. THE POLITICAL ECONOMY ARGUMENT FOR BIG BANG.

Advocates of the Big Bang approach are less concerned with *ex ante* than with *ex post* political constraints. With respect to *ex ante* political constraints, the basic idea is that there is a *window of opportunity, a grace period*. *Ex ante* political constraints do not exist today but may be present tomorrow. Therefore, it is necessary to be quick and decisive in making all the major decisions on transition.

How does the Big Bang approach deal with *ex post* political constraints? The answer to this question is seldom explicitly given. In our view, it is best understood as a strategy of *fait accompli* to constrain a successor government by increasing the costs of reversal of policies adopted today. The idea of constraining one's successor government has been put forward by Persson and Svensson (1989)². Persson and Svensson have shown that a conservative government favouring fiscal conservatism may want to constrain the policies of its democratic successor by running a budget

deficit today. The costs of servicing the public debt will then constrain the policies of the future government. Applied to transition, the Persson and Svensson argument means that the current government will take measures today to constrain an anti-reform government tomorrow. As in the Persson and Svensson model, the main instrument for achieving this goal is a reduction in the size and wealth of government. By lifting price controls and disbanding administration, one makes it more costly to reinstate price controls. By distributing freely state assets to the population and to workers, one runs down government wealth and makes it more costly to renationalize or to expand government expenditures. This is a form of "scorched earth" politics.

An important assumption in this line of reasoning is that there is an exogenous probability of losing power. This was certainly true to a great extent before the failure of the 1991 putsch in the Soviet Union where reformer governments in Eastern Europe were uncertain about future Soviet intervention in their country. The probability of returning to power may also be partly exogenous if there is big uncertainty about who will be in power tomorrow and if current policies have a low influence on reelection probability. In troubled times such as transition, one can argue that incumbent governments tend to be ousted, independently of their policy. It could be the case that political constraints among the population are such that reelection is impossible, even with a minimal reform programme. The government may then prefer to go ahead with reform and face a low probability of reelection rather than be reelected but implement a policy that would only slightly deviate from the status quo. The argument could even be refined in the following way. By constraining the next government, one may contribute to its future electoral defeat, hoping to return later to power. If a conservative government follows a reformist government and finds it too costly to return to the pre-reform status quo, it may be put in a situation where it does not want to move ahead with reforms but cannot afford to go back. A status quo in the middle of transition would then lead to an

economic deterioration that may lead to a future electoral defeat, bringing the reformers back to power. Other variations are possible along this line of reasoning.

Are there other interpretations of creating irreversibility under a big bang approach? One may try to increase irreversibility by taking political actions today that alleviate future political constraints.³ This implies however that one wants to remain in power because important decisions must be taken in the future. This would not be consistent with the logic of the big bang approach requiring that all major decisions are taken right in the beginning of the transition process.

What are the limitations of the big bang argument?

First of all, it only works in the absence of *ex ante* political constraints. This may be the case in exceptional historical periods such as the immediate period after the regime change in Eastern Europe in 1989, but it cannot be a general prescription nor a general rule of government under a democracy where governments are regularly put under parliamentary scrutiny. *Ex ante* political constraints play an important role under democracy where a serious problem is that of the *status quo* bias (Fernandez and Rodrik, 1992): reforms that may be *ex post* acceptable to a majority may not be adopted if they are *ex ante* unacceptable whereas reforms that are *ex ante* acceptable and *ex post* unacceptable get reversed. For reforms to succeed, they must be *ex ante* acceptable and deliver an *ex post* favourable outcome. In all other cases, the *status quo* obtains.

