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Great expectations: a tale of two transitions

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Abstract

Over a quarter of the world's population lives in economies that have undertaken transitions from central planning to market economies. These transitions entail far-reaching and complex changes in social, economic and political institutions and have had widely divergent outcomes. Important strands of literature have emphasised the strategic complementarities that characterise the transition process in both the economic and political realms. Contrary to a widespread assumption, market-supporting institutions do not necessarily arise when assets are privatised in a highly unstable and uncertain environment; in fact, multiple equilibria emerge and expectations may play a key role in equilibrium selection. In this paper, we survey the vast empirical literature on transition economies in order to provide evidence on the correlation between expectations at the beginning of transition and success of the transition process. We provide the first comprehensive survey of the literature on agents' subjective perceptions of transitions' paths.

JEL classification: D73 (Bureaucracy, Administrative Processes in Public Organizations, Corruption); P31 (Socialist Enterprises and Their Transitions); P26 (Political Economy, Property Rights); K42 (Illegal Behavior and the Enforcement of Law).

Keywords: Transition, expectations, multiple equilibria, property rights.

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“Ex nihilo, the jungle” (Yegor Gaidar, Russian prime minister 1991-2; Speech at the Annual World Bank Conference in Development Economics in Oslo, June 2002; cited in Hoff (2003).

“In China, the overriding need is for stability. Without a stable environment, we can accomplish nothing and may even lose what we have gained” (Deng Xiaoping to President George H. Bush, February 26, 1989; cited in Kam C. Wong, *Police reform in China*, CRC Press, 2012, p.242).

1 Introduction

Understanding the transition process from a centrally planned system to a market economy is important. It is important because about a quarter of the world’s population currently lives in countries which have not completed the transition, and because we are still experiencing the political aftershocks of the transition process, in both the domestic and foreign policies of transition countries. Transitions entail enormously complex and long-term transformations of social, political and economic institutions (Groves, Hong, McMillan, and Naughton 1995, p.888). But understanding the transition to a market economy is important also because it sheds light on the pitfalls of major institutional transformations in the presence of significant uncertainty on property rights, the rule of law, and the political framework (Hoff and Stiglitz 2008; Gans-Morse 2017).

One significant strand of the literature on transition economics has emphasised the strategic nature of agents’ decisions during transition, and the possible emergence of coordination failures. As early as 1992, Shiller, Boycko, and Korobov (1992) suggested that Russia and Ukraine may be stuck in what they called a ‘bad expectations equilibrium’, whereby a “Keynesian vicious circle may be at work: many people do not invest in the current system because they believe that it will not perform for them . . . their pessimism and reluctance may impede the system, and tend to cause the very disappointments and failures they feared” (Shiller et al. 1992, p.180). And self-fulfilling expectations are at the core of Janos Kornai’s celebrated theory of the soft budget constraint, both during the socialist era, and during transition (Kornai 1992). This paper provides a comprehensive survey of the role of ac-

tors' expectations about transition outcomes, gathering evidence from disparate studies by economists and political scientists across all transition countries.

Special attention has been devoted to the complementary role of economic, political, and institutional aspects of the transition process, and the strategic complementarities arising in a number of contexts. The dismantling of the planned system will proceed very differently depending on whether new, and functional, institutions are built, and the rule of law prevails. The experience of transition economies shows that the emergence of functioning market institutions should not be taken for granted. Coordination failures can occur with respect to the size of the underground economy (Johnson, Kaufmann, and Shleifer 1997b) and, more generally, compliance with the law (Roland and Verdier 2003). A number of studies have emphasized technological externalities in the production of the relevant institutions upholding the rule of law: when a large enough fraction of the population chooses to go underground and violate the law, and evade taxation, public finances and public sector capacity collapse. In these contexts it will be an equilibrium for most individuals to operate in the unofficial economy.¹

Coordination failures may also arise in the political process and the agents' *demand* for the *establishment* of the rule of law (Hoff and Stiglitz 2004, 2008). “[W]hen enough individuals oppose the rule of law, the probability that it will be established falls, which reduces the economic incentives of other asset holders to invest [and increases the incentives for asset stripping] and so affects their ‘votes.’ Individuals’ demands for the rule of law are thus interdependent” (Hoff and Stiglitz 2004, p.754). In a similar vein, Gans-Morse (2017) identifies coordination failures in the firms’ demand for the *use* of legal institutions to protect property rights: when a sufficiently low number of firms resort to legal strategies to protect their investments, this increases the cost of adopting such strategies for every firm.

In a related contribution, Wengle, Girardi, and Veneziani (2023) model the transition process as an assurance game, in which enterprise managers decide whether to play by the

¹See also Lau, Qian, and Roland (2000); Konstantin (2003).

rules of the newly established market economy or defect into the informal sector based on expectations about the path chosen by other actors. In their model, agents in the law enforcement apparatus face a similar choice of compliance or defection, and their optimal decision depends on what they expect others to do. As a result, both sustained growth and economic/institutional collapse can be self-enforcing equilibria, and self-fulfilling prophecies are possible.

These models predict (at least) two possible trajectories for transition economies (Johnson et al. 1997b; Hoff and Stiglitz 2004, 2008). One with high growth and the establishment of a robust political and institutional framework. And one characterised by dismal economic performance and weak institutions. “The multiplicity of equilibria should . . . be seen as relevant to understanding transition. Indeed, the massive societal change creates a huge coordination problem and coordination in law enforcement is one of the important coordination problems” (Roland and Verdier 2003, p.676).

Empirically, there is anecdotal and indirect evidence suggesting that the mechanisms emphasised by these models have been at play. In their vivid, and authoritative description of 1990s Russia, Black, Kraakman, and Tarassova (2000, p.1767) observe that “Honest and dishonest behavior alike can be contagious, and Russia fell into a dishonesty equilibrium. . . . Transfer pricing schemes and other dodges to hide profits from tax collectors and minority shareholders are all but universal. A few controllers invest some of the hidden profits in new capital equipment, but many more pocket the profits, often offshore. Total business investment is very low”. In contrast, ten years after the launch of *doi moi* reforms in Vietnam, Webster (1999, p.15) remarked that “the economic model currently in place in Vietnam reflects socialist legality with the state as the lead economic strategist and import substitution, heavy industry and state-owned enterprises as the mainstay of industrial growth. *This framework is internally consistent, transparent, and apparently accepted by the public at large.*”

More generally, it has been notoriously difficult to identify single, specific policies that

determine the success of the transition process (Stiglitz 1999). A focus on one, or a small set of variables leads almost invariably to partial conclusions that cannot be generalised (Aslund, Boone, and Johnson 1996). In their comprehensive survey of the evidence, for example, Djankov and Murrell (2002) find that privatisation is strongly associated with more enterprise restructuring and product market competition has a significant effect in improving enterprise performance. Yet, “The privatization effect is . . . statistically insignificant in the Community of Independent States, [and] in the CIS domestic competition is sometimes statistically insignificant while import competition generally has a negative effect on enterprise restructuring” (Djankov and Murrell 2002, pp.740-1). The effect of individual policies strongly depends on the institutional, social and political context. For example, “Competition creates incentives for breaking contracts when institutions are weak” (Djankov and Murrell 2002, p.763). Similarly, the rather inconclusive debate on shock therapy vs. gradualism strongly suggests that the speed of transition is not, by itself, the main determinant of success.

Granting the existence of multiple equilibria, however, immediately raises the issue of equilibrium selection. History certainly plays a role, as “past events set the preconditions that drive the economy to one or another steady state” (Krugman 1991, p.652). Nonetheless, as Krugman (1991) forcefully shows, in a range of scenarios the past will not be sufficient to explain the dynamics of the economy, and agents’ expectations play an independent – and in extreme cases even self-fulfilling – role in equilibrium selection: agents act on their beliefs and the equilibrium outcomes eventually confirm those beliefs. This seems particularly true in transition economies, because “It is at times of transition that new myths and beliefs are created” (Hoff and Stiglitz 2008, p.1493).²

²Below, we shall consider instead an indirect channel through which history may matter, as “History also affects outcomes by affecting beliefs. An obvious case is one where expectations are (at least partly) adaptive: individuals expect people to behave in the future as they have in the past. But even with fully rational expectations, history can cast a long shadow. For example, an outbreak of corruption, or the revelation that some firms in an industry passed off shoddy goods as high-quality goods, can tarnish the reputation of the whole industry and reduce the incentive of every member of the group to behave honestly in the future” (Hoff 2001, pp.149-150).

In order to evaluate the explanatory power of models with multiple equilibria one would need internationally comparable data on agents' expectations at the beginning of transition (e.g. when the reforms are announced). Moreover, an unbiased formal statistical test of the hypothesis of an independent influence of expectations would also require quantitative measurement of some source of 'exogenous' variability in beliefs, orthogonal to the other factors that can affect transition outcomes. Unfortunately, there exists no study in the literature containing such data and none can be conducted ex post. Nonetheless, the lack of a systematic empirical cross-country study gathering information on expectations at the start of transition does not mean that no evidence exists. This paper provides the first comprehensive survey of the literature on the subjective perceptions of economic agents concerning the transition path.

To fix ideas, let γ be a variable measuring the success of the transition process on a 0-1 scale. Given the strategic complementarities emphasised in the literature, γ can be thought of as the proportion of agents that opt to abide by the government's transition plan – e.g. pay taxes, stay in the formal sector, invest productively, restructure firms, and so on. When deciding their own optimal action – abide by the government transition strategy or defect into the informal sector – agents need to form an expectation on γ since their payoff will be determined by the success of the transition plan.

This paper aims to provide direct and indirect evidence on such expectations – which can be denoted as γ^e – and show that optimistic expectations are correlated with success in transition, whereas pessimistic expectations correlate with transition processes gone off the rails.

Let $\gamma^e = E(\gamma|\Omega, S)$ where E is the expectation operator, Ω is the information set which economic agents use to formulate an expectation (policies, initial conditions, the business environment, institutions, legal framework, regulations, and so on), and S captures cross-country differences which determine the way in which the same information Ω is processed, what makes certain pieces of information in Ω salient, and so on (basically, cross-country

differences in culture, history, social norms, etc.). For example, poor macroeconomic management and high levels of macroeconomic instability at the beginning of the transition process increase the level of unpredictability of the economic environment making conducting business and enforcing contracts and laws more complicated,³ and this may determine a pessimistic outlook both on the transition process and on the behaviour of other agents.

In this paper, we present an extensive review of the empirical literature in political science, economics, and sociology on the subjective perceptions of economic agents living in transition countries. On the one hand, we review the direct evidence on γ^e in a time interval that is as close as possible to the beginning of the transition process. This includes surveys measuring the SOE managers', all managers', or even the general population's, confidence on the transition process in general, and also on the likelihood that other agents will abide by government plans and policies. On the other hand, we survey a wealth of empirical studies on Ω as well as historical and sociological analyses of S , in order to highlight environmental, cultural, and historical factors that have likely influenced expectations, focusing, again, on the agents' subjective beliefs, perceptions, and attitudes.

Two disclaimers should be made at the outset. First, it is important to stress the importance of the holistic nature of our approach. For lacking direct, internationally comparable evidence on γ^e a focus on a single variable, or even a small set of variables, without taking the overall context into account is likely to be misleading. A lively press acts as a watchdog in liberal economies, but it may have a negative effect on expectations in a transition economy, when it exposes corruption scandals.

A proper account of expectations at the most crucial juncture in the transition process must therefore be as comprehensive as possible, and include both quantitative variables and qualitative analysis; econometric evidence and historical and institutional insight; policy decisions and political developments.

Second, our focus on expectations is analytical, as we believe that they do play a role

³See, for example, Blasi, Kroumova, and Kruse (1996, Chapter 3) and McMillan and Woodruff (2002, pp.162-3).

