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While in Central-Eastern Europe and in the Baltics democracy and market reform have been consolidated, culminating in entry to the European Union, in the states of the former Soviet Union democracy and economic reforms are still lagging, and in some cases we observe reversals in both political and economic reforms. The article identifies the risk of a "trap" of partial reforms, both political and economic. Incentives for further reforms are weak for policy makers, and at the same time opposition to reforms by citizens increases. Lack of competition and concentration of economic power lead to opposition by wealthy people, while the lack of social safety nets leads to opposition by those adversely affected by reforms. An external anchor (e.g., entry or candidacy to entry in the European Union) seems to be crucial; lacking such an anchor, the process is much harder.

Keywords: democracy; economic reforms; transition; reform reversals

Transition countries have been a laboratory for investigating the relationship between the politics and economics of reforms. Indeed, transition countries went through, and in some cases are still going through, a process of radical political change accompanied by far-reaching economic reforms on the way to building market economies. In the sixteen years that have elapsed since the fall of the Berlin Wall, transition has brought mixed results. While the countries of Central-Eastern Europe and the Baltics have completed their transition and secured entry into the European Union, most countries of the former Soviet Union (FSU) have built neither 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 the possibility of its 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

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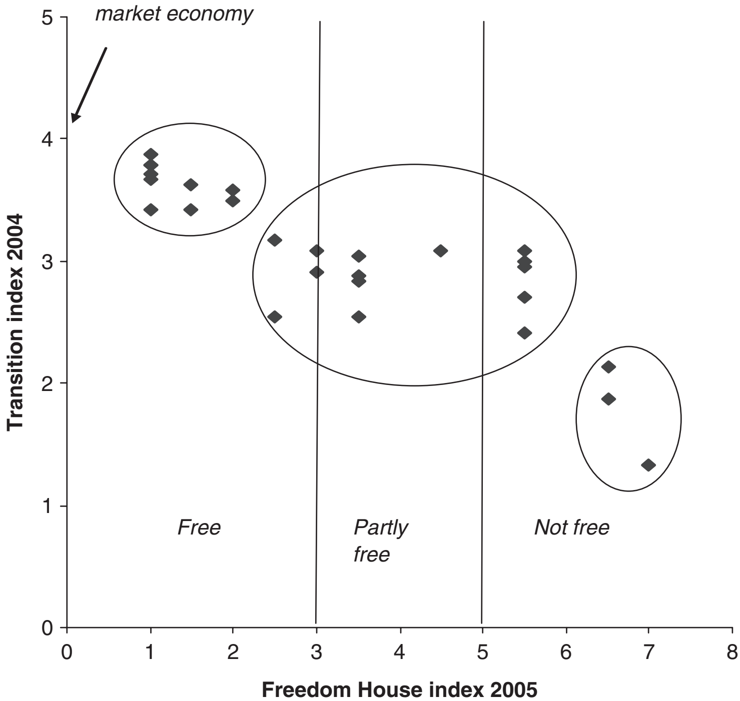
authoritarian regimes have been observed in history, in transition countries a democratic regime has been a powerful engine for economic reform, which in turn has been an important factor in consolidating democracy. We find that partial political and economic reforms expose countries to a backlash, culminating in the reversal of reforms. The problem is that once trapped in a bad equilibrium of partial reforms, governments have weak incentives to move toward a full-fledged democracy. At the same time, contrary to the views of several optimistic observers,[1] the demand of powerful lobbies (e.g., the "oligarchs" in Russia) for the imposition of the rule of law has proven to be very low. 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 European Bank for Reconstruction and Development (EBRD) transition indices as a proxy for economic progress toward a full-fledged 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 gray area in the middle, showing that gains in terms of economic reforms are very small at the margin for not free or partly free countries. Indeed, moving from authoritarian regimes to partly free regimes does not lead to visibly more ambitious economic reforms.[2] One simple inference from this stylized fact is that to achieve a market economy one needs large-scale democratization. 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 capitalist market economy is a necessary, though not sufficient, condition for democracy.[3]

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. The

Figure 1. *Democracy and economic reform*



introduction of freedoms in the political realm has created consensus and tolerance for radical economic reforms. These, in turn, have paved the way for economic growth in the medium term 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 to 2004, there have been thirty-eight elections in the new member states of the European Union; in thirty of them, elections led to a dismissal of the government.[4] In contrast, during this same period, the countries of the FSU have experienced only partial political change, poor economic performance, and minimal foreign direct investment. 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 arenas.