Second, irreversibility of reforms can never be assured with 100% probability. One can only attempt to increase the cost of reversal. This cost depends however on different factors. One of the costs of reversal is the loss of credibility. By reversing transition policies, the government may lose its credibility. If the government was not initially credible, this cost is much smaller. Another factor

influencing the cost of reversal is the current economic disruption that the reform package may have produced. If this disruption is high, the cost of reversing policies is smaller. One may argue that a higher level of disruption is associated with a higher speed of reforms. When the old system is destroyed rapidly, agents must mutually learn to adjust their behaviour to the market environment. As this process of learning inevitably takes time, a quick level of destruction of the old system necessarily creates disruption in production. Actual experience and observed disruption in Eastern Europe does not contradict this view. Note however that economic theory has failed to predict or to yet fully understand the extent of the output fall in Eastern Europe.

Third, a big bang policy announcement may fail to deliver the desired policy outcome because of coordination failures. This has been studied by Roland and Verdier (1994) in the context of privatization. If there are economies of scale to the size of the private sector, a policy of full and fast privatization may generate enough growth so as to absorb the labour force made redundant from privatization. However, as private investors decide independently upon acquisition of firms, the investor response may not be strong enough to avoid large-scale unemployment, leading to partial renationalization, the prospect of which may even further deter private investors. A low level privatization equilibrium may then entail if a critical mass of privatization is not achieved, despite the government's preference for fast full privatization.

Fourth, the big bang approach to reforms may also be dangerous for public finances. Certain types of expenditures may be either irrepressible or difficult to avoid. If the government chooses a policy of massive restructuring, then inevitably the level of unemployment benefits will be very high as is witnessed by the example of the GDR. As stated above, asymmetric information about welfare losses increases the compensation requirements. Moreover, a fast approach to reform does

not allow to screen those who lose much from those who lose less. A faster approach to reform may thus, in the presence of political constraints, put a big burden on public finances (see Dewatripont and Roland, 1992a,b). The inability of government to finance these expenditures may jeopardize macroeconomic stability obtained in the early period of reform. A "scorched earth" politics of running down government wealth and reducing the tax base may then destabilize even more the macroeconomic situation.

Fifth, associated to big bang policies is the danger of political instability. If the government has used its window of opportunity to hurt large sectors of the population in the short term through its big bang package, not only will this influence negatively future elections, but it creates room for populist and fascist demagogues. Political backlash has taken place in Poland and especially in Russia. Its consequences are very risky.

Finally, the big bang approach assumes that all major decisions can be taken at the beginning of the transition period by the reformist government. This may be technically impossible to do. Some programmes may need a long time to be implemented and need careful monitoring to be successful. This is certainly the case of privatization for example. So if there is some value of staying in power tomorrow, which will generally be the case, there exist other methods of assuring irreversibility, rather by making the reform process sustainable, by building constituencies.

Despite the limitations of the big bang approach, one should recall that it is generally acknowledged that stabilization is best done through shock therapy (Sargent, 1986). Also, the fall of the communist regime did provide an important window of opportunity and strongly alleviated feasibility constraints. However, most of the lessons from the political economy of macroeconomic stabilization, as

for example the need for a government to signal its anti inflationary credibility (Vickers, 1986) may be of more limited application in the transition process where not only macroeconomic stabilization is at stake but where a change in economic systems must take place, implying a complete change of the microeconomic environment agents are facing.

In practice, none of the countries in transition has really followed a pure big bang approach and feasibility constraints have appeared in each country.

4. THE POLITICAL ECONOMY ARGUMENT FOR GRADUALISM.

Gradualism is directly concerned with *ex ante* feasibility constraints. It also deals with *ex post* political constraints but in a different way than in the big bang approach.

A first question we may ask is: why may gradualism reduce *ex ante* feasibility problems ? Why would a majority of the population refuse a programme as a simultaneous package and still accept it as a gradual one ?

The answer we put forward here is based on uncertainty. A gradual resolution of uncertainty gives an option of early policy reversal at a low cost if the outcome turns out to be bad. Policy reversals do not necessarily mean a return to a communist regime. They may be decided for example by populist and nationalist coalitions. Communist regimes are only a subset of regimes where markets and private property are not protected against ubiquitous government intervention (see Weingast, 1993b). The *ex ante* existence of this reversal option increases the willingness of the population to engage in the reform process. Gradualism also allows, in case of a successful outcome, to build constituencies for further reform.