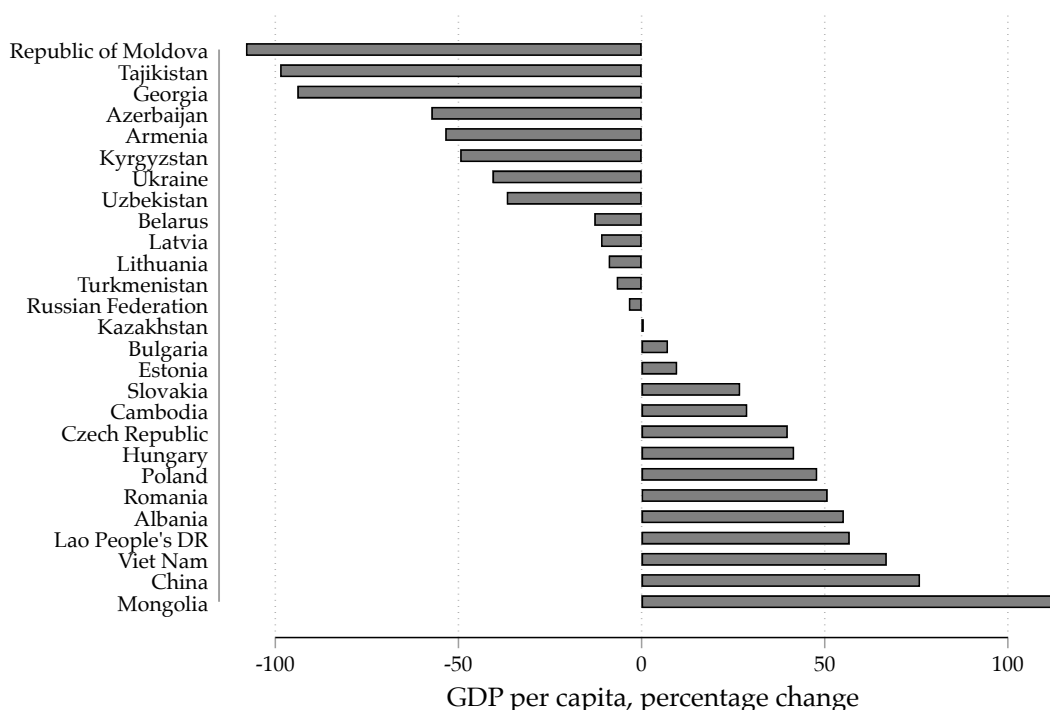
in transition economies, but we do not mean to suggest that expectations are the only thing that matters and agents can will themselves into a successful transition path. The structural features of transition economies are crucial. However, we do believe that in a highly uncertain environment, expectations are at the same time independently important and a key channel through which structural features exert their impact, and should therefore be taken into account when designing policies. A successful transition strategy is made up of sound policies which are also credible.

The rest of the paper is structured as follows. In section 2, we precisely define transition, specify the timeline for the various countries and provide evidence on the *actions* and the equilibrium *outcomes* focusing both on economic variables, and on the political and institutional environment at a later stage in the transition process. This allows us to identify clusters of countries which have succeeded or failed in the transition process. Then, in the rest of the paper we explore the literature to provide direct (section 4) and indirect (section 5) evidence on *subjective expectations*.

2 A tale of two transitions

Models with multiple equilibria examine the intersection of economic transformation and broader institutional, legal, and even cultural changes redefining property rights, and the structure of the state. Successful countries manage to solve the uncertainties inherently related to the transition and settle eventually on a growth path *and* a growth-friendly legal and institutional structure. Countries in which the transition goes off the rails are characterised by weak institutions, *and* low growth. In this section, we illustrate the existence of clusters of countries characterised, on the one hand, by high output, high compliance, optimistic expectations, and on the other hand, low output, low compliance, and pessimistic expectations. We look at various performance indicators of economic success and institutional robustness (the outcomes) *at a later stage of the transition process*, but also at the *actions*

Figure 1: Cumulative growth in GDP per capita in the 15 years after transition



taken by agents at various stages of the process.

Outcomes: output. GDP per capita is a rough and ready indicator of *economic* success (and failure). Consider a former planned economy, a decade and a half into its transition. At this stage, if economic activity is still below the pre-transition level, the country can be taken as trapped in a low equilibrium, whereas a country that has taken off (possibly after an initial fall in output) can be defined as having experienced a successful transition.

Figure 1 displays the cumulative growth in GDP per capita in the 15 years after the start of transition, for a range of transition economies. In the Figure, the year in which transition starts is not common to all countries, but country-specific. For example, for China, we take the growth in GDP per capita over the 1979-1994 period. For the Russian Federation, we compute GDP growth over the 1987-2002 period.

To be sure, the comparison between the level of pre-transition income and GDP after 15 years – while plausible – has an inevitable degree of arbitrariness. Nonetheless, GDP corre-

lates with various other indicators of successful transition (European Bank of Reconstruction and Development 1999; Havrylyshyn and van Rooden 2000). More importantly, given the well-known inefficiencies of planned economies, and the explosive effect of competitive forces predicted by theory, if a country has not recovered from the initial output shock after a decade and a half, this suggests that something has indeed gone wrong (Stiglitz 1999).

From this perspective, it seems clear that China, Vietnam, Mongolia, Poland, Hungary and the Czech Republic represent paradigmatic examples of successful transitions, while Russia, Ukraine, and, to some extent, Bulgaria have been trapped in a low-output path.⁴

In general, “there is a growing body of evidence that the business environment . . . has a significant impact on aggregate economic performance” (Carlin, Fries, Schaffer, and Seabright 2001, p.6) and a number of empirical studies have found strong links between the business environment, broadly conceived, and a number of performance and restructuring indicators in transition economies (Johnson et al. 1997b). For example, Hoff and Stiglitz (2004, p.755) observe that in the six transition economies where property rights were found to be most insecure in 1999 in a survey study, by official statistics GDP in 2000 was still 30 percent lower than GDP in 1989.⁵ It is therefore to be expected that a similar clustering appears when looking at various indicators of institutional robustness.

Outcomes: the unofficial economy and the rule of law. Roughly five years into the transition, Johnson, Kaufmann, and Shleifer (1997a, p.17) find that “there is indeed a strong difference between countries in the former Soviet Union [FSU] and countries in Eastern and Central Europe [CEE] in both the share of the unofficial economy and the growth rates”.⁶ In 1995, the estimated share of the unofficial economy was 12.6% in Poland,

⁴Fifteen years after the beginning of transition Bulgaria had recovered from the initial recession, and thus in principle it does not represent an example of failed transition. Nonetheless, it had only *barely* recovered and most of the recovery occurred after 1997 when the country started accession talks with the EU (Stiglitz 2000, Figure 3). Up until 1997, Bulgaria had one of the worst transitions in Eastern Europe (OECD 1997).

⁵On Russia, see Blasi et al. (1996, pp.139-40) and Black et al. (2000); on Bulgaria, see OECD (1997, pp.59, 94); on China, see Gordon and Li (1995); Naughton and Yang (2004).

⁶Belarus and Uzbekistan are clear outliers, while the Baltic countries and Bulgaria are somewhat exceptions in the former and in the latter group, respectively. The two groups of countries also display very different trajectories, with an upward trajectory in the former group.

19.1% in Romania, 5.8% in Slovakia, but 48.9% in Ukraine and 41.6% in Russia (Johnson, McMillan, and Woodruff 2000, p.5).

Based on a survey of 437 top managers (CEOs) of SMEs in Russia and Bulgaria in the Summer of 1995, Pissarides, Singer, and Svejnar (2003, p.508) find that “two-thirds of the Bulgarian [and] 44 percent of the Russian firms report paying for protection of their premises and the cost or constraint associated with this activity is not reported to be important”. Hillman, Mitov, and Peters (1996) estimate that from 1992 on, 90 per cent of the estimated operational surplus in the Bulgarian economy was in the informal sector. By mid-1996, the size of the unofficial economy in Ukraine was estimated to be about one-half of overall GDP, possibly the largest share among CEE and FSU countries (Kaufmann 1997).

Based on a panel of investment professionals, at the end of 1997, on a 0-10 scale, the robustness of the rule of law was rated 9 in Poland, 6.4 in Romania, 6.2 in Slovakia, but 5.4 and 3.9 in Russia and Ukraine, respectively, and a similar ranking emerged concerning corruption (Johnson et al. 2000, p.5).⁷ More generally, the two groups of countries differ starkly along a number of dimensions, including the percentage of firms making extralegal payments, the fraction of unreported income and employees, the amount of bribes paid, and the use of extralegal means of settling trade disputes (Johnson et al. 2000, Table 1).⁸ See also Shleifer and Frye (1997, Table 1) and the World Bank worldwide survey of entrepreneurs conducted in 1996-7 (Brunetti, Kisunko, and Weder 1997, 1998).

According to Tenev, Carlier, Chaudry, and Nguyen (2003, p.15), in Vietnam the informal sector was about 30 % of GDP in 1997, which is not particularly high given that, unlike many other transition countries, Vietnam is not just a transition economy but also a *developing* economy. Indeed, the share of the informal sector in Vietnam is *lower* than that of countries at an analogous development stage.

⁷Quite tellingly, when asked about the initial sources of capital firms in these five countries reacted very differently: response rates “were near 100 per cent in Poland, Romania and Slovakia, but only around 30 per cent for Russia and Ukraine” (Johnson et al. 2000, p.10).

⁸Interestingly, contra Boycko, Shleifer, and Vishny (1993) the official burden of taxation in the two groups is not so large and therefore cannot explain the existence of multiple equilibria.

These results are confirmed by the World Bank's Business Environment and Enterprise Performance Survey conducted in 1999, which shows a clear divide along similar dimensions between a number of FSU countries (including Russia, Ukraine and Moldova) and Bulgaria, on the one hand, and the CEE countries, the Baltics, and Romania, on the other hand (Hellman, Jones, Kaufmann, and Schankermann 2000; Carlin et al. 2001).⁹ Based on a survey of privatised firms in 1996, the picture in Mongolia is quite similar to that of the virtuous countries both in terms of the means to settle trade disputes (Anderson, Korsun, and Murell 1997, Table 12) and in terms of respecting the law (Anderson, Korsun, and Murrell 1999, Tables 8-9).

In the 2000 World Business Environment Survey, Chinese entrepreneurs reported levels of corruption comparable to those of OECD countries, with 0.6% of revenues going in bribes and more than 80% of firms declaring to pay nothing in bribes (Batra, Kaufmann, and Stone 2002, Section B.4). With 2.6% of revenues used for bribes, Vietnam was also below the world average and fared better than most areas of the world (Tenev et al. 2003, Table 2.6). In both China and Vietnam, corruption was a problem various orders of magnitudes smaller than in CIS countries (and even in CEE countries) (Batra et al. 2002, Section B.4).¹⁰

Actions: asset stripping and noncompliance. There are many detailed accounts of the massive phenomena of asset stripping ('spontaneous privatisation') and noncompliance both during Gorbachev's perestroika (Johnson 1991; Solnick 1998) and in the Eltsin era (Black et al. 2000). In their 1992-93 survey of Russian firms, Shleifer and Blasi (1996) find breath-taking rates of noncompliance with corporate governance laws, and in particular with the two Presidential decrees on cumulative voting (86%) and on the upper limit on insider members of boards of directors to 1/3 (98%).

⁹"In response to the survey question, 'I am confident that the legal system will uphold my contract and property rights in business disputes,' a staggering 75 percent of firms in Russia, Kyrgyzstan, Moldova, and the Ukraine stated that they disagreed" (Hoff and Stiglitz 2004, p.755). See also the division between high-capture and low-capture countries in European Bank of Reconstruction and Development (1999).

¹⁰Enforcement by means of private security companies or criminal organisations is also much less common in Vietnam than in Russia or Ukraine (McMillan and Woodruff 2002, p.644).

Similar phenomena have taken place in the first phase of transition in Bulgaria (Avramov and Sgard 1996; Bogetic 1996; Hillman et al. 1996; Peev 2002; Ganey 2007). Asset stripping was so widespread that “decapitalise the other one” can be described as the basic behavioural rule of economic agents in Bulgaria during the first phase of the transition (Avramov and Guenov 1994). The transfer of resources through informal networks and illegal relationships “has been so substantial that it has been responsible for a significant decapitalisation of state enterprises during the transition period” (OECD 1997, p.111).

The picture is quite different in the virtuous countries. It seems generally accepted that asset stripping and spontaneous privatisation have not been common either in Vietnam (Gainsborough 2003, p.60) or in China (Walder and Oi 1999, p.23). “[C]ontrary to the experience in many transitional economies where SOEs managers have engaged in significant ‘asset stripping’ as they moved from state to private business, this survey revealed no evidence of this phenomenon thus far in Vietnam” (Webster and Taussig 1999, p.20). Similar survey results hold in China too (CESRRI 1987, pp.102-104), and in their study of Chinese SOEs during 1980-1989, Groves, Hong, McMillan, and Naughton (1994, p.205) find no evidence of (legal) asset stripping at the micro level.

3 Timeline and exceptions

As shown in the previous section, the empirical literature points to the existence of two clusters of transition countries: one with high output, high compliance, robust institutions, and another with low output, low compliance, and weak institutions. The rest of the paper explores the literature on transition economies in order to ascertain whether economic agents’ expectations *at the beginning of transition* also correlate with transition outcomes, as predicted in the literature on multiple equilibria.

