

WHAT ARE THE LESSONS FOR DEVELOPMENT SUCCESS FROM TRANSITION ECONOMIES: PUTTING THE SUCCESS STORIES IN THE POST-COMMUNIST WORLD INTO A BROADER PERSPECTIVE*

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There are at least three reasons, why many transition economies succeeded by pursuing policies that are so different from radical economic liberalization (shock therapy) that is normally credited for the economic success of Central European countries.

First, optimal policies are context dependent, they are specific for each stage of development and what worked in Slovenia cannot be expected to work in Mongolia. Second, even for countries at the same level of development, reforms needed to stimulate growth are different; they depend on the previous history and on the path chosen. The reduction of government expenditure as a share of GDP did not undermine significantly the institutional capacity of the state in China, but in Russia and other CIS states it turned out to be ruinous. It is the growth diagnostics that should reveal the missing ingredient for economic growth. Introducing this "missing ingredient" should not result in the destruction of other pre-conditions for growth. The art of the policymaker is to create markets without causing the government failure, like it happened in many CIS countries. Finally, third, and most important, there are long term trajectories of development that are path dependent: once the country gets on a particular trajectory, it is sometimes better to stay on track because the costs of transition to a seemingly superior trajectory may be prohibitively high.

QUAIS SÃO AS LIÇÕES DAS ECONOMIAS EM TRANSIÇÃO PARA O SUCESSO DO DESENVOLVIMENTO: COLOCANDO OS CASOS DE SUCESSO NO MUNDO PÓS-COMUNISTA EM UMA PERSPECTIVA MAIS AMPLA

Há no mínimo três razões para o sucesso de muitas economias em transição na condução de políticas tão diferentes de liberalização econômica radical (terapia de choque), à qual normalmente se atribui o sucesso econômico dos países centro-europeus.

Em primeiro lugar, políticas ótimas dependem do contexto, são específicas para cada estágio de desenvolvimento, e não se pode esperar que o que funcionou na Eslovênia tenha igual efeito na Mongólia. Em segundo lugar, até mesmo para países em igual nível de desenvolvimento, as reformas necessárias para estimular o crescimento são diferentes: dependem da história anterior e do caminho escolhido. A redução da despesa governamental como proporção do produto interno bruto (PIB) não prejudicou significativamente a capacidade institucional do Estado na China, mas na Rússia e em outros estados da Comunidade dos Estados Independentes (CEI) foi um desastre. É o diagnóstico do crescimento que deve revelar o ingrediente que falta para o crescimento econômico. A introdução de tal "ingrediente que falta" não deve resultar na destruição de outras pré-condições para o crescimento. A arte do formulador de políticas é criar mercados sem causar o fracasso do governo, como aconteceu em muitos países da CEI. Finalmente, em terceiro lugar, e mais importante, existem trajetórias de desenvolvimento de longo prazo que dependem do caminho: uma vez que o país inicia uma determinada trajetória, às vezes é melhor permanecer neste caminho porque os custos da transição para uma trajetória aparentemente superior podem ser muito altos.

* This article is partly based on Popov (2009a) and Popov (2009b).

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1 ABSTRACT

There are at least three reasons why many transition economies succeeded by pursuing policies that are so different from radical economic liberalization (shock therapy) that is normally credited for the economic success of Central European countries.

First, optimal policies are context dependent, they are specific for each stage of development, and what worked in Slovenia cannot be expected to work in Mongolia. Second, even for countries at the same level of development, reforms needed to stimulate growth are different; they depend on the previous history and on the path chosen. The reduction of government expenditure as a share of GDP did not undermine significantly the institutional capacity of the state in China, but in Russia and other CIS states it turned out to be ruinous. It is the growth diagnostics that should reveal the missing ingredient for economic growth. Introducing this “missing ingredient” should not result in the destruction of other pre-conditions for growth. The art of the policymaker is to create markets without causing government failure, as happened in many CIS countries. Finally, third, and most important, there are long term development trajectories that are path dependent: once the country gets on a particular trajectory, it is sometimes better to stay on track because the costs of transition to a seemingly superior trajectory may be prohibitively high.

2 STYLIZED FACTS

As Leo Tolstoy claimed in “Anna Karenina”, “happy families are all alike; every unhappy family is unhappy in its own way”. This wisdom, however, can hardly be applied to the development success of countries: it appears that success stories in the development and transition world are as different as they can be. It is not uncommon to come across contradictory statements about the reasons for economic success: economic liberalization and free trade are said to be the foundations of rapid growth in some countries, whereas successes of other countries are credited to industrial policy and protectionism; foreign direct investment, which is normally considered a growth-contributing factor, did not play any significant role in the developmental success of Japan, South Korea and pre-1990s China. Privatization of state enterprises, foreign aid, immigration, liberalization of the financial system, democratic political institutions – all these factors, just to name a few, are usually believed to be prerequisites of successful development, but it is easy to point out success stories that are not associated with these factors.