This approach allows to design optimal sequencing of transition programmes from the political economy point of view.

To make the argument clear, we take a simplified version of the model of Dewatripont and Roland (1993). The reasoning can be followed with the help of figure 1.

INSERT FIGURE 1

Figure one shows the different choices under a big bang and a gradualist programme. We assume there are two reforms, reform 1 and reform 2, each having a good outcome $G_i > 0 (i = 1, 2)$ with probability $p_i (i = 1, 2)$ and a bad outcome $L_i < 0 (i = 1, 2)$ with probability $1 - p_i$. Each reform has a cost of reversal $\xi_i < 0$. We assume there is no discounting, thereby excluding the case where gradualism is preferred because the bad reforms are delayed in the future. We also assume that there is complementarity of reforms in the sense that under a gradualist programme, once a first reform has been implemented, the only possibilities are either to go forward or backward. This assumes that the transition process is inherently unstable and that it is impossible to remain in a no man's land between capitalism and socialism. Complementarity of reforms is analyzed by Murphy, Shleifer and Vishny (1992) and Gates, Milgrom and Roberts (1993). It is usually invoked as an argument in favour of big bang.

Looking at figure 1, one sees that the gradualist programme gives an option that is not present under a big bang programme. Indeed, if the first reform is implemented and its outcome is L_1 , it is possible to return to the status quo, assumed equal to 0 at a reversal cost ξ_1 . This is the option of early reversal.

The expected outcome of big bang is :

$$E(\text{BB}) = p_1 p_2 (G_1 + G_2) + p_1 (1 - p_2) (G_1 + L_2) + (1 - p_1) p_2 (L_1 + G_2) + (1 - p_1) (\xi_1 + \xi_2)$$

The expected outcome of a gradualist programme with reform 1 implemented first and reform 2 implemented later is:

$$E(G_{12}) = p_1 (G_1 + p_2 G_2 + (1 - p_2) L_2) + (1 - p_1) \max\{\xi_1, p_2 (L_2 + G_2) + (1 - p_2) (\xi_1 + \xi_2)\}$$

We immediately see that:

$$E(G_{12}) - E(\text{BB}) = (1 - p_1) \max\{\xi_1 - p_2 (L_2 + G_2) - (1 - p_2) (\xi_1 + \xi_2), 0\}.$$

If the cost of reversal ξ_1 is smaller than the expected outcome of reform, given that L_1 has realized, then one will exercise the option of early reversal. If the option of early reversal has value, then the expected outcome of a gradualist reform will be bigger than the expected outcome of big bang. If the expected outcome of big bang is negative and therefore unfeasible, it may still be that the expected outcome of gradualism is positive, thus making it feasible. Gradualism may therefore alleviate the feasibility constraint and get reforms started.

Why push reforms ahead if the expected outcome of big bang is negative ? One reason may be that the government and the population have different prior expectations. The government may be composed by strong believers in market reform wanting to convince a population who has a negative expected outcome. One may also take a decision-theoretic point of view and try to design the speed and sequencing of the reform package so as to maximize the expected outcome.