This requires both defining the notion of ‘transition’ and pinning down its ‘beginning’. As for the former, some authors define transition generically as a large scale institutional change

(Dewatripont and Roland 1997). Given the focus of our study, transition has to do especially with a radical change in the ownership of the means of production (Brada 1996). As Dusan Triska, the architect of Czechoslovakia's privatization programme argued, privatization "is not just one of the many items on the economic program. It is the transformation itself" (McMillan and Woodruff 2002, p.153).

As for the latter, there is no widely agreed date of the beginning of the *transition* process – as opposed to more generic *reforms* within a generally socialist economic system. In an authoritative study, Sachs, Zinnes, and Eilat (2000) propose the following timing: 1990: Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia; 1991: Albania, Croatia, Macedonia, Slovenia; 1992: Armenia, Azerbaijan, Belarus, Estonia, Georgia, Kazakhstan, Kyrgyz Republic, Lithuania, Latvia, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan. Different dates would emerge, however, if one focused on stabilisation policies, as the IMF suggested, or on full price liberalisation (for a discussion, see Johnson et al. (1997b, pp.181-2)).

Even if one focuses on privatisation, the dates are by no means uncontroversial. It is far from clear that in 1992 Belarus, Tajikistan, Turkmenistan, and Uzbekistan were anywhere close to starting on a transition path (Johnson et al. 1997a,b; Kaufmann 1997). Further, privatisation in Poland and Bulgaria started much later than 1990. Contrary to a widespread belief, Poland's transition was gradual. In particular, the privatisation process was very slow. State planners implemented a limited privatisation programme, focusing on small businesses, and effectively substituted state created monitors (in which citizens could invest) for direct state ownership. They "created a climate in which new businesses could thrive, and built strong capital markets regulation that largely preceded large-firm privatization" (Black et al. 2000, p.1738). Bulgaria embarked on a similar, albeit much less successful, gradual path focusing first on passing the enabling legislation and the regulations bearing on cash privatisation, on creating the responsible institutions, and on preparing firms for

privatisation (Pamouktchiev, Parvulov, and Petranov 1997, p.207).¹¹

Similarly, in Asian countries, the conventional dates are often taken to be 1978 for China; 1979 for Vietnam; and 1990 for Mongolia. However, while a number of experiments allowing for individual initiative in agriculture started in 1979 in Vietnam, it was only in December 1986 that the *doi moi* policy was adopted by the VCP. A land law granting long term user rights to tillers was approved in 1987 and the nonprivate agricultural sector was officially recognised only in 1988, with a comprehensive reform package approved only in 1989 (Hemlin, Ramamurthy, and Ronnas 1998, p.1). Private property was officially enshrined in a constitutional amendment in 1992; privatisation of SOEs started even later and the whole process has been extremely slow up until the mid 2000s with fewer than 200 SOEs ‘equitised’ by 1999). In China the reforms were limited to the countryside up until the mid 1980s and privatisations started even later.

Part of the difficulty in dating the beginning of transition stems from the vagueness of the very notion of privatisation (Stiglitz 1999), and one has to distinguish between the moment privatisation plans are drafted, and when they are implemented; between formal privatisation programmes and so-called ‘spontaneous privatisation’ (Johnson 1991), or other spurious forms of property relations, such as the Chinese ‘Township and Village Enterprises’; and between privatisation of small enterprises and parts of agriculture (something that was compatible with the socialist system, as in Poland and Hungary in the 1980s) and privatisation of medium and large manufacturing firms.

Therefore while we will use the above dates as reference points in defining “the beginning of the transition process” in each country, they should be interpreted as indicative rather than hard cut-off points, and we shall collect evidence in the literature in a nontrivial neighbourhood of the dates above.

¹¹The Russian transition officially started after the break-up of the Soviet Union. “On June 11, 1992, the Russian parliament passed the new privatization program and Yeltsin signed it into law. . . . The central plan was to distribute property rights to most of the big firms in about eighteen months, from January 1993 to June 1994” (Blasi et al. 1996, p.39). However, others would push the beginning of the transition in the USSR back to perestroika, and the law on cooperatives passed in 1987.

The exceptions. In the analysis below, we provide evidence on most, but by no means all of the transition countries. Armenia is excluded because in 1988 an earthquake killed between 25000 and 50000 people and destroyed a large part of the industrial base and infrastructure. Furthermore, Armenia, Azerbaijan, Georgia, Tajikistan, and countries in the former Yugoslavia (except for Slovenia) suffered from civil war. The status of Belarus and Uzbekistan and to some extent Turkmenistan is also somewhat unclear, and they often appear as outliers in which the transition process had hardly started (Johnson et al. 1997b).

4 Great expectations: γ^e

4.1 Divergent Expectations

German Democratic Republic. The starkest example of optimistic expectations is probably East Germany, where unification implied the wholesale adoption, in one go, of the entire legal, economic, and institutional framework, as well as the enforcement apparatus, of West Germany. “Mummert (1997) has conducted interviews with company managers to find out how they evaluated their external environment . . . The interesting conclusion emerging from his study is that monetary union fundamentally changed the external environment as perceived by East German entrepreneurs and made their expectations statistically indistinguishable from their West German counterparts” (Raiser 2001, p.227). “[T]he East German top-down approach to institutional reform relied on the credibility and strength of the German state. It is arguably precisely the trust in West Germany’s institutions that has led to a rapid convergence of expectations among East and West Germans” (Raiser 2001, p.229). Indeed, according to a survey conducted in 1990, eastern German citizens turned out to be even *more* optimistic than western Germans (Shiller et al. 1992, fn.33).

Central and Eastern Europe. Pinto, Belka, and Krajewski (1993) presents evidence from a survey of managers of 75 Polish SOEs. The main finding is that the performance of

all firms significantly improved across a range of indicators (output, profitability, productivity, and so on) even *before* they were privatised, and this is due precisely to the managers' expectations concerning the success of the transition process. The credibility of the government transition policies and the prospect of eventually being the beneficiaries of transition motivated the managers of SOEs to improve performance even before SOEs were privatised. "By and large, managers expected the government to stick to the original Balcerowicz policies" (Pinto et al. 1993, p.250). There was "virtually no expectation of government help" (Pinto et al. 1993, p.251). More generally, they expected to gain from privatization, and believed "that good performance will be rewarded at the time of privatization" (Pinto et al. 1993, p.255).

Commenting on the results of another survey of Polish managers of SOEs, Pinto and van Wijnbergen (1994) observe that managerial compensation was not designed to encourage managers to maximize the long-run value of their firms, and the past history of failed reforms in Poland could have weighed negatively on their expectations, leading to decapitalisation. And yet survey evidence "shows that managers believed that the reforms were indeed permanent and that the hard budget constraint and the end to subsidies were going to last" (Pinto and van Wijnbergen 1994, p.26). Indeed, "only 9 out of 59 respondents felt that there would be any sort of dilution in reforms" (Pinto and van Wijnbergen 1994, p.27). On a scale from 0 to 5, Polish managers rated the credibility of various aspects of the transition process between 3.7 and 4.7 (Pinto and van Wijnbergen 1994, Table 15).

Even more explicitly, "Our survey indicates that there was a positive side too, captured by the expectation of rewards at the time of privatization. ... When asked why they had defied the negative stereotypes associated with state companies and focused on the long-run solvency of the companies, managers ... all indicated that they expected financial rewards at the time of privatization" (Pinto and van Wijnbergen 1994, p.28).

Analogous studies by Estrin, Gelb, and Singh (1995) and Pohl, Anderson, Claessens, and Djankov (1997) confirm the findings about Poland and show that similar results hold also in

the Czech republic and Hungary. Indeed, “The figures for Hungary and the Czech and Slovak Republics suggest that the Pinto study may in fact understate the amount of restructuring that is going on in state owned firms in the region as a whole. . . . It was surprising to discover that a majority of firms in Hungary and the Czech republic had formulated a long-run strategy, which they were actively seeking to implement” (Estrin 1994, p.1352).

Roland and Sekkat (2000) explain this evidence in terms of managerial incentives focusing on career concerns, which may lead good managers to restructure their company once transition, and especially privatization policies are initiated. Yet such benefits will only accrue in the future and therefore managers’ expectations about the success of reforms are central. Indeed, Estrin (1994) explicitly explains international variation in the behaviour of SOE managers with different expectations on the transition process. Thus, while “there is no simple correlation between hardness of the budget constraint and the degree of restructuring . . . we find strong evidence that the degree of restructuring is closely associated with *progress towards* privatization” (Estrin 1994, p.1352, italics added). In contrast, “in a situation when the future of the organisation is probably beyond hope . . . we see the emergence of endgame strategies, with managers and workers consuming assets before strong property rights emerge to protect the residual owners’ interest” (Estrin 1994, p.1353).

Brown, Earle, and Telegdy (2006) also find that in Romania and Hungary firms start to restructure before privatisation occurs. However, consistent with our narrative, and with the evidence on asset stripping, this does not happen in Ukraine and Russia; nor, according to Pohl et al. (1997) and Jones and Stoyko (1997), does this happen in Bulgaria. Similar results can be found in the meta-analysis of the literature on case studies by Carlin, Reenen, and Wolfe (1995), and in the studies discussed by Brada (1996).

Benacek (1995) reports a number of indicators of optimism and trust in the transition process in the Czech population, in 1992 and 1993. Public opinion polls reveal, for example, the belief of the median voter that “layoffs, unemployment and bankruptcies should be expected to rise in the future and that they are a necessary condition for future prosperity”

(Benacek 1995, p.43).¹²

China. In 1984-85, the newly reconstructed Chinese Economic System Reform Research Institute (CESRRI) conducted the first large scale survey of Chinese workers and managers, but also of the general public, after the Cultural Revolution (CESRRI 1987). This was a massive exercise with millions of data points, and it focused explicitly on the challenges of transition. Although the survey is conducted after the beginning of the reforms, it is worth keeping in mind that the transition process was still in its early stages, the privatisation of SOEs had not started yet, and, more importantly, the survey focuses on the urban sector whose reform had been kicked off precisely in 1984.

The survey results are striking and show a remarkable level of confidence in the reform process, both among the general public and specifically among managers. Roughly 85% of managers disagree, or strongly disagree with the statement that “With so many problems, China’s economy is hard to change”; and even more – roughly 92% – disagree, or strongly disagree with the statement that “With so many obstacles in the way, reform has no hope of success” (CESRRI 1987, p.78). Four fifths of managers (very) confidently affirm that “economic reform is bound to win a complete victory” (CESRRI 1987, p.79). Summarising the evidence, the authors state that “cadres are fundamentally optimistic about the future of reform” (CESRRI 1987, p.79). This general confidence on the reform path, and therefore of all actors involved in the process, is reinforced by significant confidence in the country’s leadership, and their policies.¹³ When asked “When opinions differ about a public problem, whose ideas do you believe the most?” The managers’ top answer is: “Party and state leaders” which are trusted 20% more than “Specialists in the field”, 25% more than “oneself” and various orders of magnitudes higher than family, friends and the media (CESRRI 1987,

¹²Further, in March 1993, 72 percent of respondents declared that their living standard was at least as high as ‘in the past’ (Benacek 1995, p.43). This reported trust is consistent with behavioural data showing increases in savings and the reversal of migration (Benacek 1995, p.43).

¹³A similar attitude is revealed by the general public with 75%-80% of respondents declaring that the reforms “are worthwhile even if entailing greater risk to one’s own welfare” and “As long as one has skill and ability, one won’t suffer from the reform” (CESRRI 1987, p.8).

p.82).¹⁴

Interestingly, the survey also provides some evidence of the managers' trust in their peers and their willingness to work together. "A survey on the 'inclination for cooperation' of factory directors shows that 88 percent of the enterprises are willing to establish a kind of cooperative relationship with other enterprises, and 54 percent wish to merge or enter into joint-ventures with others" (CESRRI 1987, p.26).

A possible concern with this evidence – and with similar survey evidence we will present from other non-democratic polities like Vietnam – is whether it might be subject to bias from 'preference falsification' (Kuran 1997). Survey respondents who are subject to autocratic rule might not respond truthfully to politically sensitive questions, skewing their answers in a way that is perceived as favorable to the government, if they believe that the survey administrators are not independent from the government (Tannenbergs 2022). While any survey evidence from autocratic countries is potentially subject to this concern, it is unlikely that 'preference falsification' is the main explanation for our results. First, the questions we consider are not directly assessing the popularity of the government or loyalty to it, but investigating opinions on specific aspects of a reform process on which there was considerable debate within the government and the Communist Party (Weber 2021). Second, in the same surveys, respondents do express pessimistic views or dissatisfaction on other topics (for example taxes in Vietnam, or the quality of enterprise cadres in China).