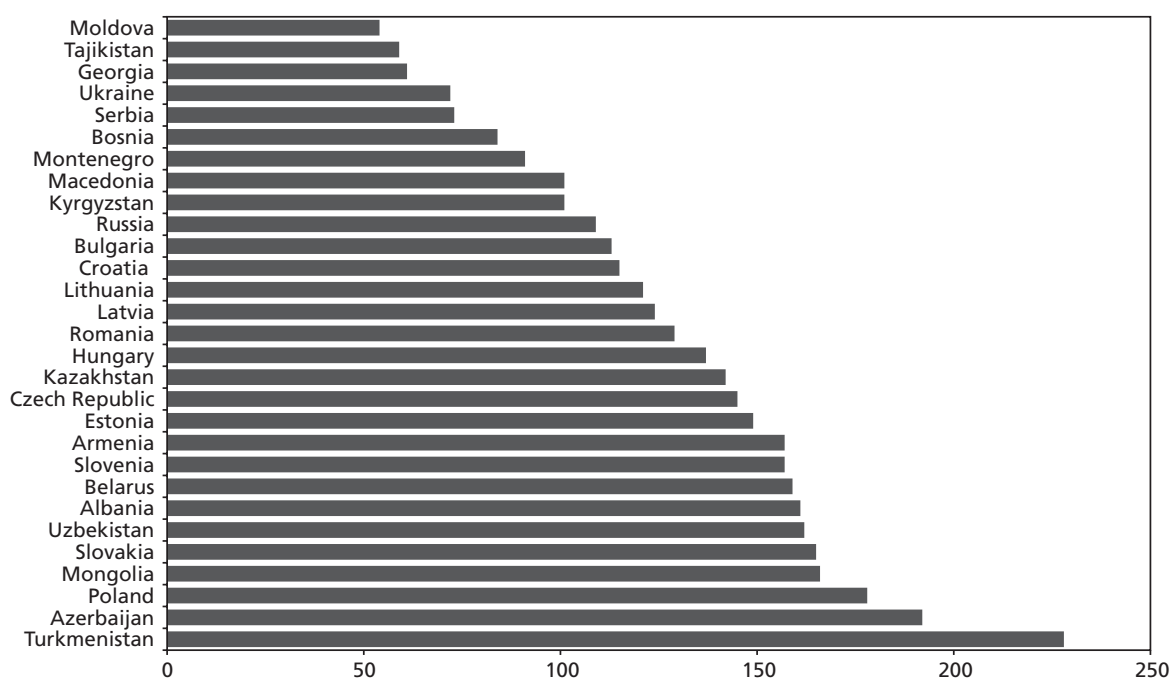
In the 1970s, the breathtaking economic success of Japan, which transformed itself into a developed country in just two postwar decades, was explained by the “Japan incorporated” structure of the economy – special relations between the government and companies (Miti), between banks and non-financial companies (bank-based financial system), between companies and workers (lifetime employment). After

the stagnation of the 1990s, and especially after the 1997 Asian financial crisis that affected Japan as well, these same factors were largely labeled as clear manifestations of “crony capitalism” that should be held responsible for the stagnation.

Similar patterns can be observed in transition countries – from Vietnam and China to former East Germany and Albania. Obviously, what worked in some countries did not work in others. Central European countries – Czech Republic, Hungary, Poland, Slovakia and Slovenia – and to a lesser extent other East European countries are claimed to be success stories of transition. The success is attributed to radical (shock therapy type) reforms – deregulation of prices and markets, macroeconomic stabilization, privatization, the elimination of soft budget constraints (subsidies to state and non-state enterprises), openness to trade and FDI, fast transition to consolidated democracy and membership in the EU.