Not only may gradualism increase the feasibility of reforms, but it may also create irreversibility by building constituencies to get unpopular reforms adopted at a later stage of transition. To make this argument clear, assume that the expected outcome of the first reform is positive and that the expected outcome of a second reform is negative. Moreover the expected outcome of big bang is assumed to be negative. If reforms were perfectly separable, i.e. if it would be possible to have a stable situation with only half of the reforms adopted, then only reform 1 would get adopted. Reform 2 would never be adopted. However, if there is complementarity of reforms, it is by assumption only possible, after the first reform, either to go forward or backward. Then it is possible to have the second reform adopted. Indeed, if the first reform has a good outcome, G_1 , then the expected outcome of reform 2 given this good outcome is $p_2G_2 + (1 - p_2)L_2$ (negative by assumption) $+G_1 - \xi_1$, the last two expressions being positive. Indeed, if the first reform yields a good outcome people will be more ready to accept the second reform to keep the good outcome⁴. Also, pushing ahead with reform 2 avoids reversal cost ξ_1 . A good outcome in the first reform thus increases the overall expected outcome of reform. This amounts to *building constituencies* for further reform. When uncertainty is large, people are more willing to engage in the reform process once they know that initial reforms have been successful for them. People who become successful entrepreneurs were maybe reluctant to support reforms when they were still workers or ordinary employees.

In order to build constituencies at early stages of reform to push decisions at later stages of reform, it is important to avoid sequencing mistakes. In Dewatripont and Roland (1993), we show the following results:

- 1) It is better to start first with reforms having a higher expected outcome than with reforms having a lower expected outcome.

2) Under a democratic framework, it is always better to start first with reforms that are advantageous for a majority.

3) Between two reforms having an equivalent expected outcome, it is better to start first with the more risky reform. Indeed, it would be wrong to delay the more risky reform in the future. Implementing the more risky reform first reduces the risk associated to a low outcome and allows to take advantage of the early reversal option. We will come back to the risk dimension in the next section.

These are general principles of sequencing. They can be applied in various contexts, to the sequencing of different reforms, or to the sequencing of a single broad reform. For example, if restructuring is viewed to hurt more than price liberalization, then it is better, from the political economy point of view, to start with price liberalization before restructuring. Similarly, if political constraints impose gradual privatization, it is better to start privatizing the best enterprises rather than the bad enterprises. Politicians are often criticized by economists for taking half way measures or adopting inconsistent packages. This criticism often misses the point. Such political decisions often reflect political feasibility constraints. For example, a criticism often made to the Russian privatization programme is that it favours too much insiders (workers and managers). This weakness is known to the designers of the programme, but they claim that this feature of the programme reflects existing political constraints in Russia. Even in countries where the big bang rhetoric is adopted, gradualist decision-making has been taking place at different points in time. For example, all countries are in practice following a gradualist approach to restructuring as loss-making enterprises continue to be subsidized. The rhetorics of deficit-slashing has removed many subsidies from the State budget but these subsidies continue to take place in hidden form through bank credit and interenterprise arrears (see e.g. Begg and Portes, 1992).

Sequencing not only allows to take advantage of the partial resolution of uncertainty to build constituencies, it may also use "divide and rule" tactics to get reforms adopted, a point developed in Dewatripont and Roland (1992a). In the case of restructuring for example, government may start with partial redundancies hurting one group today followed by later redundancies hurting other groups, eventually hurting a potential majority of people. Hurting all groups simultaneously would be politically impossible, but it is possible, through gradual sequencing, to defeat a coalition of future losers through measures and transfers including groups in today's majority who know they will be in the minority tomorrow.

What are the limitations of the gradualist approach ?

1) The feasibility constraint is alleviated under a gradualist program only if the option value of reversal is positive. It may however be the case that no contingent reversal of early reforms can be expected. If the option of early reversal has no value, feasibility constraints are the same under a gradualist and a big bang approach. Both may then be unfeasible.

2) Conversely, gradualism may be useless if a window of opportunity exists and a big bang package is feasible. Note however that because gradualism is in general more feasible than big bang, one should observe that gradualist programmes tend to start first. Indeed in terms of our framework, it is not a coincidence if gradualist reforms in Hungary and China started earlier. It may be interpreted, other things equal, as the result of a lower feasibility constraint for gradualism. Big bang packages tend more to be adopted when there is a sharp deterioration of the status quo and a strong crisis perception. According to our

framework, gradualist programmes may start before such a strong deterioration or crisis.