Vietnam. In the second half of the 1990s, Han and Baumgarte (2000) conducted 224 face-to-face interviews with private SMEs in Hanoi and Ho Chi Minh City in order to gauge their views about the reforms and the general direction of the economy at the time of the survey but also retrospectively. Only 27% of the firms declared that the overall business

¹⁴It is worth noting in passing that the Confucian ethics of SOE managers forcefully emerges from the survey. "When asked 'Which of the following do you try hardest to avoid?' only 23 percent were concerned primarily about legal breaches or harm to their own reputation, while 64 percent responded 'Something contrary to conscience.' This suggests a cadre who is internally motivated and directed." (CESRRI 1987, p.79). Further, when asked "In your opinion, what is the greatest enjoyment in life?" 73.6% of managers say "Being at work", well above being with friends or family, or enjoying leisure time (CESRRI 1987, p.82).

environment was unfavourable in 1986, a percentage that dropped to 20% at the time of the survey (Han and Baumgarte 2000, Table 1). The SMEs' perception of current economic conditions and the degree of confidence regarding the direction of change was even more striking with 80% deeming economic conditions presently good (or being neutral), and a bare 7% thinking that they will deteriorate (Han and Baumgarte 2000, Table 2).¹⁵ While a majority of respondents find the legal system still too cumbersome, inconsistent or unstable, only 23% of them consider it overall unfavourable and a mere 6% do not believe that it will improve (Han and Baumgarte 2000, Table 5). Similarly, only 5% of SMEs considered the social climate weak and deteriorating (Han and Baumgarte 2000, Table 6). Overall, the survey suggests that SMEs had a rather positive view of the status quo – including the legal system – and, perhaps more importantly, “SME's responses to queries concerning future outlook and pace of change betrayed a certain level of optimism” (Han and Baumgarte 2000, p.19).¹⁶

Russia and Ukraine. Surveys conducted in the Soviet Union during perestroika clearly show a general scepticism concerning the direction of reforms. In a poll conducted in the Russian Federation in November 1990, 47% of respondents think that “mistakes of the leadership” are responsible for the crisis (Rutgaizer 1992, p.44). Perhaps more directly relevant for our purposes, in a survey conducted in Russia in October 1990 respondents were asked, “Some people object to plans to let individuals buy government-owned property in the belief that this will open the way for laundering ill-gotten money. Do you share this view?” A plurality of respondents provided an affirmative answer. This is particularly relevant since the question provides a clear indication of general scepticism on the beneficiaries of the transition process and the kinds of behaviours that can be expected after economic liberalisation.¹⁷

¹⁵Very similar results hold for more specific questions concerning commercial, monetary and financial conditions (Han and Baumgarte 2000, Tables 3-4).

¹⁶Similar responses were obtained in a survey of 295 Vietnamese firms – both private and SOEs, small medium and large – conducted a few years later by the International Finance Corporation (IFC), the World Bank and the Mekong Private Sector Development Facility (Tenev et al. 2003, Table 1.3).

¹⁷We consider Russia and Ukraine together because they followed very similar transition paths, both during perestroika and in the early years after independence (Snelbecker 1995; Kaufmann 1997; Estrin, Hare, and

Shiller, Boycko, and Korobov (1991) conducted a survey of Soviet (and US) citizens in 1990 in order to investigate their attitudes towards markets and private economic activity. Remarkably, the results show no significant differences between the two countries concerning general opinions on a number of dimensions concerning economic activity. However, at the beginning of the transition process, Soviet citizens were significantly more sceptical than Americans about entrepreneurs, and in particular about their honesty (60% of Soviets deemed ‘those who try to make a lot of money’ dishonest, against 40% of Americans) (Shiller et al. 1991, p.395). Perhaps more importantly, 60% of Soviet respondents expressed major scepticism about the future of the reform process, deeming major policy reversals likely or very likely.

These findings are confirmed, and indeed extended, in a follow up research by Shiller et al. (1992) conducted in 1991 which also included residents in Ukraine, East Germany, and Japan. Not only did a similar percentage of Russian and Ukrainian respondents deem major reversal in policy possible or quite likely; around a third of them considered the return of Stalinism a concrete possibility, and thought it better to adopt prudential measures avoiding to appear “too capitalist” (Shiller et al. 1992, pp.159-160), while roughly 40% of Ukrainians and 58% of Russians deemed civil war “in the next five years” possible or quite likely (Shiller et al. 1992, p.161).¹⁸ Further, over three quarters of Ukrainians and Russians considered a ‘dramatic fall’ in living conditions possible or quite likely (compared with 25% of East Germans) (Shiller et al. 1992, p.161).

When comparing capitalist countries with Russia and Ukraine, Shiller et al. (1992, p.164) conclude that “more features of the perceived situation would discourage a rational individual in Russia or Ukraine from undertaking entrepreneurial endeavors or long-term investments. This conclusion does not seem to apply to eastern Germans, who are relatively optimistic.” Actually, over half of the Russian and Ukrainian respondents are not prepared to make investments of their time that are specific to their current organisation and roughly 40% (Rosevear 1998).

¹⁸There are no major differences in responses before and after the attempted coup of August 1991.

said that young people should delay forming a family and having children “Because in the near future our economy may fall apart” (Shiller et al. 1992, p.178).

Various other studies confirm these conclusions. The Eurobarometer survey conducted in the early 1990s shows very clear differences in attitudes and beliefs at the outset of the reform process consistent with our model. Consider the question: “Do you personally feel that the creation of a market economy, that is, one largely free from state control is right or wrong for your country’s future?” In 1990, positive responses exceeded negative responses by roughly 30-55 percentage points in virtually all CEE countries except Bulgaria, where the margin was significantly smaller (22 percentage points), while in 1991 in Russia the margin was only 8 percentage points and in Ukraine it was negative (-12) in 1992 (Aslund et al. 1996, Table 15). Similarly, the net positive responses to the question “In general, do you feel things in your country are going in the right or wrong direction?” were, in 1990, 37 percentage points in the Czech Republic and 13 in both Poland and Slovakia; while they were only 4 in Bulgaria in 1990 and actually -12 in Russia in 1991 and -24 in Ukraine in 1992 (Aslund et al. 1996, Table 13).

Finally, “A Public Opinion Center poll in September 1992 showed that almost three-quarters of the population . . . looked upon privatization with indifference or negative views” (Blasi et al. 1996, p.48).

Similar, if not starker results, are obtained if one looks at managers. In 1992-1994, Blasi (1994) surveyed the senior managers of 150 enterprises undergoing privatisation. While generally favourable towards privatisation, managers complained vocally about the specific privatisation process adopted and spent substantial amount of time and resources to control and manage ownership change in light of “the acute uncertainty of what will happen after privatization” (Blasi 1994, p.128). Indeed, such uncertainty, and in particular “the expectations of senior managers about their power and and ownership”, were “the main problem” (Blasi 1994, p.135) blocking major restructuring and investment in privatised firms.

Further, one thing that emerges very clearly is that even though not all directors were

crooks, their expectation was that there would be plenty of crooks around, and this led them to adopt (legal and illegal) pre-emptive measures. “In a series of conversations throughout the country before privatization began, managers and trade union leaders indicated that they were terrified that some unknown outsider, perhaps a Mafia figure or a foreign investor, would come to the auctions after the initial employee purchases and buy a majority of the shares in their firm” (Blasi et al. 1996, p.42).

In 1997, Johnson et al. (2000) surveyed 1500 firms in Russia, Ukraine, Poland, Romania, and Slovakia, the vast majority of which had been founded between 1988 and 1990. When asked ‘When you started the business, how long did you expect it would take to earn back the cost of your initial investment’, over three quarters of Russian entrepreneurs, and more than half of the Ukrainians, said 6 months or one year and almost none more than three years, revealing an extremely short termist attitude. This is in stark contrast with entrepreneurs in the other three countries where 20-50% of entrepreneurs had a time horizon of three years or more.

Up until 1995, 55% of private firms surveyed in five large Ukrainian cities thought that reforms had either not started yet (38%) or that they were not irreversible (17%) and an analogous number thought that the transition process had not had a positive impact on their business (Kaufmann 1997, Table 1).

Bulgaria. The case of Bulgaria is particularly interesting, as there is significant evidence that managers behaviour was determined by expectations’ and in particular that managers were quite aware of the strategic complementarities in the transition process. Kotzeva and Perotti (1995) conducted a survey of Bulgarian firms in 1993 (and then repeated it in 1994) in order to investigate the expectations and attitudes of enterprise managers (as well as their views about other managers’ attitudes) concerning credit to illiquid customers, repayment of arrears, and expectations of any future bailout policy. The goal is to determine whether individual answers suggest a set of expectations and attitudes which may lead to a deliberate,

‘collusive’ creation of unenforceable credit, granted by firms potentially capable of adjustment but which prefer to remain inertial in the expectation of a bailout.

In 1993, two thirds of respondents believed a collapse of good firms due to bad firms’ behaviour was “very likely, suggesting a diffuse perception of the risks of a domino effect. One sixth of the first sample even stated that the situation was so serious that a bailout was most likely” (Kotzeva and Perotti 1995, p.6). Further, among those voicing an opinion almost 80 % expected “a complete or partial bailout of bank arrears, which suggests diffused expectations that pressure on the government would have led to a broad bailout of bank arrears.”¹⁹

Commander, Liberman, Ugaz, and Yemtsov (1993) find indirect evidence of similar beliefs concerning the systemic effects of inter-enterprise arrears and similar strategic behaviour among Russian firms in 1992. Most of the Russian managers interviewed by Blasi et al. (1996) in 1992-3, “expected the government to continue to assist their firms after they were privately owned, in a kind of communist capitalism” (Blasi et al. 1996, p.126). In contrast, 85% of privatised firms in Mongolia expected little or no help from the government in 1996 (Anderson et al. 1997; Anderson, Kosun, and Murrell 2000).

4.2 Behaviour

The informativeness of opinion polls is sometimes put into question due to the lack of proper incentives. We find the wealth of evidence presented above persuasive and rather intuitive. Nonetheless, the attitudes of managers, and of the general public, towards the transition process can sometimes be inferred from their behaviour, rather than their reported beliefs.

In countries which have adopted mass privatisation, there is another indicator of confidence in the transition process that focuses on agents’ choices rather than their reported beliefs – namely, stock market activity. Popular participation, quantities traded, and stock

¹⁹The results observed in 1994 broadly confirm these conclusions although they are not directly comparable since NSI slightly changed the formulation of some questions and eliminated others. See also OECD (1997) for a discussion.

prices can be taken as indicators of the confidence in the transition process. “Indeed, the prices offered for vouchers in Russia’s first ‘stock exchanges’ in 1992, 1993, and 1994 became good indications of public confidence in the program” (Blasi et al. 1996, p.44).

Only 44% of Russian citizens actually used their vouchers to invest in companies (14%) or in voucher investment funds (30%). “Despite the great publicity accorded the voucher program, doubts, lack of information, or cynicism led 58 million people, or almost 40 percent, not to participate in the program” (Blasi et al. 1996, p.78).²⁰ Further, “[t]he point . . . is inescapable: [in 1993] the entire Russian industrial complex is valued in voucher auctions at something like the value of a large Fortune 500 company” (Boycko et al. 1993, p.159). This is due to rational behaviour by potential investors facing massive uncertainty and instability. “The plausible explanations [of such a low value of the whole Russian industry] fall under a general category: expropriation of shareholders by stakeholders. That is, while assets themselves have some value, the part of the return to these assets that is expected to accrue to outside shareholders after the stakeholders have taken their own cut is very small” (Boycko et al. 1993, p.161).²¹

Bulgarian mass privatisation was carefully designed to build confidence and enlarge participation. For example, “The financial position of the companies in the list for mass privatization is close to the average for the economy. The ‘deadbeats’ are deliberately excluded, thus reducing the probability of quick loss of confidence or immediate failure.” (Pamoukchiev et al. 1997, p.225). Yet “Although it is stated that ‘Bulgaria has moved substantially ahead’ with the process of mass privatization in 1997 (EBRD Transition Report 1996, p. 22), it is not a big success in terms of popular participation. Despite the massive campaign in the national media, Bulgarians were not in a hurry to become owners of investment vouchers, adopting a wait-and-see approach. A month after the process started, only 4-5 percent of en-

²⁰There is no information about the remaining 16% but it is likely that they too did not participate (ibid.).