Figure 2. *Democracy and growth: A highly nonlinear relationship*

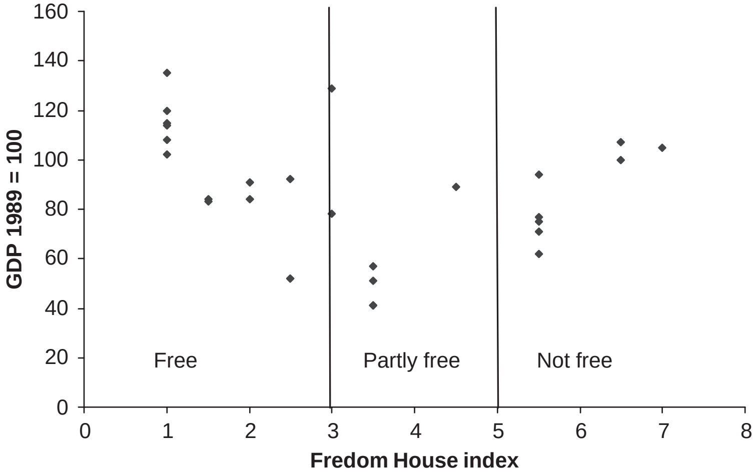


Figure 2 illustrates the "trap" of partial economic reforms and partial political liberalization. Although full-fledged democracies display better outcomes in terms of cumulative growth since the start of reforms, the worst performance is associated with intermediate regimes. This implies that the "opening up" of authoritarian regimes will confront them with the quandary of more political freedom and some additional economic reforms being associated with a deterioration of economic performance, which may in turn create dissent with and opposition to governments.

These results are consistent with the idea that economic reform has a short-term negative impact on growth. Only over the course of time does the effect turn positive.[5] Thus, the benefits of reforms are not immediately discernible. Under these conditions, myopic governments may backpedal so as to avoid losing support among citizens who have been adversely affected by reforms.

The countries of Central-Eastern Europe benefited from two main factors that enabled them 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 their potential costs were weighed against the benefits of freedom.[6] Later on, accession to the European Union provided a credible anchor and a unifying framework for reforms. A peculiarity of EU accession was also that political and economic reforms were complementary, as entry into the European Union required the prior establishment of a democratic society and a well-functioning market economy. The countries of the FSU, meanwhile (with the notable exception of the Baltic states), lacked both the initial "honeymoon" period and the external anchor of accession to the European Union. Right now, only Ukraine has a chance, albeit small, to use accession to the European Union as a driving force for implementing domestic political and economic reforms.

In addition to the aggregate effects of reforms and the consequent support or opposition evinced, it is important to analyze their distributional or asymmetric effects. Indeed, such asymmetries may create opposition to reforms even when, taken in aggregate, the overall effects would be positive. A well-known argument in the political economy literature that looks at such reforms is that negative effects are immediately visible, while benefits are more diluted and less readily discernible.[7]

As a result, even a dissenting minority may effectively block reforms while there exists uncertainty over who exactly would ultimately benefit and who would lose out. An interesting question is thus the relationship between democracy and inequality.

Democracy and income inequality

The empirical literature, especially as it concerns developing countries, finds that democratic regimes tend to be characterized by less inequality in income distribution.[8] The experience of transition countries, however, contradicts such a view, as inequality increased with the movement toward more democratic societies. However, as has been noted by Gradstein and Milanovic,[9] there is a timing problem in evaluating the relationship between democracy and inequality in transition countries. Indeed, democracy may ultimately reduce inequality, but this takes time; initially the simultaneous introduction of democracy and market reforms tends to increase inequality while having an adverse initial effect on growth. Looking at more recent data, we find that democracy is also associated with less inequality in transition countries (Figure 3).