3) Gradualism may also be useless if one learns nothing from the first reforms about the outcome of transition. Indeed, If the implementation of the first reform creates such disruptions that it is impossible to distinguish between the disruptions created by the destabilization of the old system and the future outcome of reform (wether good or bad), then one learns nothing from implementing partial reforms first. Some level of disruption and of noise is inevitably associated with any transition policy, but it would probably be extreme to argue that no learning takes place before all reforms are implemented.

4) The use of "divide and rule tactics" is not possible under all types of demcratic framework. It presupposes that the government has agenda-setting power, i.e. the power to determine the agenda of measures put to vote without being subject to amendements. The typical example of agenda-setting is a referendum. In many cases, government may not have agenda-setting power and decision-making is best understood by the theory of voting in committees. We know however from that theory that political equilibria often do not exist when politics has more than one dimension, and that decision-making in committees often leads to paralysis in decision-making (see Mueller, 1989 on voting in committees). From a normative point of view, this means that governments in the transition period should be endowed with a minimum amount of agenda-setting power.

5) Another important objection that may be made to the gradualist approach is that the option value of reversal deters investment. This is certainly true and may have adverse consequences on welfare⁵. A too low investor response may lower the outcome of reforms and indeed increase reversal, whereas a higher investment

response would enhance the outcome and increase irreversibility. However, the real question is whether there is more investment response under big bang or under gradualism. Recall that under big bang, policy reversal is also possible after reforms are implemented, albeit at a higher cost. Because of the uncertainty specific to the transition process, investors will in general, both under big bang and gradualist reform, gain from waiting for uncertainty to resolve before to invest. A strong investment response can therefore not be expected in either case. However, a higher speed of reforms generates higher gains from waiting. If the option value of waiting to invest is sufficiently high, one can show that gradualism may induce a higher investment response than big bang (see Dewatripont and Roland, 1993).

6) Another objection to the gradualist approach is that without a critical mass of reforms, a government does not signal future political feasibility of the reform programme to economic agents. It may indeed be the case that economic agents are less informed than the government about feasibility constraints and wait for a government signal to learn about feasibility, and thus about reversal probabilities. It may then be the case that only a radical programme can be adopted, but it will be adopted with delay. Stabilization is the usual case where this argument is made, and indeed successful stabilization packages are usually radical ones but there are often long delays before such programmes are adopted (see Alesina and Drazen (1992) on delays in stabilization). Eastern Europe has its gradualist nightmares like the Ukraine where policymakers pretend to try to fight hyperinflation through gradualism.

Finally, gradualism with a wrong sequencing of reforms may prove in some cases more damaging than a big bang approach. This leads to the issue of sequencing.

5. INSTITUTIONAL CHANGE AND SEQUENCING.

We have already written elsewhere about sequencing in transition (Roland, 1991, 1993). So in this section, we will concentrate only on the place of institutional change in the sequencing of reforms by trying to illustrate the principles of sequencing defined above in the light of the experience of transition. This is more an illustration than an application as many aspects of institutional change are still not well understood. The main question we ask here is whether institutional change should take place at the beginning of transition, before important economic reforms, or rather after economic consolidation.

Institutional changes imply first the elaboration of a new constitution defining the right of citizens, the limits of government, the political institutions of the country and basic rules governing society. Institutional change also implies the setting up of a new tax system, central bank, market regulations, etc...

Observers of transition too often equate political change only with the advent of non communist governments and free parliamentary elections. Other dimensions of constitutional change are often underestimated, such as the clear establishment of the boundaries of government, an important prerequisite for the protection of fundamental rights (Weingast, 1993a). The fundamental rules of conduct of citizens and politicians included in the Constitution are called upon not to be violated and must be the object of a large consensus. The institutionalized establishment of credible commitment for a minimum set of rules and rights is an important prerequisite for political stability which is in turn one of the most important requirements for the development of private property, investment and growth (see e.g. Rodrik, 1987).