²¹See also Black et al. (2000). The problem persisted for a long time. “As an indication of the scale of [continued asset stripping], the market capitalization of the two hundred biggest Russian companies traded on the stock market, many of which are in the energy sector, was only 6 percent of GDP in early 1996” (Aslund et al. 1996, p.259). And even in 1999, “A country with potential market capitalization of around \$3 trillion has an actual market capitalization of under \$30 billion” (Black 2001, p.2139).

titled citizens had registered to take part, contrary to the expected 17 percent. Many waited until the last moment to obtain their voucher books. The initial deadline for registration, expiring on April 8, 1996, was extended. The initial expectations were that about 70 percent of the population would take part in the mass privatization process. In reality, around 3 million eligible citizens signed up through privatization funds or independently out of the 6.5 million Bulgarians that could take part” (Michailova 1997, pp.86-87). Among the main causes of failure, poor information and misleading advice played an important role (World Bank 1996). But “The majority of the population did not believe they could profit from the mass privatization program ... [T]he alienation of the population was difficult to overcome” (Michailova 1997, p.87).²²

“What [Ukrainians] saw and heard through their mass media is that their neighbors were being plagued with scandal after scandal ... As a result, the attitude of Ukrainian citizens toward certificate privatization has generally been one of cynicism and apathy, as few Ukrainians bothered to acquire or invest their certificates. An emphasis by western donor public relations campaigns on family and security rather than on speculation sought to address this cynicism but did little to assuage it” (Snelbecker 1995, p.33).

In contrast, mass privatisation in the Czech republic was a success with citizens actively participating in auctions as individuals or via investor funds, and with investors clearly taking “into account risk and return considerations in valuing assets in place, despite negligible financial literacy” (Hingorani, Lehn, and Makhija 1997, p.350).

Confidence in the government and the privatisation program in the Czech and Slovak Federative Republic (CSFR) was high (Webster and Swanson 1993, p.19). “The large privatization program began to take off in 1992. By Spring 1992, nearly 9 million coupon books had been bought by citizens for about one week’s salary each (\$33). Nearly 70 percent of coupon holders opted to invest at least some of their vouchers in privatization investment funds offering guaranteed returns of 1,000 to 2,000 percent. The first wave of privatization

²²It should be noted that part of the lack of trust in the mass privatisation programme may have also been due to the financial scandals – financial pyramids and Ponzi schemes – emerged in the previous years.

targeted about 1,500 firms to be sold entirely or in part through the voucher scheme. By Fall 1992, three rounds of bidding had taken place, and the first phase of voucher privatization should be completed by end-1992. Privatization of small and large firms is ongoing through auctions, direct sales and foreign investment” (Webster and Swanson 1993, p.23).

Mass privatisation was not the strategy adopted by the Chinese or Vietnamese governments and therefore there are no comparable data. Nonetheless, other behavioural indicators of confidence can be identified. For example, Groves et al. (1994) develop a thorough empirical analysis of Chinese SOEs from 1980 to 1989. Using investment as a measure of belief in reforms, they observe that that increased managerial autonomy did appear to increase the resources available to the enterprise and “This increase in investment suggests that managers viewed the reforms as likely to be permanent rather than temporary” (Groves et al. 1994, p.205, italics added).

Similarly, Groves et al. (1995) analyse empirically managerial contracts and incipient managerial labour markets in China in the 1980s, which were the central innovation of the managerial reforms of the period. One of the key features of the contracting system, in which some managerial contracts were actually auctioned out, is that “in many cases, the manager was required to put up a security deposit, which could be forfeited if the firm failed to perform as promised. This security deposit was substantial: the mean level in our sample was 8,500 yuan, compared to an annual average wage of 2,177 yuan in state-owned industry in 1989. There is anecdotal evidence that some managers did indeed lose some or all of their security deposit following poor firm performance: it was genuinely at risk” (Groves et al. 1995, p.879, italics added).²³

A certain degree of confidence in the transition process can also be inferred from the entrepreneurial choices of Vietnamese managers. For example, “Unlike the case in many other transitional, high-risk economies, few sample firms demonstrated any degree of diversification in their products. Half received 100 percent of their revenue from one main product group”

²³More generally, Groves et al. (1995) find clear evidence of contract enforcement and a significant degree of control of the government over enterprises.

(Webster and Taussig 1999, p.27). Another important indicator of trust towards other entrepreneurs is the willingness (or lack thereof) to extend credit: a survey of 259 Vietnamese non-state firms conducted in 1995-7 finds relatively high levels of inter-firm credit even in the presence of relatively weak third party enforcement (McMillan and Woodruff 1999, 2002).

5 Evidence on Ω and S

In this section, we provide some evidence on the historical, political, institutional and social factors that may have contributed to form pessimistic or optimistic expectations about the success of the transition process. The aim is not to provide a comprehensive account of the early phases of transition in each country. Rather, we summarise some key elements that are directly relevant for our analysis.

Two important methodological points should be noted at the outset. First, some of the determinants of (and the proxies for) γ^e will also be determinants of (and proxies for) security of property rights more generally. This is to be expected since the transition process entails a redefinition of property rights and therefore control rights over income streams from assets. The literature on the security of property rights identifies various proxies for the security of property rights (Frye 2003): (1) Social Factors: Trust and Civic Participation; (2) Elite Partisanship (political leaders committed to market-oriented reforms in a transitional economy can increase confidence in the security of private property); (3) Corruption; (4) Credible Commitment (norms, laws, institutions and so on). We organise our evidence around these four themes focusing on subjective perceptions on (1)-(4) as possible determinants of expectations about the success of the transition process including the credibility of government plans, the robustness of reforms, and compliance by other actors.

Second, elite partisanship, trust, corruption and credible commitment have a *direct* effect on the agents' payoffs and therefore may make a given equilibrium more or less likely (see for example the comparative statics analysis in Hoff and Stiglitz (2004, 2008)). In this section,

we focus instead on their *indirect* effect on equilibrium selection via agents' expectations. Hence, we survey the literature focusing in particular on subjective individual perceptions.

5.1 Social Norms: Trust and Civic Participation

Trust. There is a large literature exploring the role of informal institutions on growth and macroeconomic performance. We are interested in them here because “Informal institutions are usually understood as the set of social and moral norms, which coordinate peoples’ expectations of one another” (Raiser 2001, p.219). Social norms and values provide an important signalling device that allows agents to coordinate their actions, and are typically self-reinforcing and may either promote, or undermine, the functioning of formal institutions. Here we focus on extended trust and generalised norms that, if widely adopted, and commonly known to be widely adopted, can be taken as a proxy for γ^e . A generalised lack of trust, and a social norm that considers moving to the informal economy as acceptable if not just, will lead agents to expect their fellow citizens to defect (Stiglitz 1999).

Further, “[T]rust among anonymous individuals may be as much a function of their moral predispositions and social experiences as of their trust in government institutions to provide impartial enforcement. The behaviour of government has therefore an important role to play in the reproduction of extended trust . . . [Conversely,] extended trust is also needed to make third-party enforcement by the state function efficiently” (Raiser 1999, p.5).²⁴

The second wave of the World Values Survey was conducted in 1990 and it included Russia and China.²⁵ The differences between the two countries in terms of trust and overall

²⁴It is important to stress that we focus on *extended* trust, or trust among anonymous individuals, rather than trust within close-knit networks. This is consistent with the observation that overall Russia was not “an especially low-trust country at the beginning of the 1990s. Russians didn’t trust their government, but enterprise managers routinely dealt with each other on an oral basis (often to circumvent formal regulations). Indeed, these informal contacts helped to make extensive barter chains a feasible substitute for cash-based transactions” (Black et al. 2000, p.1758). Indeed, the kind of trust that fuels close-knit business networks may be most hurtful to generalised trust and third party compliance, and encourage all sorts of misdemeanours.

²⁵In analysing the World Values Survey we focus on China and Russia, because the differences are so large that they are unlikely to be the product of flukes or measurement errors. Differences between Russia and other transition economies are much smaller and there is some evidence that they are not very robust, if compared with other surveys (Raiser, Haerpfer, Nowotny, and Wallace 2002, p.702).

social capital are stark. Almost 60% of Chinese say that ‘most people can be trusted’, while two thirds of Russians deem “that you need to be very careful in dealing with people”, and similar results hold for trust towards fellow citizens. At the beginning of transition, Russians were also much more sceptical about the state of the legal enforcement system: 36.7% of Russians trusted the justice system a bit or a lot, as opposed to 74.3% of Chinese, while 34.1% of Russians trusted the police a bit or a lot, as opposed to 64.7% of Chinese. A similar difference can be found in the degree of confidence towards the Parliament (Russia: 43.1%; China: 78.1%).

Further, a full 81% of Chinese say that cheating on taxes is never justified, as compared with 48% of Russians, and a similar difference can be observed concerning paying fees on public transport or illegitimately claiming benefits. While these attitudes are not directly relevant in our model, if these general attitudinal traits are common knowledge, as part of national culture, and/or people project their attitudes to others, then these responses may tell us something about agents’ expectations concerning the behaviour of others in the transition process.

In 1993, the New Democracies Barometer collected survey responses from a total of 10,087 individuals in nine east European countries (Bulgaria, the Czech Republic, Slovakia, Hungary, Poland, Romania, Slovenia, Belarus and Ukraine) on a range of questions regarding their approval of the existing political and economic system, the previous regime, and specific public and civil institutions (Rose, Mishler, and Haerpfer 1997). As it turns out, “trust is lower in the countries of the FSU and Bulgaria and highest among the more advanced transition economies” (Raiser 2001, p.233). The differences are particularly stark when it comes to trust in institutions guaranteeing the rule of law (the police and the courts).

Further, Rose et al. (1997) construct an overall index of trust in the nine countries and investigate econometrically its determinants. One interesting finding is that the insertion of country dummy variables raises the explanatory value of the regression by about 5 percentage points, with a particularly strong effect “in Bulgaria, where people are much more distrustful

than elsewhere, even after controlling for differences in performance and socialization factors (Rose et al. 1997, p.107). This relatively small, but significant, effect suggests that transition economies embark on the transition process from different levels of social capital which is likely the legacy of their different histories, cultures, and institutions.²⁶

Civic participation. One important aspect of the transition in Poland was the strength of the union movement and the church. Poland “had two institutions at the beginning of reforms that played a critical role in the transition of its government: the Catholic Church and the Solidarity Labor Union” (Shleifer 1997, p.398). This translated into a very strong and credible government right after the fall of the regime and strong worker control over SOE managers which limited asset stripping (Hanley 2000).²⁷ This is not the case in Hungary, where workers *initially* adopted an individualistic survival strategy, foregoing any attempts at collective action, which has likely allowed for the initial asset stripping (Stark 1990; Hanley 2000).

While workers’ councils played an important role in pre-transition Hungary and Poland and continued to exist even after corporatisation, employees had no rights in Bulgaria (Peev 2002). More generally, organised labour played virtually no role in Bulgaria during the transition and had no say on the management of SOEs either right before or during the transition period (Jones 1995; Jones and Stoyko 1997). Nor, among other things, did it have the strength to monitor managers and prevent asset stripping. In 1992, Jones (1995) conducted a survey of Bulgarian workers and managers concerning their perception of their own (workers), and the workers’ (managers) degree of influence over a whole range of decisions, including in particular on privatisation over 1989-1992. The most interesting findings are

²⁶It is worth noting in passing that, more than a decade after the beginning of the transition, countries in the FSU (minus the Baltics) seemed trapped in a low-trust equilibrium, especially as compared with CEE countries. The BEEPS 2002 wave and wave 4 of the World Value Survey forcefully show major differences across the two groups in the level of trust towards others in the general population but also in the level of trade credit managers award to other firms and in the prepayment required, which are both good measures of interfirm trust as well as confidence in the rule of law (Raiser, Rousso, Steves, and Teksoz 2007).

²⁷Although some spontaneous privatization took place during the late stages of the regime, “redressing the wrongs of spontaneous privatization was an important element of Walesa’s presidential campaign during 1990” (Johnson 1991, p.10).

that (i) workers feel very much powerless (“the issues workers believed that they had the least influence over were strategic issues, such as . . . privatization decisions” (Jones 1995, p.120)); and most importantly that (ii) employers believed instead that workers had much more influence (“whereas employees did not feel they had much to say on issues regarding privatization, the findings of the [Bulgarian Managers Survey] indicate that managers believed that, relative to many other issues, employees had a reasonable degree of influence” (Jones 1995, p.121)). The contrasting perceptions may reflect a genuine uncertainty associated with the whole process and a “lack of clarity on the part of the two groups concerning the appropriate nature of their roles . . . The confusion as to ‘who governs’ (and to what extent) seems to be especially acute . . . on aspects of privatization” (Jones 1995, p.129).

Russian workers have also been exceedingly passive as noted by Boycko et al. (1993, p.169) and Black et al. (2000, p.1740). A survey of 150 managers in Russian privatised enterprises in 1992-4, finds that “managers also report that the trade union in most companies is a perfunctory organization. Indeed, the overwhelming conclusion about employee ownership is near complete passivity on the part of the Russian worker” (Blasi 1994, p.138).