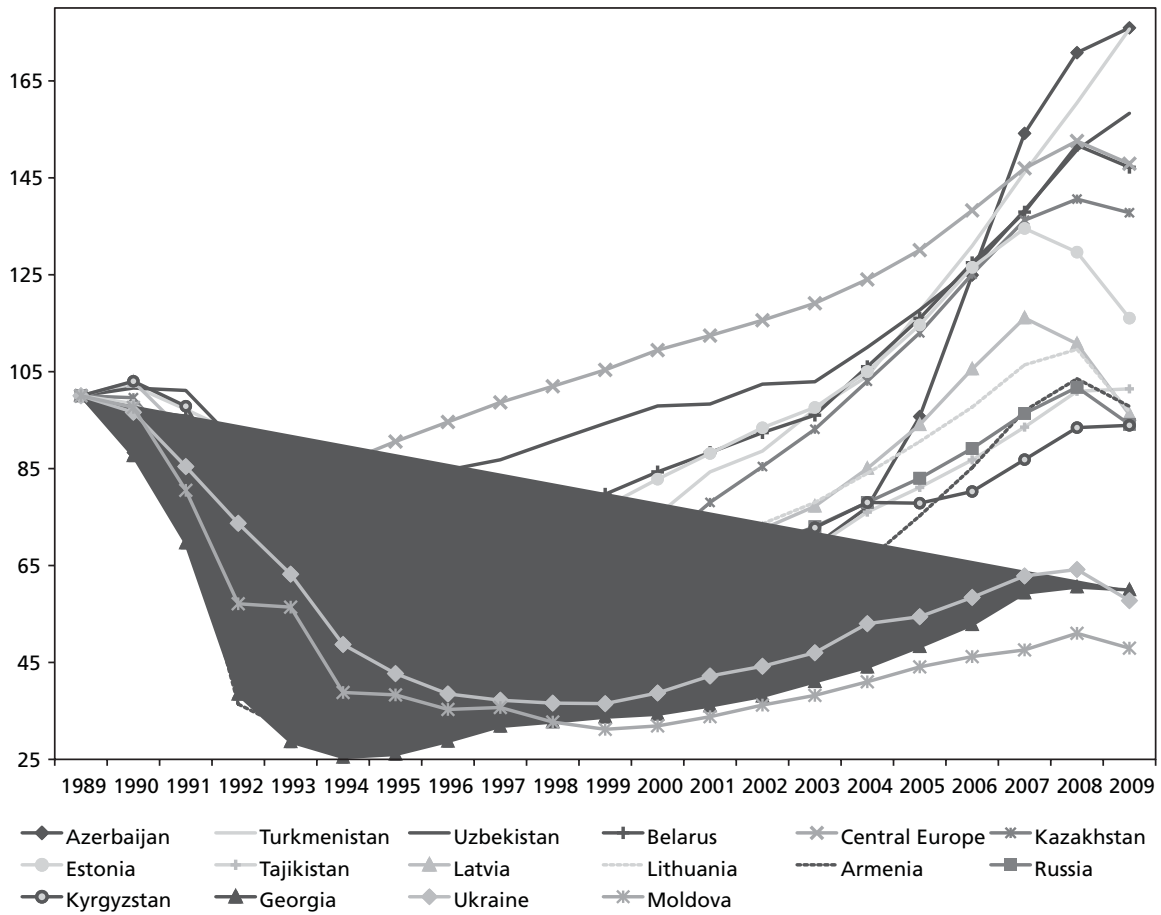
But there are other examples of successes in the region as well. Suffice it to look at the charts below to realize that in the transition world, as elsewhere, “success” (at least as measured by the growth of GDP) is not always associated with economic liberalization and democracy. In 1989-2006 Turkmenistan was doing better than Poland; and Uzbekistan and Belarus – no worse than Hungary and Czech Republic (fig. 1). And whereas former Soviet Union states experienced on average a steeper and more lasting decline in output during the transformational recession of the 1990s (fig. 2), their speed of economic recovery was in many instances higher than that of Central European countries. In 2000-2007 average annual growth rates of GDP in Azerbaijan were 15%, in Armenia, Kazakhstan, and Turkmenistan – over 10% (fig.3).

FIGURE 1
2008 GDP as a % of 1989 level



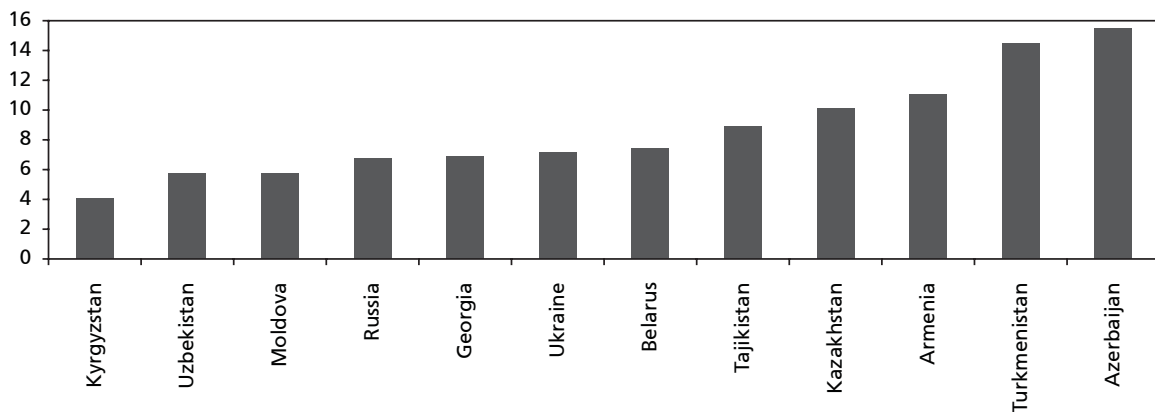
Source: Transition Report for various years, European Bank for Development and Reconstruction (EBDR).