The framework set up in the previous section leads us to conclude that it is important to realize important institutional changes right at the beginning of the transition process. Why? First, these reforms are likely to bring the highest expected return. Democracy and freedom were certainly one of the most important aspirations of populations in Eastern Europe. Only a small minority was expected to lose from them. Second, institutional change is also very risky. It may produce a solid consensual democracy but may also lead to institutional chaos and paralysis in decision making, to durable exclusion of important minorities and revival of ethnic conflicts. These two dimensions of high expected outcome and high risk imply that institutional change should be carried out at the beginning of the transition process.

The importance of constitutional changes at the beginning of the transition process has also been emphasized in recent political science literature. Ackerman (1992) criticizes the piecemeal approach of revising communist constitutions in many East European countries and insists that the establishment, through special acts visible to the public, of a constitution defining citizen's rights and the boundaries of government is fundamental for the success of economic transition (see also Rüb, 1993).

Isn't our emphasis on fundamental institutional change right at the beginning of transition contradicted by the experience of China where economic reforms are proving very successful under a communist regime?

First, one must emphasize the differences in initial conditions in China and Eastern Europe. In a rural country like China, constituencies in favour of democracy are not as strong as they were among the populations of Eastern Europe. There, the absence of political changes also blocked any move towards the market. If Gorbachev had not initiated *glasnost*, "brezhnevian "stagnation" may have

continued to the present day in Eastern Europe. Once the communist regime imploded, institutional reforms also became urgent in order to avoid an institutional vacuum. In China by contrast, Deng could get popular economic reforms like decollectivisation adopted and use them as an instrument to reinforce his power position against the Maoists, with the aim of transforming China into a new Taiwan, the Chinese Communist Party playing the role of the Kuomintang. Due to different conditions, China and Eastern Europe thus differ in the sequencing of transition.

Second, it would be false to identify institutional changes only with democratization. According to Weingast (1993a), even though China has not moved towards democracy, it has achieved an important degree of political decentralization, implying an important loss of control at the Centre and a transfer of power to local authorities⁶. Because this led to limit the power of central government, it enabled the establishment of what Weingast (1993b) calls "market-preserving federalism". Efforts after Tian Anmen to reverse economic reforms proved to be vain, as the conservatives at the Centre did not have enough power any more to curb local reform initiatives. By contrast with China, Weingast thinks that political changes in Eastern Europe, and especially in the Soviet Union and Russia, have not gone far enough in the direction of federalism, but instead relied on the discretion of reformers at the Centre to initiate economic reform.

We find it difficult to subscribe to the often expressed view that the *absence* of political change is a *cause* of the success of chinese reforms. The absence of deeper political changes leaves important uncertainties with respect to the future of reforms such as privatization for example. It is rather remarkable that, within the constraints to political reforms in China, decentraliization appeared a most clever strategic move of reformers to advance the transition process (see e.g. Qian and Roland, 1993).

The events of the past few years in Eastern Europe do not contradict the view that prior institutional changes help facilitate the transition process and conversely that the absence of such changes is an obstacle to economic reform. Let us illustrate this by offering some speculations on actual developments in economies in transition.

Russia is probably one of the clearest examples of wrong sequencing with respect to political and institutional change. The stabilization efforts of the Gaidar government have systematically been blocked by Parliament in 1992 and 1993, but this was a consequence of keeping a Parliament elected in March 1990, more than one year before the August 1991 putsch. According to our framework, it would have been necessary right after the putsch, a true window of opportunity for political changes, to immediately call for elections for a new Parliament and the democratic elaboration of a new Constitution. Much time has been lost and the success of the new fascist movement of Zhirinovsky is a heavy cost of wrong sequencing. Also, the way the recent Constitution has been elaborated is open to criticism. It is generally acknowledged that it has been drafted for Yeltsin himself and there are expectations that the Constitution may be changed in the future. The current Constitution has thus a very low credibility. One is also worried about the effect of such a Constitution if a man like Zhirinovsky gets elected for president. Centralization of power in the transition period is a very risky strategy, as emphasized by Weingast (1993a). Also, the regional aspirations to autonomy have not been well understood at the Centre. There is today the possibility of separatism at the regional level and of a generalization of ethnic conflicts. Expectations of political instability in Russia are greater than in other countries.