Recall that a lower index score correlates with a higher democratic governance score. In Figure 3, democracy is measured by the 2004 democracy index, while inequality is measured by the 2002 Gini coefficient of income distribution (latest available). With the exception of one outlier (Belarus), less democracy is clearly associated with more inequality. However, the relationship between the change in inequality and democracy is highly nonlinear with respect to the latter. Again, we find that partial democratization leads to the worst outcomes (Figure 4). Partial, limited democracy is indeed associated with more inequality than either full democracy or, conversely, no democracy.

It is important to note that the countries of Central-Eastern Europe tackled the adverse effects of reforms on income inequality by constructing social safety nets. Central-Eastern European countries spend almost twice as much in terms of GDP in social protection than countries of the FSU.

This is an additional element in the partial reform trap that we identified earlier: more democracy and more reforms produce more inequality initially, which in turn induces opposition to economic reforms and democratization by governments that want to ensure consensus.

Finally, the level of democracy exerts an important effect over the probability of a backlash or reversal of economic reforms.

Durability of reforms and reversals

Using the EBRD transition indices, we identify reversal in reforms as a negative change in reform indicators. We found 27 cases of reversal. Reversals were not affected by negative economic performance, such as slow growth of GDP and low inflow of foreign direct investments.[10] However, it is remarkable that all reversals occurred in countries with incomplete democracy.[11] This is consistent with the view that in less democratic regimes there is more uncertainty concerning the path of reforms and the durability of reforms implemented in the past.

Figure 3. *Democracy and income inequality*

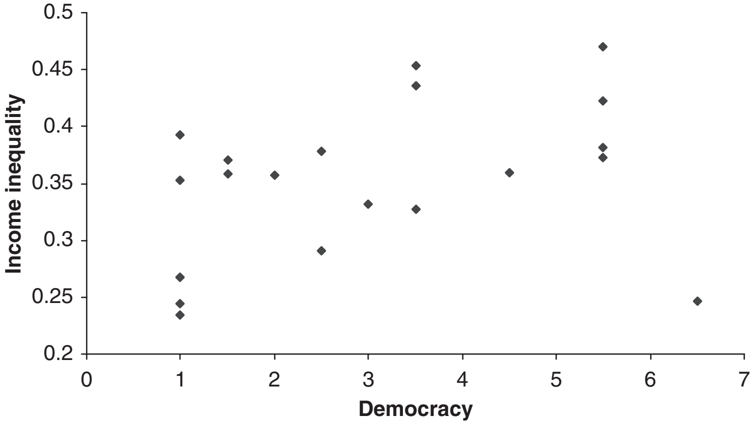
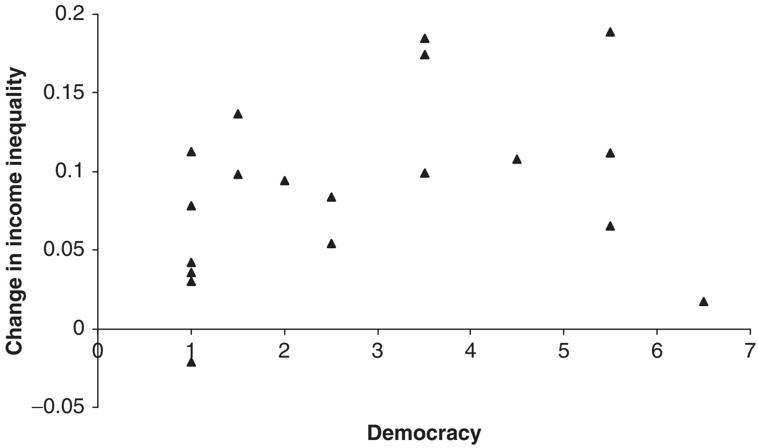