FIGURE 2
GDP change in FSU economies, 1989 = 100%



Source: Transition Report for various years, EBRD.

FIGURE 3

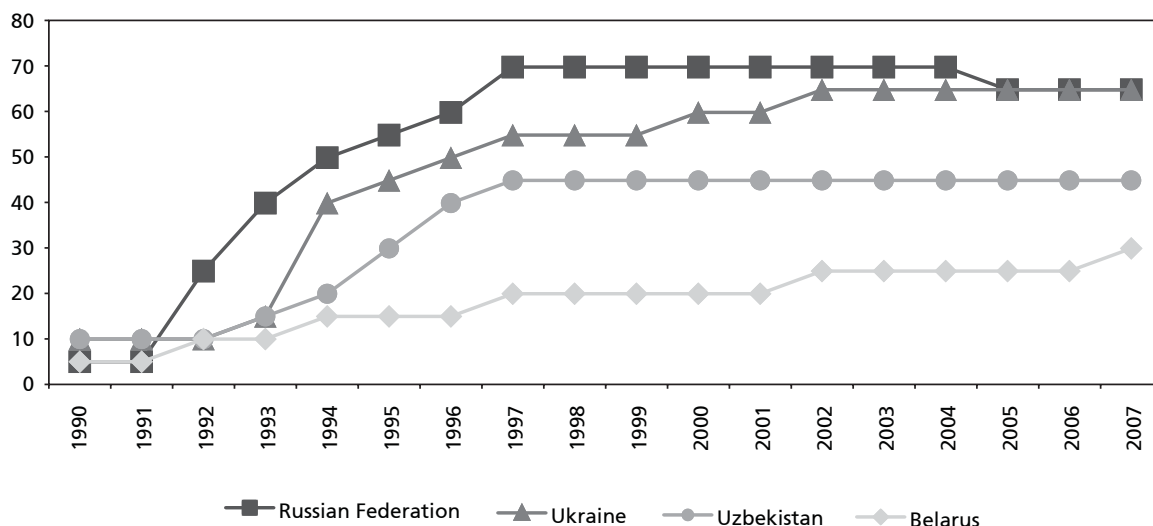


Source: Transition Report 2007, EBRD.

Among the “other”, non-orthodox, success stories in the post-communist world are fuel rich Turkmenistan, Kazakhstan and Azerbaijan, fuel self-sufficient Uzbekistan and Vietnam, and fuel importers – Belarus and China. All these countries are non-democratic, but some are quite

liberal economically (Kazakhstan), whereas others carry out heavy-handed industrial policy and even did not bother to privatize state enterprises in nearly two decades of economic reforms (the share of private sector in GDP in Uzbekistan – 45%, in Belarus – 25%, fig. 4).

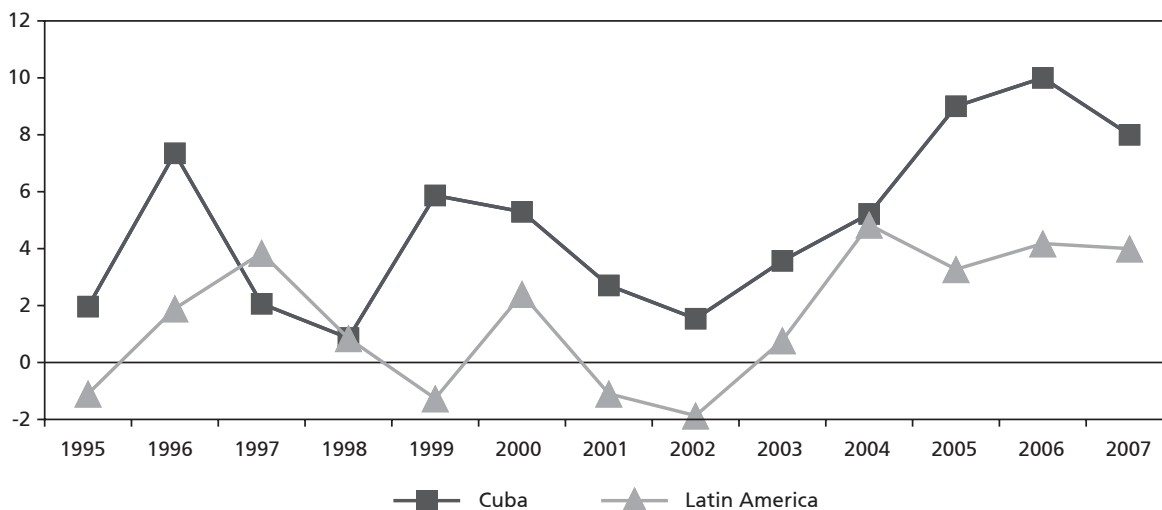
FIGURE 4
Private sector share in GDP, %



Source: Transition Report 2007, EBRD.