Economic changes in Poland in early 1990 would have been impossible without prior legitimacy of the Mazowiecki government, previous attempts at

stabilization in Poland under the Jaruzelski regime having failed. Still the institutional changes leading to the fall of the Jaruzelski regime were the result of piecemeal changes decided at the Roundtable agreements. It is an open question whether it should not have been necessary, right after the institution of the Mazowiecki government, to consolidate these changes. The new Solidarity government had the possibility to reorganize the whole civil society along new principles. There seems to have been a strong underestimation of the importance of building constituencies and of the value of political unity among former Solidarity leaders. The initial concern of the Mazowiecki government was to get the government out of the economy and to break the power of the Nomenklatura, but there was a misunderstanding, or at least a strong underestimation, of the need to have stable State institutions to support emerging market institutions. The initial unity of the Solidarity movement was not preserved and bitter divisions started to take place in the reform camp. These divisions have helped the former coalition with the Social Democratic party and the Peasants' party to come back to power. The current government does not have high credibility with respect to stabilization or to privatization.

In Czechoslovakia, there has been in the beginning of transition an important discussion and debate on constitutional change and institutional preparations have been much more careful than in Russia and Poland. However, the break up of the country itself signals a wrong message to the whole region. It implies that regional conflicts may be solved by break up of the country or even by border changes. This spells bad news for the possibility of generalized conflict in the region and increased political instability. Czech and Slovak leaders hoped that free trade would prevail after the break up of the country. They were wrong. Not only were they not able to maintain a common currency more than a few weeks after separation but trade between Czech and Slovak republics broke down and decreased roughly by 40% in the first six months of 1993.

6. CONCLUSION.

We have attempted in this paper to clarify the political economy arguments underlying the big bang and the gradualist approach to economic transition. The big bang approach emphasizes the importance of windows of opportunity when *ex ante* political constraints are less binding whereas gradualist programmes are defended because of their higher *ex ante* political feasibility. Both approaches aim at achieving irreversibility but through different means. The big bang approach emphasizes how speed in reforms may constrain a successor government, whereas the gradualist approach tries to design the sequencing of reforms so as to build, at each stage of transition, constituencies for further reform.

In concluding, it is important to emphasize again the limitations of the analysis and the complexity of the whole transition process. Paradoxically, it is a field where our knowledge as economists is very limited, and at the same time one of the fields where economists tend to be most assertive and emotional. We hope that our knowledge on transition will gradually build up at sufficient speed so as to be sufficiently useful to policy-making.

ENDNOTES

¹See e.g. Roland (1991), on the discussion of winners and losers.

²For a closely related analysis, see also Alesina and Tabellini (1992).