5.2 Credible commitment and the business environment

As we have noted, there is a general scarcity of internationally comparable empirical work on transition economies, especially at the microeconomic level. In particular, there is precious little empirical work that allows for comparisons of managers’ views in European and Asian transition economies. The one exception is survey work on private sector firms in transition economies conducted by Leila Webster and collaborators – largely as part of a study under the sponsorship of the World Bank in the initial phase of the transition process.²⁸ In the various countries surveyed, they asked firms to mention the three main problems they faced: the questions were open and interviewers would then classify the answers within certain predetermined categories. One of the categories is “Rules and policies change too often”

²⁸We note in passing that surveys conducted later in the transition process largely confirm the basic divide highlighted in this section, see e.g. Brunetti et al. (1997, 1998) and Carlin et al. (2001, Table 6).

which can be taken as a proxy for the instability of the environment in which firms operate, and thus a key determinant of expectations on the behaviour of other agents and on the success of transition.

In 1991, the two main sources of concern of private entrepreneurs in Poland were lack of demand, which was cited first by 30 percent of entrepreneurs and financial problems (28 percent). They are followed far behind by an uncertain and unstable environment – in terms of constantly changing government regulations – mentioned by 10 percent of entrepreneurs, and ‘too much competition’. The main sources of instability, according to firms, were changing in taxation, import duties, and government spending (Webster 1993b).

The same survey conducted in the same year in Hungary returned very similar, if starker results: “Two issues dominated when entrepreneurs were asked to name the biggest problems affecting their businesses: inadequate finance and soft product demand. Problems with finance were the major constraint for 54 percent of entrepreneurs” (Webster 1993b, p.40). These are problems that firms in any private economy may face and do not signal a failure of the transition process per se, let alone lack of commitment to transition by the government. Instability of the transition process and of government policies is never mentioned.

In January 1992, Czech and Slovak entrepreneurs were asked the same questions. Among the biggest problems in order of importance the three most frequently cited were: excessive taxes (31%), delinquent payments by state enterprises (28%), and high interest rates (27%). Unstable business conditions was only fifth in the list (after weak product demand), and is mentioned by a bare 13% of firms (Webster and Swanson 1993, Table 5.1).²⁹

The business environment in Vietnam has been often considered to be hostile by outside observers as property rights seemed to be rather vaguely specified,³⁰ and laws appeared at

²⁹“The transformation program in the former CSFR was well-designed and implemented. In addition, the government also took seriously the task of marketing its program, communicating with its citizenry about the strategy and content of reforms and creating a broad base of support through mass privatization. The high degree to which entrepreneurs viewed themselves as participants and stakeholders in the reform process was observed” (Webster and Swanson 1993, p.50).

³⁰“To quote the seminal Vietnamese reformist Dao Xuan Sam – ‘O Viet nam, tu khong han la tu, cong khong han la cong’ – ‘In Vietnam, the private is not entirely private and the public is not entirely public’ ” (Fforde 2004, p.32).

best confusing. The surveys of Vietnamese entrepreneurs lead to a different conclusion.

A survey of 95 large private Vietnamese manufacturers in 1999 tells a similar story (Webster and Taussig 1999). The three main concerns are lack of access to investment capital (59%), lack of information about foreign markets (41%) and insufficient working capital (39%). Unclear government policies came a very distant fifth (16%) and did not reflect any lack of confidence in the transition process or any major concerns related to the business environment.³¹

These findings are confirmed by the comprehensive surveys run in 1991 and then in 1997 of some 900 (SOEs and non-state) and 500 (non-state) manufacturing enterprises in Vietnam by Ronnas (1992) and Hemlin et al. (1998), respectively. In 1991, shortly after the launch of *doi moi*, the five most cited ‘Main constraints to growth of enterprises’ were (Ronnas 1992): ‘Shortage of capital’ (54.9% of Urban firms, 65.7% of Rural firms), ‘Limited demand for current products’ (23.1% and 23.6%), ‘Lack of marketing/transport facilities’ (27.8% and 19.2 %), ‘Too much competition’ (16.0% and 13.2%), and ‘Lack of energy’ (17.1% and 7.2%). The uncertainty of the transition process and government policy came far below (mentioned merely by one firm out of ten) and interference of government officials was hardly ever cited as a major constraint (Hemlin et al. 1998, Table 1.3). Six years later with transition still largely incomplete and the privatisation process in its infancy, the results are even starker (Hemlin et al. 1998): ‘Shortage of capital’, ‘Limited demand for current products’, and ‘Too much competition’ are by far the most cited problems (by between a quarter and a third of firms of all types). Instability of the transition process and uncertainty of government policies are mentioned by fewer than 5% of firms, and interference of public officials is almost never cited (Hemlin et al. 1998, Table 2.16).³²

³¹ “[M]anagers complained about the lack of clarity concerning land and tax laws. Managers in the wood and furniture industries were particularly irate about a series of sudden changes in laws governing wood exports” (Webster and Taussig 1999, p.32).

³² When asked about the main type of assistance desired from the government, only about one tenth of firms mentioned ‘Clarity in government’s long term policies’ in 1991. This number went down even further in 1997, when about 70% of firms said that they needed no assistance whatsoever (Hemlin et al. 1998, Tables 2.17 and 2.18).

In summary, “Cumbersome government regulations, licensing procedures and unfavorable attitudes of officials do not seem to have been a severe problem for most of the enterprises” (Hemlin et al. 1998, p.70). In general “whilst property rights may be unclear to outsiders, often the traditional questions of economic anthropology (e.g., ‘who decides’, and ‘who gets what’) are easily answered by insiders” (Fforde 2004, p.33).³³

The picture is quite different in Russia. In 1992, 55% of private firms in St. Petersburg considered significant instability and ambiguity of the environment they operate in – including taxes and regulations, and lawlessness – as one of the three main problems they faced (Webster and Charap 1993). This was by far the most cited problem. To be specific, “To a significant extent, business decisions relied on speculation and rumor about future government policies. Presidential decrees are issued frequently: some are published; some are ignored; some are implemented; and some are contradictory. Enforcement reportedly was often at the discretion of local officials. In the view of the researchers, the lack of clear and enforceable contracts and property rights was a critical factor slowing and distorting private sector growth. The lack of such rights greatly increased uncertainty in the business environment, fostered a provisional quality in leases, purchase and sales contracts and real estate markets, and reinforced the power of personal contacts in securing resources. The judicial system appeared to be poorly developed, and contract enforcement seemed closely linked to the ability to enforce. Ambiguous property rights, particularly with respect to the assets of state-owned enterprises, also had created strong incentives for all levels of society to expropriate state property with few mechanisms to prevent them from doing so” (Webster and Charap 1993, p.5). While interpreting these responses, the authors also highlight the relevance of corruption and also isolation as a means of guaranteeing anonymity and protection: “Researchers formed the impression that most entrepreneurs were isolated from each other, from the state sector and from the outside world” (Webster and Charap 1993, p.6).³⁴

³³This conclusion is strongly supported by later surveys of entrepreneurs and managers, see Gainsborough (2002, 2003).

³⁴“Entrepreneurs tended to conceal their physical location and limit their contacts with each other, out of concerns about physical security and suspicion of contacts originating from outside their own networks.

But the uncertainty and instability of the environment in which managers need to operate and form expectations actually dominates all of the firms' answers. This includes severe macroeconomic instability (Webster and Charap 1993, p.51) and uncertainty and instability in capital markets. Indeed, according to the researchers in many cases, asset stripping, insider deals, and the siphoning off of SOEs' assets are a rational response: "The variety of production arrangements reflects entrepreneurs' attempts to cope with the uncertainty of the business environment" (Webster and Charap 1993, p.34).

As noted above, the pattern of transition in Russia and Ukraine has been remarkably similar in most respects. It should therefore not be surprising to see that managers' views of, and beliefs concerning the transition process are also very close. In June 1994, private firms in major Ukrainian cities were asked to rank the main impediments for conducting business on a scale from 1 (no impediment) to 5 (maximum severity). The most important impediment was precisely the instability of the business environment, which was rated roughly 4.5 on average (significantly higher than taxation, import and export restrictions, and inflation) – raising to 4.75 in April 1995 (Kaufmann 1997, Figure A1).

Although there are no comparable surveys of Bulgarian managers, in the first phase of the transition process, instability in the economic environment is often cited by firms in the private sector as one of the major constraints to the expansion of their activities according to the OECD (1997, p.110). "Among complaints of foreign investors, common themes concern the instability and lack of transparency of various rules, procedures, laws, and government commitments . . . Investors complain of frequent discretionary decisions on the part of various officials that alter or nullify what were understood by foreign partners as implicit or explicit contractual commitments" (OECD 1997, p.129). Indeed, the first phase of reforms has been characterised by "an extremely uncertain environment for private entrepreneurs and has undoubtedly contributed to the 'informal' nature of private sector development in Bulgaria"

Isolation from the state sector was more common in new ventures than among privatized units of state enterprises, but even the latter tended to have links only to their state parent rather than to a larger business community" (Webster and Charap 1993, p.57).

(World Bank 1996, p.12).³⁵ Further, some of the policies adopted contributed to undermine confidence. In hindsight, particularly damaging, given the importance of the banking sector in the Bulgarian transition process, were “the goals set out in the legislation of 1991-1993, [which] while possibly feasible for new banks, appear not to have been attainable by a few of the larger distressed banks, irrespective of incentives and management” (OECD 1997, p.88). This, and the acute awareness of systemic effects, led banks to operate under the expectation of a bailout of banks themselves, as well as of their main debtors, the large ‘strategic’ firms with high employment (OECD 1997, pp.88-91).

There exists no comparable data for China, either. However, policy stability – and stability more generally – has famously been a foremost concern for Chinese legislators throughout the transition period. One important anchor of credibility has been anti-inflationary policy. At the outset of reforms, China still remembered vividly the hyperinflation that accompanied the collapse of the Nationalist government in 1948-49, and the meticulous price stability of the subsequent thirty years (Weber 2021).

5.3 Corruption and enforcement

Corruption. Hoff and Stiglitz (2008) note that culture is often considered to be an equilibrium selection device and conjecture that a number of characteristics of Russia at the beginning of the 1990s made it unlikely that the ‘good’ equilibrium would be a focal point, focusing in particular on the widespread perception of corruption.

There exists limited research on SOE managers during perestroika, and nothing on their expectations, especially concerning the success of reforms. Nonetheless, some opinion polls were conducted on the general population which may be informative of a more general expectational environment conducive to a pessimistic attitude. In particular, in the second half of the 1980s, Soviet citizens had a generalised perception of collapse of discipline, lack

³⁵During the first fifteen months after the fall of communism, “[t]he reform ideas were quite similar to those in other CEE countries. However, unlike Poland and its Balcerowicz-Plan, the Bulgarian reform goals were neither publicly announced, nor were they included in any explicit government statement.” (Christev and Petersen 1999, p.3).

of enforcement, pervasive corruption, and individualistic survival and enrichment strategies at a cost for the general public.

As for strategies, Russian and Soviet citizens very quickly realised the strategic complementarities emerging in the transition process and their implications for individual behaviour. In 1985 an opinion poll asked Soviet citizens to evaluate broadly defined ‘illegal acts’. While only 6% of the respondents considered them morally right, a full 54% considered illegal acts to be the only realistic option as “problems cannot be solved legally” (Rutgaizer 1992, p.47). In 1989, 44% of Soviet respondents did not condemn “use of a government-owned car for personal gain” and 52% did not condemn “theft from place of work” (Rutgaizer 1992, p.47).

These beliefs are supported by the widespread perception of the pervasiveness of corruption and illegal activities. “The Soviet people seem to be transfixed by arguments to the effect that in the Soviet Union there exist millionaires, and that the shadow economy is a ubiquitous phenomenon. The public is particularly impressed by figures about the volume of underground ‘turnover’ ” (Rutgaizer 1992, p.4). Even though the figures appearing in the press, or in policy briefs, may have been exaggerated, they did influence people’s perceptions. Interestingly, as early as 1987, widely publicised reports from the USSR Academy of Sciences explicitly linked the large size of the unofficial economy with asset stripping and the loss of discipline and monitoring capacity on the state sector.³⁶

The public perception of the pervasiveness of corruption and unofficial activity, on the one hand, and of the collapse of the system, on the other hand, emerges forcefully in opinion polls performed by Rutgaizer (1992) in the Russian Federation and in Ukraine in 1990.³⁷

³⁶ “[T]he main cause of unearned income in the national economy on such a wide scale is the loss by workers and employees of a collective feeling of master and owner of the national property as well as of the feeling of being the owner of one’s own enterprise” (A . Sergeev “Netrudovyye dokhody : ekonomicheskaya priroda, struktura, puti likvidatsii,” *Voprosy ekonomiki*, 1987:3, pp. 92-93 cited in (Rutgaizer 1992, p.13)).