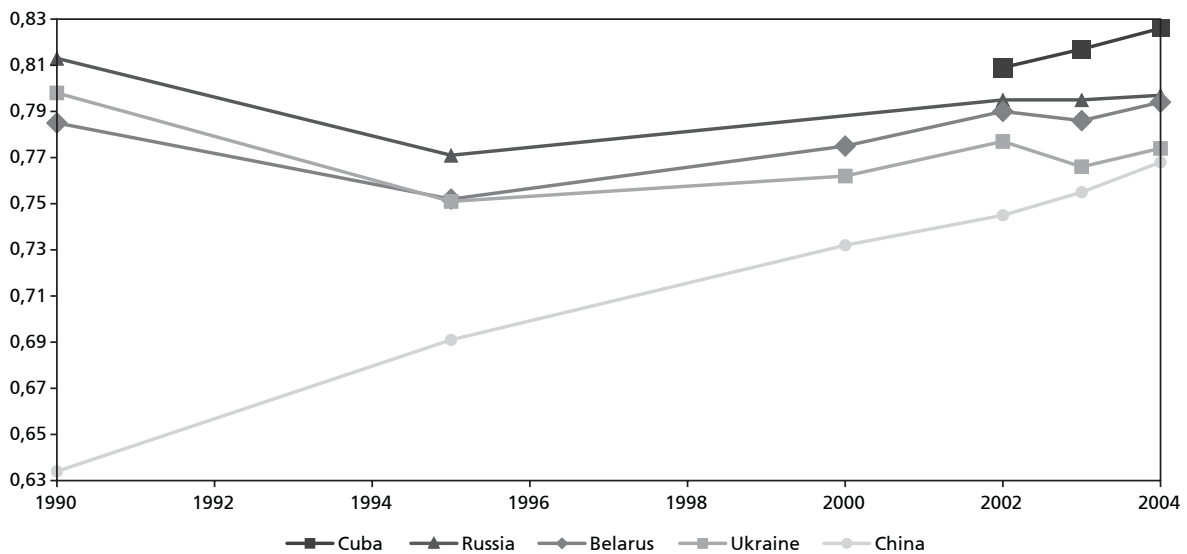
Not to mention the example of Cuba, which still has (despite all recent reforms) a centrally planned economy, but grows faster than Latin American countries on average (fig. 5). In addition, with the life expectancy of 77 years – one of the highest in Latin America (only Costa Rica has a similar indicator) and among communist and post-communist countries – Cuba has a very high Human Development Index, higher than most FSU republics and many EE countries (chart 6).

FIGURE 5



Source: World Development Indicators, 2007, World Bank.

FIGURE 6



Source: Human Development Report, 2007, UNDP.

3 STAGES OF DEVELOPMENT AND OPTIMAL POLICY

One explanation for the different foundations of success is that good policies are context dependent. There is a large body of literature that emerged in recent years and that questions the universality of recipes for reform. Simply put, this literature states that what may be good for a relatively developed country with reasonable institutions is not necessarily good for countries that are farther away from the technological frontier and where corruption flourishes. Even the simple enumeration of the areas where market-oriented reforms are found to be detrimental for less developed countries is quite impressive: free international trade and migration of skilled labor, elimination of subsidies to producers and promotion of competition, liberalization of capital flows and deregulation of domestic financial markets. The general conclusion of such studies is that developing countries should not embark blindly on market friendly policies/reforms, even if the latter proved to be beneficial in more advanced countries. On the contrary, in other areas, such as the protection of intellectual property rights or environmental standards, Western regulatory requirements are perceived to be too strict for poorer countries.

The argument in both cases is that most Western countries 100 years ago did not have either *laissez faire* markets, or today's strict standards of protection of environmental and human rights. Advocating the acceptance of these standards in less wealthy parts of the world, and even threatening developing countries with economic sanctions in case they refuse to accept such standards, the West, whatever the good intentions may be, *de facto* undermines the competitiveness of poorer countries and preserves their backwardness. There are even accusations

of double standard (when the West was industrializing, it was not maintaining these standards) and “kicking away the ladder” (after the West got rich through exploitation of colonies and child labor, it does everything to slow down the growth of “the other world” – Chang, 2002).

Two recent papers by Acemoglu, Aghion, Zilibotti (2002a,b) offer a model to demonstrate to what extent economic policies depend on the distance to the technological frontier. These papers consider policies with respect to hiring managers (lifetime employment vs. temporary contracts) and vertical integration and size of firms¹, but the general principle can be extended to quite a number of areas, from trade liberalization to policies with respect to migration. Optimal policies do differ at various stages of development and the art of a policymaker is to shift gears at the appropriate time. For instance, even if private property is more efficient than state property in developed countries, government-controlled business entities can still be superior to privatized businesses in poor institutional environment, when contracts are poorly enforced, especially in areas where resource rent is generated (Chang, 2007).