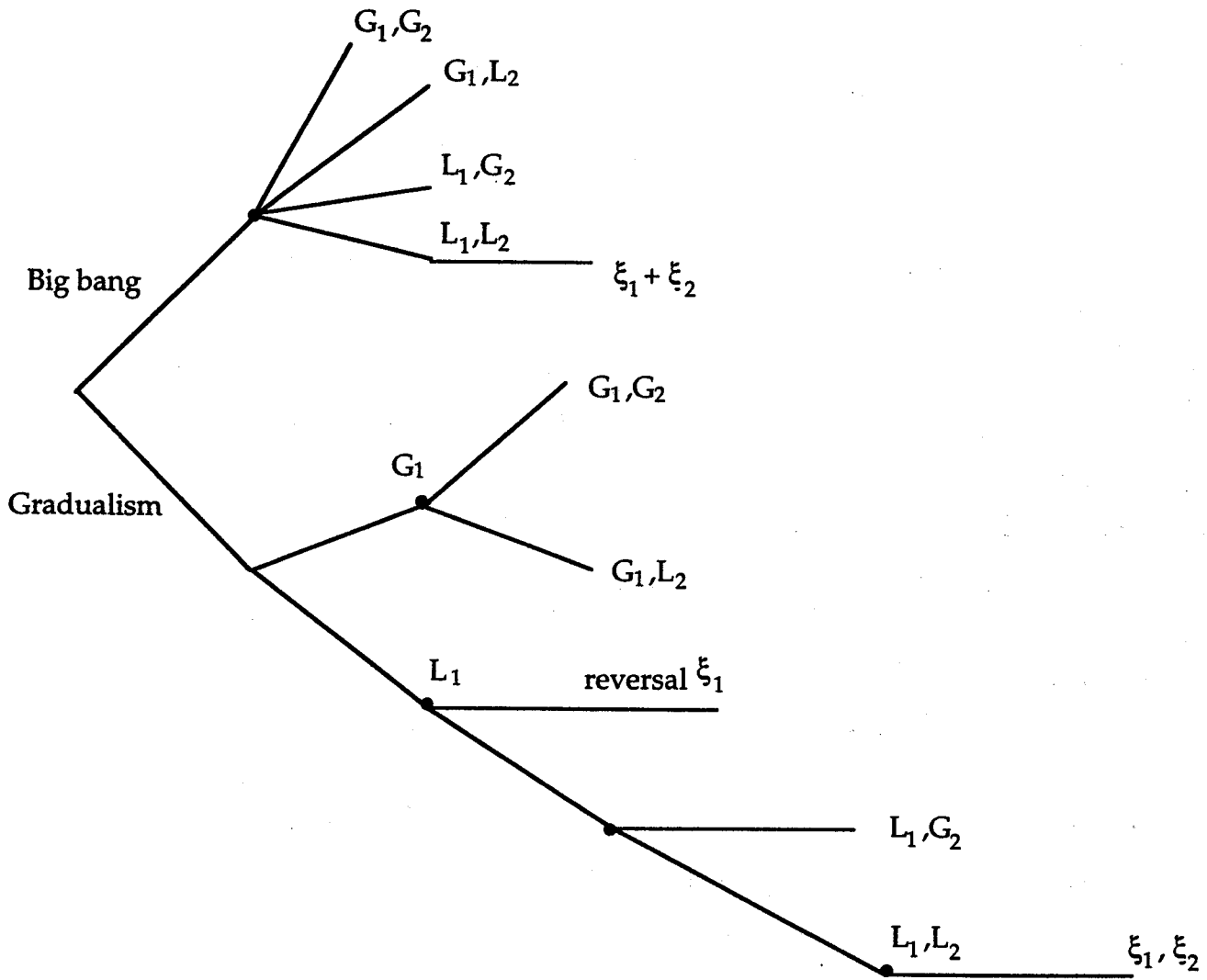
³Aghion and Bolton (1991) show how a government can positively influence its probability of reelection.

⁴ G_1 doesn't necessarily have to be directly realized, but people will have at least learnt that the outcome of the first reform will be positive in the future if the second reform gets adopted. For a more detailed analysis see Dewatripont and Roland (1993).

⁵Note however that in the socialist economy, before transition, there are more problems with overinvestment than with underinvestment. Because of soft budget constraints, ex ante screening of projects was the only instrument available to avoid overinvestment. Qian and Xu (1991) show that this feature of the socialist economy had adverse effects on innovation because of too much early screening.

⁶See also Montinola, Qian and Weingast (1993).

FIGURE 1.



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