³⁷ “Most of those questioned in the poll in November 1990 in the Russian Federation hold the black market and the mafia responsible for most problems besetting the country” (Rutgaizer 1992, p.42). When asked, ‘What is the root cause of recent economic setbacks?’ the top two answers are ‘action by the commercial mafia’ (27%) and ‘collapse of the central planning system’ (22%) (Rutgaizer 1992, p.43). One month later the results of a similar poll were even starker: the main reason behind the problems facing the country today was ‘mafia and organized crime’ (identified as one of the possible causes by 51% of respondents) and in the top 10 responses one can also find thievery (30%), corruption (25%), and “a drop in the number of decent and honest people” (20%). An analogous, if starker, attitude is expressed by Ukrainian respondents.

A survey run in 1991 investigated, among other things, the main problems private entrepreneurs face. Over 70% of Russian and Ukrainian respondents “gave substantial weight to concerns about potential government interference and fear of ‘bandits’ ” (Shiller et al. 1992, p.162), with roughly a quarter of Russians and Ukrainians believing that “The world of business is full of cruel and dishonest people, some as bad as bandits” (Shiller et al. 1992, p.161).³⁸

Prior to, and at the outset of transition, countries differed considerably in terms of the institutions and practices guaranteeing the rule of law. Campos and Coricelli (2002) present an index that measures the rule of law on a 1-10 scale based on three components, one capturing the type and substance of the law itself and two measuring enforcement. In 1989 and 1990, the index was almost twice as high in the CEE and Baltic (CEEB) countries as compared to the CIS countries (5-6 vs. 3-3.5), and the gap quickly widened, consistent with our model: “It is clear from these data that the process of institutional build-up took off much faster in the Central and Eastern European countries, despite starting at a much higher level. Among CIS countries, Belarus, Ukraine, and Russia are characterized by an extremely slow process of deepening of a rule of law tradition. There is also considerable heterogeneity among CEEB countries; on the one hand we can see a consistent process of institutional deepening in the Visegrad and Baltic countries, while very little of it is observed in the Balkan group” (Campos and Coricelli 2002, pp.813-4).

In the 1996-7 World Bank’s Worldwide Survey of the Private Sector, entrepreneurs were asked whether theft and crime substantially increased the costs of doing business *five years earlier*, right at the beginning of transition: roughly 80% of entrepreneurs in the CIS agreed with the statement, which is almost 30 percentage points higher than in CEE countries (Brunetti et al. 1997, p.17). Further, more than 70% of entrepreneurs in the CIS felt that

When asked to define the mafia, 80% of respondents chose the following answer: “a criminal network with accomplices in law-enforcement agencies and governmental organizations” (Rutgaizer 1992, p.45).

³⁸“In December 1991, the Vorovskoi Mir met at Vedentsovo, outside Moscow, to discuss their response to the economic transition. The group’s trading activities at that time—they dealt mainly in spare parts, autos, caviar, and gems—were estimated to account for about \$1.3 billion, or 15 percent of the volume of goods and services at the end of 1991” (Blasi et al. 1996, p.118).

state authorities would not have protected their person and property five years earlier, and a similar percentage complained about the unpredictability of the judiciary for business operations, as opposed to roughly 55% and 50%, respectively, in CEE countries (Brunetti et al. 1997, pp.18-9).

Enforcement and the chain of command. The disintegration of the law enforcement apparatus and state institutions started during perestroika, and contributed to the collapse of the Soviet Union. Gorbachev repeatedly excluded the use of force to establish central authority even when he faced major threats to the very existence of the USSR. More generally, by the end of the 1980s the deterring ability of the Soviet system had been long debilitated and its credibility undermined. As the Soviet apparatus was unable to fight the second economy by economic measures, the struggle against the underground economy took the form of a struggle against criminal offences. And yet “many notorious trials, referred to the category of private entrepreneurship, with time turned out to be nothing more than soap bubbles” (Rutgaizer 1992, p.20). In December 1990, the All-Union Center of Public Opinion Research asked Soviet citizens: ‘Is a return to mass reprisals possible in the Soviet Union?’ Only 17% of respondents responded affirmatively. “Nearly half the respondents could not answer this question. Nonetheless, the proportion of those believing that new reprisals are impossible was double the number of those who believed that this turn of events is quite possible” (Rutgaizer 1992, pp.32-33).

“Russia in 1992 was a huge country with a weak central government, that had neither will nor capacity to force privatization onto unwilling company managers” (Black et al. 2000, p.1739). To make matters worse, Russia “chose to privatize immediately, and hope that the laws and institutions would follow later” (Black et al. 2000, p.1753). The laws did follow, but it took between 3 and 6 years to pass them.

In the Russian Federation, enterprise managers could clearly observe the crumbling of the law enforcement apparatus, and the lack of enforcement of laws. For example, in their survey

of managers of Russian shops in 1992-1993, Barberis, Boycko, Shleifer, and Tsukanova (1996) found that in some of the main cities shops were privatised illegally via a noncompetitive sale. Although the privatization contracts specified all sorts of restrictions, “the vast majority of the surveyed shop managers did not consider the restrictions to be binding” (Barberis et al. 1996, p.767).

Indeed, “The government’s own behavior reinforced disrespect for rules. Managers had to cheat on their taxes, bribe tax and customs inspectors, and avoid cash transactions to survive. The government didn’t pay its own bills to companies that provided it with goods and services, hardly an incentive for those companies to pay their tax bills. It became increasingly clear that corruption went right to the top-to the extended Yeltsin ‘family’ ” (Black et al. 2000, p.1754).

A main difference between China and the Soviet Union is the Cultural Revolution. After a decade of lawlessness bordering anarchy, the destructuring of the state and bureaucracy, the dismantling of the educational and research & development system, the weakening of the rule of law and the judiciary, and a dismal economic performance, the almost universal desire was one of stability. The direction of reforms was towards a strengthening and reconstruction of the state, the public administration, the judiciary and the educational sector, not one of ‘opening up’ or glasnost. It was a *reconstruction*, not a *deconstruction* process.

One of the key aims of the post-Mao leadership was to redefine the limits of what was permissible in terms of dissent and freedom in China. “Since 1978, concerted efforts have been made in China to rebuild both the state bureaucracy and the national legal system. . . . In China, the rebuilding of the state and Communist Party bureaucratic structure has engaged the full attention of the political leadership since the very beginning of the reform era in 1978” (Naughton 2016, p.404).

In fact, the common emphasis on decentralisation and local experimentation in China might need some important qualification and delimitation. While a certain degree of *economic* decentralisation was tolerated if not actively promoted, the *political* structure of the

Chinese state was strongly centralised and the repressive apparatus was intact and fully operational. “A 1978 editorial in the People’s Daily catalogued an impressive list of fears that kept most local officials from innovating: ‘The fear of being labeled as a ‘capitulationist’; the fear of being dismissed from one’s post; the fear of being expelled from the party; the fear of being divorced by one’s wife; the fear of serving a prison term; and the fear of being beheaded.’ Repression was less extreme than during the Cultural Revolution, but officials knew nevertheless that in the past initiative had been punished as often as rewarded” (Cai and Treisman 2006, p.515).³⁹

These fears are not unfounded as the Chinese government managed to establish credibility in terms of penalties for defections. While no hard data exist, “a multitude of press reports on China suggests that the government has imposed harsh penalties, including the death penalty, for enterprise managers who abuse their power ” (Djankov and Murrell 2002, p.777). More generally, whenever the authority of the CCP has been threatened, its leaders have not hesitated to resort to brutal force to maintain ‘social order’, for example during the ‘wall of democracy’ events in Beijing in 1979 (Dreyer 1980) and most deplorably a decade later on Tiananmen Square.

Although the initial doi moi reforms emphasised enterprise autonomy and started the equitisation process for SOEs, in Vietnam the whole transition was initiated in response to the potential threats faced by the VCP due to economic crisis, and its explicit aim was to reassert VCP control on the economy and society. Even when it started relaxing the planning constraints on firms, the VCP never lost control of SOEs and indeed increased its control and monitoring capacity after doi moi was launched by making SOEs part of a state-led developmental agenda (UNDP 2006). During interviews with researchers held in the late 1990s, SOE managers insisted that production and business plans had to be approved by the relevant government agency (Fforde 2004, p.16) and no manager felt that running the

³⁹“As late as 1985 party secretary Hu Yaobang felt the need to reassure local officials that, although they might be fired for committing this ‘mistake,’ at least they would ‘normally not be deprived of their material privileges, nor would their family members and relatives be discriminated against’.” (Cai and Treisman 2006, p.515).

firm at a loss would be permissible (Fforde 2004, pp.21-22). According to a World Bank survey, “some 40 per cent of the first companies to equitize said that the state remained a significant influence in their company after equitization” (Gainsborough 2003, p.61). See also UNDP (2006).

Much like in China, while a Vietnamese version of perestroika was implemented, no glasnost took place, and the government maintained a tight – albeit less than comprehensive – control of society and clearly defined the scope of the permissible, without hesitating to repress any form of dissent; see Greenfield (1994, p.207) and Kerkvliet (2001, p.S170).

In Mongolia, privatisation started almost immediately and, as in China, it was a tightly controlled and highly centralised process (Anderson et al. 1997). “The Privatization Commission staff ordered enterprises to prepare plans, but there was very little discretion applied in the preparation of plans and no discretion applied in the method of privatization – every enterprise would be sold for vouchers on the stock exchange” (Anderson et al. 1999, p.218). Further, local and central governments maintained significant ownership stakes in a substantial proportion of firms and governmental involvement in corporate governance was pronounced: “fully 91% of the directors of the enterprises with state ownership identified a specific government entity when asked which particular authority exercised the state’s ownership rights. Moreover, 65% of these directors met with this authority at least once a month, rather frequently in view of the sometimes formidable difficulty of travel to such meetings in this poor, vast country. Eighty-nine percent of enterprises with majority state ownership had governmental representatives on their boards of representatives” (Anderson, Lee, and Murell 2000, p.530).

5.4 Elite Partisanship and the political system

Post-Communist states. Several authors have also emphasised the importance of political reforms, and the political process more broadly, arguing that the transition of government from a communist state to an institution supporting a market economy is as critical as eco-

conomic reforms (Shleifer 1997; Shleifer and Frye 1997). In addition to the direct relevance these elements may have had, one may argue that they have also played an indirect role in orienting expectations concerning the success of reforms.

There are two aspects of the political process right at the beginning of transition that seem relevant in our context. First, as Shleifer (1997) argues, significant renewal in the political elite is an important determinant of the success in the transition process. Indeed, contingent on the communist system collapsing, it is likely that significant change in the political elite is important in lending credibility to reforms. Further, “Moral leadership, including by public officials, is necessary to provide legitimacy to these new structures” (Raiser 1999, p.14). Second, and related, political stability is crucial in order to coordinate expectations.

Both mechanisms can be seen at play in Bulgaria. On the one hand, after the coup against Zhelyuzkov in November 1989, the Bulgarian Socialist Party (former Communists) won a significant victory in the first general elections in 1990. On the other hand, from the very beginning the whole transition process was plagued by massive political instability and political stalemate up until 1997 with no fewer than seven governments in 1989-1996 leading to “rapidly changing economic regulations and policy priorities” (OECD 1997, p.20). Further, “Since its establishment in 1992, the Privatisation Agency has experienced four changes in directors, and the Supervisory Board has also changed frequently. Changes in personnel and the line ministries were even more frequent, often resulting in staff changes at still lower levels” (OECD 1997, p.122). Similarly, newly elected governments routinely changed “hundreds of state-owned enterprise executives. In this situation, executives can expect that their appointment will last until the election of a new government. . . . For the executives themselves the objective becomes maximization of their personal gain during the short period of the current administration” (Pamouktchiev et al. 1997, p.206).