It was also shown that policies in a variety of areas (trade protectionism, “exchange rate protectionism” – accumulation of foreign exchange reserves, technological imitation versus indigenous innovation, protection of IPR, industrial concentration versus development of small businesses, bank-based versus market-based financial system, liberalization of capital account, including FDI, migration of skilled/unskilled labor) do depend on the level of development (distance to technological frontier) and on the quality of institutions: cross-country regressions reveal the thresholds in per capita GDP and institutional indicators that separate positive and negative influence of various policies on growth (Polterovich, Popov, 2005, 2006)².

The same is true with regard to political regimes conducive to growth – democratization, unfortunately, leads to the weakening of institutional quality and lower growth, if carried out in countries with poor initial tradition of the rule of law and large resource wealth (Polterovich, Popov, 2007; Polterovich, Popov, Tonis, 2007; 2008).

1. The authors assume that a change of a country's technological level is equal to the weighted sum of technological change due to imitations and innovations. The speed of imitation is fixed, whereas the speed of innovation is larger for more advanced economies. The experience of new managers is most important for imitations, whereas their talents are crucial for innovation. If the distance to the technological frontier is large, the economy would be better off giving managers long-term contracts that would lead to imitation and investment-based growth. But once the economy approaches the technological frontier and innovation yields greater returns than imitation, the lifetime employment system should be replaced by competitive selection.

2. Regression equations have the general form: **GROWTH** = **Control Variables** + **P(a-bX)**, where **P** is the policy variable, for instance, degree of trade protection, and **X** is per capita GDP and/or institutional indicator, for instance, government effectiveness. There is a threshold level of per capita GDP and/or the quality of institutions: before this level is reached, the impact of particular policy on growth is positive, after it is exceeded, the impact turns negative.

In general, such a theory that prescribes a particular mix of policies to countries at different levels of development and with different institutional quality (different levels of human capital, different endowment with natural resources, etc.) seems to be the new emerging conventional wisdom that lays the new foundations of new development economics. In a sense, it is like filling the cells of the economic periodic table – once all initial conditions are factored in, a unique set of policies can be prescribed. The idea in its general form seems to be very intuitive and even trivial, especially to non-economists, but once it comes to particular policy prescriptions (for instance, trade protection can stimulate growth in countries with low level of development, but relatively good institutional capacity), the debates intensify.

Such an approach may explain why particular post-communist countries at a lower stage of development and with poor tradition of the rule of law (Azerbaijan, Belarus, China, Kazakhstan Turkmenistan, Uzbekistan, Vietnam) succeeded under authoritarian regimes and by pursuing economic policies that were often not at all liberal and differed a lot from shock therapy treatment that was used in Central Europe and is credited for its success. And it can also explain why their more democratic and more economically liberal counterparts with similar level of development and similar quality of institutions (Armenia, Georgia, Kyrgyzstan, Moldova, Mongolia, Russia, Tajikistan, Ukraine) did worse, sometimes much worse (fig. 1, 2).

4 GROWTH DIAGNOSTICS: MISSING INGREDIENTS

Still, this is a universal scheme – less straightforward than Washington consensus, but a universal one nonetheless. Another factor explaining successful performance of countries that pursued different policies is that there is more than one route to success. And the routes are path dependent. As Lenin wrote in 1916, “all nations will reach socialism, that is inevitable, but none in exactly the same way”. It may well be that similar countries and even the very same country can achieve what is vaguely labeled “success” by taking different paths that lead to the same final destination and that are not very different in terms of costs and benefits along the way.

As a first step, it may be appropriate to distinguish between market-led and state-led economic systems. If for a given level of economic development there is one and only one optimal combination of state and markets, there should be countries on both sides of the optimal trajectory: leaning to the market, like SSA (Sub-Sahara Africa) and LA (Latin America, with the exception of Cuba, of course), South Asia (SA) and Commonwealth of Independent States (CIS) today, and leaning towards the state, like East Asia (EA) and communist countries before the 1990s. While the former had a lot of deregulation and markets, but not sufficient state capacity, the latter had a lot of state capacity, but heavily regulated

and poorly liberalized markets or sometimes no markets at all. Whereas the major problem in the former was state failure, in the latter it was market failure.

A close analogy is that by Wassily Leontief (1974), who has written that an economy using the profit motive but without planning is like a ship with a sail but no rudder. It may move rapidly, but cannot be steered and might crash into the next rock. A purely planned economy that has eliminated the profit motive is like a ship with a rudder but no sail. It could be steered exactly where one wants it to go, if only it moved. To move forward while avoiding dangerous pitfalls, an economy needs both some reliance on the profit motive and some planning, a sail and a rudder.