Figure 4. *Change in inequality and democracy*



Conclusions

The above analysis identified the trap of partial reforms and partial democratization, a finding in line with the view propounded by Weingast on the stability of unconsolidated, and thus incomplete, democracies.[12] It is unclear how a country can extricate itself out of such a negative equilibrium. This implies that it is unlikely that democracy and the building of a well-functioning market economy will emerge gradually within states that are authoritarian or only partly free. Revolutions of different colors seem necessary: countries have to go through radical political changes that will ensure the introduction of democratic political regimes. It is true that Russia may be more "normal" than we assume;[13] after all, many Western capitalist societies have wealth and power, as well as control over the media, concentrated in a few hands. Nevertheless, there is still a long way to go before the process of transition is completed in most FSU countries. How is it possible to get out of the dual trap of partial democratization and partial economic reform? The key is to create sufficient incentive for politicians to implement reforms and popular support for them. The development of a much stronger middle class is thus perhaps the key to ensuring a successful process of democratization and market reform. Important as well are safety nets for the poor as well as those segments of the nascent middle class still at risk of falling into poverty. The rule of law should be strengthened. Governments cannot be held hostage by oligarchs, but at the same time government cannot arbitrarily confiscate private property. The attention of the international community should be increasingly directed toward ensuring respect for the rule of law, seeing to it that greater numbers of the individuals have recourse to social safety nets, and defending the democratic process. The dilemma, to paraphrase 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 such as the oligarchs.[14] An additional dilemma is how to ensure effective safety nets (which imply large social expenditures), without interfering with incentives for economic progress and low distortions from the tax system.

Notes

1. See, among others, Andrei Shleifer and Daniel Treisman, "A Normal Country" (NBER Working Paper 10057, National Bureau of Economic Research, Washington, D.C., 2003).
2. This may explain the absence of correlation between the change in democracy and the change in transition index (magnitude of reform): the correlation coefficient is indeed .048.
3. Janos Kornai, "The Great Transformation of Central Eastern Europe: Success and Disappointment" (Presidential Address, International Economic Association, 14th World Congress, Marrakech, Morocco, 2005).
4. Ibid.

5. Bruno Merlevede, "Reform Reversals and Output Growth in Transition Economies," *Economics of Transition* 11:4(2003): 1146-55.
6. See Kornai, "The Great Transformation."
7. Raquel Fernandez and Dani Rodrik, "Resistance to Reform: Status Quo Bias in the Presence of Individual-Specific Uncertainty," *American Economic Review* 81:5(1991): 203-34.
8. See Mark Gradstein and Branko Milanovic, "Does Liberté = Egalité? A Survey of the Empirical Links between Democracy and Inequality with Some Evidence on Transition Economies" (Policy Research Working Paper 2875, World Bank, Washington, D.C., 2002), among others. This is consistent with Hellman's idea that more democratic regimes are characterized by a more inclusive attitude toward losers (e.g., utilization of social transfers) than less democratic regimes, which usually protect only small groups of winners ("oligarchs"). See Joel S. Hellman, "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions," *World Politics* 50 (1998): 649-69.
9. Gradstein and Milanovic, "Does Liberté = Egalité?"
10. We carried out a probit estimation on the twenty-seven cases and found that the sign of coefficients for GDP growth and foreign direct investment inflows were correct, but they were not statistically significant. By contrast, a one-unit decrease in the democracy index reduces the probability of reversal by more than 40 percent.
11. Nauro Campos and Roman Horvath, "Reform Redux: Measurement, Determinants and Reversals," (CEPR Discussion Paper, CEPR London, May 2006).
12. B. Weingast, "The Political Foundations of Democracy and the Rule of Law," *American Political Science Review* 91:2(1997): 245-63.
13. See Shleifer and Treisman, "A Normal Country."
14. Kornai, "The Great Transformation."