Unlike in Bulgaria and Russia, in Poland, Hungary and the CSFR, the transition process led swiftly to a major turnover in political elites. “For example, 75 percent of local leaders

elected in Poland in 1990 had no record of government service, and 45 percent of newly elected mayors were under the age of 40. While I have not been able to find comparable percentages for Russia, they are certain to be a good deal lower even now. The reason that Poland had such substantial replacement of political leadership is the popularity of Solidarity. In 1990, 47 percent of newly elected politicians came from civic opposition movements (mainly Solidarity) and another 39 percent were independents, with only 8 percent being communists. In the Russian election to the local soviets in 1990, a much lower 33 percent of the winners came from civil opposition movements and a vastly higher 49 percent were communists” (Shleifer 1997, p.400).⁴⁰

The new elites in Poland, Hungary and the CSFR could credibly mobilise support for reforms and effectively used the longer term prospect of EU accession as a mechanism for coordinating expectations. In Poland and Hungary, “elites appealed to different symbols in the process of reconstituting the state: continuity with the partial reforms in Hungary, and mass movement and conflict in Poland. These differences have influenced the techniques of institution building and may yet have lasting effects. However, political elites in both cases were able to draw on historical traditions of nationhood and rally public opinion around the principles of free market economy and democracy, with the ultimate aim of regaining a place among the European nations . . . This provided a long-term prospect and potential gain that helped public officials to bind their hands and achieve some policy credibility, against the background of public distrust. Hence, at least basic (if limited) third-party enforcement

⁴⁰More precisely, from June 1989 to May 1990, Hungary did experience a political vacuum, with a long negotiated transition out of the Communist regime – unlike CSFR and Poland, where the regime collapsed. During that period Hungary was a case of devolved, or dissolved power without a set of clear institutions and without a strong opposition. “The debate over privatization thus took place in a context in which the formal mechanisms of governance of the old order were decomposing, while the political and societal institutions of a new configuration of were only in formation” (Stark 1990, p.356). Besides, while economic reform was part of the negotiations, no agreement was reached at this stage.

Based on field research, Stark (1996) argues that the spontaneous privatisation occurring at the beginning of transition was a rational response to the significant uncertainty faced by managers who opted for diversifying their assets. Stark (1990) reports of ‘startled enterprise managers’ who learned that their firms were scheduled to be privatised from the press. Thus, “In the 1990s, corporatization paradoxically involves efforts by the state to reclaim the actual exercise of the property rights that had devolved to enterprise-level actors” (Stark 1996, p.1001). In other words, Hungary was about to experience a vicious circle of the Russian type but it was stopped in time (Webster 1993a, p.27).

was available relatively quickly, supporting the gradual emergence of extended trust. The importance of the goal of membership in the European Union in binding policy makers' hands in central and eastern Europe points more generally to the advantage of geographical proximity to the West" (Raiser 1999, p.12).

Indeed, it is quite likely that EU accession acted as an important mechanism coordinating expectations for many of the CEE countries (Hoff and Stiglitz 2008, p.1494). "Entry into the EU ... is seen as one of the main objectives for the populations of CEE countries, and it is likely that individuals' beliefs are that EU institutions represent the right institutions" (Campos and Coricelli 2002, p.826).⁴¹

Mongolia was de facto the 'sixteenth republic' of the USSR and shared many of the latter's problems, but its independence allowed it to start the transition earlier and on an autonomous path. A peaceful revolution led to free elections in 1990 and a very broad coalition government taking office, which reflected a broad national consensus and promoted a programme of sweeping reforms.⁴²

Communist states. Gorbachev's approach to reform was fundamentally Leninist, as Solnick (1998) and more recently Zubok (2021) have forcefully shown. Gorbachev perceived the Soviet Union and the CPSU as slumbering giants that needed to be awakened with a shock. He proceeded to break down structures and habits to decentralise power and reduce control. This implied breaking down the traditional chains of command without replacing them with new ones.⁴³ But it also implied that reforms proceeded at a fast pace whenever the window of opportunity presented itself, and without necessarily building consensus around them. He considered the Party and State apparatus more like dead weight than part of the reform

⁴¹The Bulgarian case confirms this. A major economic crisis in 1997 prompted the beginning of EU Accession talks in 1999, which were used as a commitment device to exit the bad equilibrium.

⁴²A certain degree of autonomy of, and competition between, local governments in the management of privatised enterprises was allowed, which rapidly hardened the firms' budget constraints. "In Mongolia, local governments have hard budget constraints but also the flexibility to aid enterprises within these constraints. In addition, the local governments face inter-jurisdictional competition for mobile resources" (Anderson et al. 2000, p.228).

⁴³See for example the major weakening of the chain of control after Gorbachev removed the power of the cabinet ministries to fire SOE managers.

coalition. From this viewpoint, Gorbachev was a true Bolshevik, and according to Stiglitz (2000), a similar Bolshevik approach characterised the post-Soviet leadership.

“The Chinese were not historically immune to this mentality but they seem to have ‘got it out of their system’ in the Great Leap Forward and the Cultural Revolution. They learned the hard way where that Bolshevik mentality would lead” (Stiglitz 2000, p.155). After getting rid of the ‘Gang of four’ in 1976, the leadership of the CCP was unanimous that changes were necessary and Deng Xiaoping’s priority was the rehabilitation of the old guard of revolutionaries who had been in charge of the state apparatus and the economy until the mid 1960s, who had clear Communist credentials, links with the military, and significant personal credibility (especially the architect of the economic reforms, Chen Yun). The message was not one of dismantling and freeing up, but one of regaining control and re-establishing the rule of law, procedures, control over the economy, and so on. Major efforts were made to build a broad consensus over policies.

On the one hand, conscious efforts were made to manage peoples’ – and, especially cadres’ – expectations by setting limited, but feasible policy goals, namely economic growth and social stability. Thus, “the system works the way people within it thinks it will work. People believe that the Communist Party runs the system of evaluation and promotion, and that their expectations about what will affect their careers have been realistic. Expectations in the system are in equilibrium” (Naughton 2016, p.408).

On the other hand, by the end of the 1980s, China was more politically centralised than the USSR, and strong mechanisms were in place both to punish *and* to reward cadres Cai and Treisman (2006) .⁴⁴

Local experimentation of economic policies was conducted under the close supervision of (different factions of) the central apparatus. “Although grassroots initiatives played a part in [Chinese] reforms, their design and geographical spread owed much to the authoritarian

⁴⁴Naughton (2016, p.407) argues that “high-powered incentives evolved in the Chinese context as an essential regime survival response, since they prevented a ‘cascade of defections’ from the regime, such as occurred in the Soviet Union”.

centralization of Chinese politics” (Cai and Treisman 2006, p.518). Successful economic policies were used in the political struggle at the central level and they were part of the – initially informal and then increasingly formalised – mechanism of performance review and promotion within Party ranks (Cai and Treisman 2006; Naughton 2016). The nomenklatura system of personnel management “gives the central leadership enormous power vis-à-vis local authorities [and] is the most important institution reinforcing national unity” (Naughton and Yang 2004, p.9).

Indeed, “At several instances, the central authority was reasserted, as Beijing attempted to reconcile regional autonomy with the national interest. The traditional policy measure used to this effect has been the central credit plan (Naughton 1995) but occasionally, such as during the 1989-91 rectification programme, direct interventions in pricing decisions and material allocation were also used. While institutional design in the Chinese context thus emerged from below and institutional reforms may duly be characterized as bottom-up, the reform process has also been tightly controlled by the top and experiments deemed unsuccessful have been reversed. The strength and credibility of the central government’s reform commitment have thus been of crucial importance for China’s success so far” (Raiser 2001, p.227).⁴⁵

Unlike in Russia, the strategy of the Vietnamese reformers was all but ‘Leninist’: as in China, the aim was to build a broad consensus on reform with an emphasis on collective decision-making and avoiding fractions within the VCP (Painter 2003).⁴⁶ Local fence-breaking experiments were not conducted against the VCP, and the cadres promoting reforms did not want to undermine the party’s power. “The group of local leaders adopting this approach to foster economic reform included Mr. Vo Van Kiet as one of its most respected figures, but also several Party Secretaries at the provincial level and many directors of state-owned enterprises. In trying to promote change on a broader scale, they did not want to

⁴⁵For a further analysis of the role of central credit in reinforcing the central authority in China, see Ma (1995). The control of credit flows has played an analogous role in Vietnam (UNDP 2006).

⁴⁶During doi moi, “Centralized decision making was thus replaced by strong leadership but without individual leaders” (Rama 2008, p.20).

subvert Party hierarchies. They respected the country leadership and did not aim to uproot it; instead, they wanted it to change its mind and come to a new consensus” (Rama 2008, p.18).

Part of the credibility of the transition process stemmed from the fact that the VCP had led the country to victory in war against a foreign aggressor, and the memory of war discipline was still fresh in the party, and in the country. The local leaders promoting economic experiments “had one thing in common, and that was to be politically ‘bullet proof,’ given their track record during the wars” (Rama 2008, p.15). A large number of war veterans (and cadres) could be found among rural entrepreneurs (Hemlin et al. 1998, p.81).⁴⁷ And war may have strengthened social cohesion and limited defections by allowing the VCP to build a narrative around reforms based on nationalism: “Defence of the nation has, over the centuries, been regarded as a supreme duty and Vietnamese histories include numerous accounts of victory in circumstances of unfavourable odds ... Nationalism also plays a significant role as a kind of ‘social glue’. In the doi moi period, economic reforms have been presented as benefiting the nation as a whole and one of the key targets of the reforms has been to eliminate poverty” (Edwards and Phan 2013, p.17).⁴⁸

As noted in a World Bank case study, “Strong national ownership of the reform process has been crucial in successfully implementing change. A strong domestic commitment to increased living standards, employment, and incomes through business development was key factor in achieving progress. Strong national ownership of the reform process helped in building public support for reforms, and this has helped in subsequent implementation” (Mallon 2004, p.43). Further, Vietnam People’s Army has acted as a major stabilising force by playing a very active, prominent role in the economy both directly (Thayer 2000) and

⁴⁷In a survey of Vietnamese enterprises, in the 1990s “Twenty managers (21%) were current members of the Vietnamese Communist Party and two more were former members. ... Forty five percent of sample managers had close relatives in the Party” (Webster and Taussig 1999, p. 16). See also Takada (2001).

⁴⁸Greenfield (1994) forcefully highlights the role played by nationalism in guaranteeing social cohesion and discipline in the early steps of the transition process. “Vietnam’s leading economic advisor, Le Dang Doanh, a proponent of the ‘Taiwanese model’, stated unequivocally, ‘The Vietnamese people are nationalistic. When they’re told something’s in the national interest, they’ll do it’ ” (Greenfield 1994, p.204).

indirectly with a significant number of managers of equitised or private enterprises having a military background; see Takada (2001, Table 10) and Gainsborough (2009, p.265).

Finally, throughout the whole reform process the Vietnamese government adopted a clear, explicit strategy of building investor confidence in reforms. In an evaluation of the transition process, a World Bank report noted: “Strong official endorsement (by the Party, Government and the National Assembly) of the private sector appears to have had a significant impact in building investor confidence, and in increasing pressure on those mid-level officials that have been reluctant to implement streamlined business procedures” (Mallon 2004, p.37).

6 Conclusions

The literature surveyed amounts to a forceful argument to the effect that the transition process may be plagued by coordination failures and expectations may be self-fulfilling, leading to Pareto sub-optimal outcomes. This is an important lesson for any large scale transformation of the economy and the institutional framework. Successful policies are sound policies that are also credible. For, “effective state building depends not only on rulers’ policies but also on societal actors’ strategies” (Gans-Morse 2017, p.339).

In strategic contexts, individual strategies depend, among other things, on the beliefs that agents hold concerning other agents’ actions. “Because privatization is a difficult, long-term process, the incentives, monitoring, and capital market constraints that shape state firm behavior in the period before privatization have a crucial impact on the overall trajectory of the transitional economy” (Groves et al. 1995, p.888). Moving away from a situation where social expectations were widely pessimistic and reforms lacked credibility is difficult, once the economy is locked in a low growth/high informality equilibrium. One observer of the late Gorbachev and early Yeltsin reforms noted that “we do not know how to move out of such equilibriums . . . people do not change their expectations quickly, even when confronted with such dramatic events as the dissolution of the Soviet Union” (Shiller et al. 1992, p.180).

Bulgaria started on the wrong path and settled initially on the bad equilibrium with low credibility, pessimistic expectations, massive asset stripping and output decline. But the country eventually moved out of the bad equilibrium by using EU accession as an institutional shock and coordinating mechanism.

In Russia, the economic collapse that accompanied market reforms clearly also had far-reaching consequences. The initial lawlessness and instability have been (partly) reined in, central authority has been restored, and the economy has experienced some economic growth. Gans-Morse (2017) provides robust evidence that Russian managers' behaviour and beliefs increasingly aligned with the legal reforms of the Putin government in the 2000s. Nonetheless, the disastrous effects of the 90s continued to be important. It is now widely accepted that the government of Vladimir Putin in Russia has used the disastrous economic consequences of Russia's market transition to legitimize the de facto centralization of authority and far-reaching constitutional and legal changes, which now underpin its authoritarian rule at home and made possible a war with Ukraine.

The long-term consequences of divergent expectations are thus clearly important. This paper has provided a first comprehensive survey of the literature and evidence on these subjective expectations. Our survey highlights that, notwithstanding lack of quantitative comparable and harmonized data, a substantial wealth of evidence does exist and appears consistent with models emphasizing strategic complementarities and multiple equilibria. Further clarifying the connections between divergent expectations and long-term outcomes of transition is an important task for future inquiries.

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