Similarly, Steven Holmes (1997) claimed that the major lesson to be learned by Western democracies from recent Russian developments is exactly the one about the crucial importance of state institutions: whereas the Soviet Union has proven that a non-market economic system with a strong state cannot be efficient, Russia today is proving that the market without a strong state is as good as exchanging unaccountable power for untaxable wealth, leading to economic decline.

To put it differently, reforms that are needed to achieve success are different for countries with different backgrounds. Manufacturing growth is like cooking a good dish – all the necessary ingredients should be in the right proportion; if only one is under- or overrepresented, the “chemistry of growth” will not happen. Fast economic growth can materialize in practice only if several necessary conditions are met simultaneously, at the same time. Rapid growth is a complicated process that requires a number of crucial inputs – infrastructure, human capital, even land distribution in agrarian countries, strong state institutions, economic stimuli among other things. Once one of these crucial necessary ingredients is missing, growth just does not take off. Rodrik, Hausmann, Velasco (2005) talk about “binding constraints” that hold back economic growth; finding these constraints is the task of “growth diagnostics”. In some cases, these constraints are associated with the lack of market liberalization, in others – with the lack of state capacity or human capital or infrastructure.

Why did economic liberalization work in Central Europe, but not in SSA and LA? The answer, according to the outlined approach, would be that in Central Europe the missing ingredient was economic liberalization, whereas in SSA and LA there was a lack of state capacity, not lack of market liberalization. Why did liberalization work in China and Central Europe and not in CIS? Because in CIS it was carried out in a way that undermined state capacity – the precious heritage of the socialist past, whereas in Central Europe, and even more so in China, state capacity did not decline substantially during transition.

Take a closer look at the Chinese case. It is important to realize that the rapid catch-up development of the post-reform period is due not only to and even not so much to economic liberalization and market-oriented reforms. The pre-conditions for the Chinese success in the past 30 years were created mostly in the preceding period of 1949-76. In fact, it would be no exaggeration at all to claim that without the achievements of Mao's regime the market-type reforms of 1979 and beyond would never produce the impressive results that they actually did. In this sense, economic liberalization in 1979 and beyond was only the last straw that broke the camel's back. The other, most important ingredients – strong institutions and human capital, had already been provided by the previous regime. Without these other ingredients, liberalization alone in different periods and different countries has never been successful and has sometimes been counterproductive, such as in Sub-Sahara Africa in the 1980s.

Market-type reforms in China in 1979 and beyond brought about the acceleration of economic growth because China already had an efficient government that was created by CPC after Liberation and that the country had not had in centuries³ (Lu, 1999). Through the party cells in every village, the communist government in Beijing was able to enforce its rules and regulations all over the country more efficiently than Qing Shi Huangdi or any emperor since then, not to mention Guomindang's regime (1912-49). While in the late XIX century the central government had revenues equivalent to only 3% of GDP (against 12% in Japan right after the Meiji restoration) and under the Guomindang government they increased only to 5% of GDP, Mao's government left the state coffers to the Deng's reform team with revenues equivalent to 20% of GDP. Chinese crime rate in the 1970s was among the lowest in the world, Chinese shadow economy was virtually non-existent, corruption was estimated by Transparency International even in 1985 as the lowest in the developing world. In the same period, during "clearly the greatest experiment in mass education in the history of the world" (UNESCO-sponsored 1984 Report) literacy rates in China increased from 28% in 1949 to 65% by the end of the 1970s (41% in India).

To put it differently, by the end of the 1970s, China had virtually everything that was needed for growth except some liberalization of markets – a much easier ingredient to introduce than human capital or institutional capacity. But even this seemingly simple task – economic liberalization – required careful management.

3. To a lesser extent it is true about India: market-type reforms in the 1990s produced good results because they were based on previous achievements of the import substitution period (Nayyar, 2006).

The USSR was in a similar position in the late 1980s. True, the Soviet system lost its economic and social dynamism, the growth rates in the 1960s-80s were falling, life expectancy was not rising, and crime rates were slowly growing, but institutions were generally strong, human capital was large, which provided good starting conditions for reform. Nevertheless, economic liberalization in China (since 1979) and in the USSR and later – Russia (since 1989) produced markedly different outcomes (Popov, 2000, 2007a).

5 LIBERALIZATION WITHOUT DESTRUCTION OF STATE INSTITUTIONS

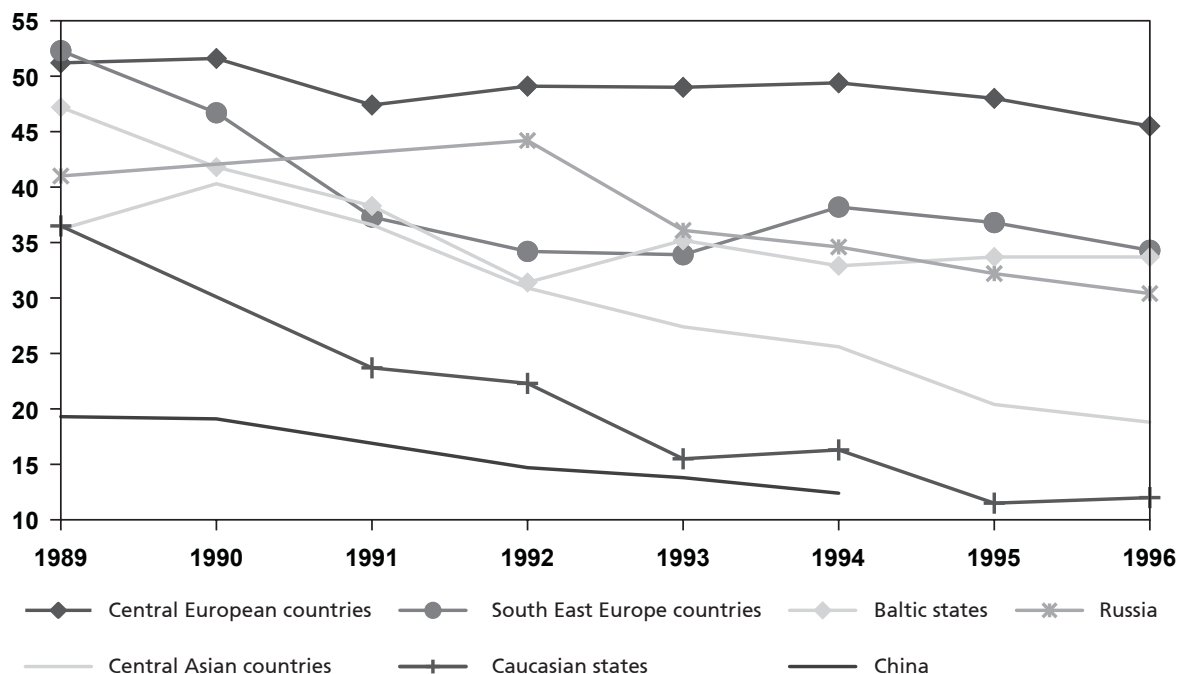
Searching for the reasons for China's successful performance, experts point to the household responsibility system and to township and village enterprises (TVEs), to SEZ (special economic zones) and to the one child policy, to FDI and to connections with *huaqiao* (overseas Chinese). But other countries tried more than once to replicate all these elements of Chinese policy – and generally failed. Not only because they did not have the preconditions in the form of physical infrastructure, human capital and working institutions (the USSR had all these), but because these preconditions for successful liberalization were often not preserved during the reforms. The trick of transition, as is evident *post factum*, was not to carry out economic liberalization, but to carry it out in such a way as not to throw away the baby with the bathwater, not to squander the precious achievements of the previous communist period in the form of strong institutions. China generally did not squander this heritage⁴, even though government spending fell, income inequalities rose and crime rates increased, whereas Russia and most other CIS states did.

4. The post 1979 reform Chinese model of economic growth is based on principles that have nothing to do with the Washington or even post-Washington consensus. Responsible macroeconomic policies (no high inflation) is about the only principle of the Washington consensus that China has adhered to after 1979 (as well as before 1979), whereas with respect to other fundamental principles (fast deregulation and liberalization of prices and markets, downsizing of the government, privatization, opening up of the economy) Chinese policy was not only different from, but exactly the opposite of neoliberal prescriptions (Popov, 2007b). Since 1979, the Chinese economic model is based on:

- Gradual democratization and the preservation of the one-party rule in China helped prevent institutional collapse, whereas in Russia institutional capacity was adversely affected by the shock-type transition to democracy (Polterovich, Popov, 2007);
- Gradual market reforms – “dual track price system” (co-existence of the market economy and centrally planned economy for over a decade), “growing out of socialism” (no privatization until 1996, but creation of the private sector from scratch), non-conventional forms of ownership and control (TVEs);
- Industrial policy – strong import substitution policy in 1949-78 and strong export-oriented industrial policy afterwards with such tools as tariff protectionism (in the 1980s import tariffs were as high as 40% of the value of import) and export subsidies (Polterovich, Popov, 2005);
- Macroeconomic policy – not only in the traditional sense (fiscal and monetary policy), but also exchange rate policy: rapid accumulation of foreign exchange reserves in China (despite positive current and capital account) led to the undervaluation of yuan, whereas Russian ruble became overvalued in 1996-98 and more recently – in 2000-08. Undervaluation of the exchange rate via accumulation of reserves became in fact the major tool of export-oriented industrial policy (Polterovich, Popov, 2004).

Out of 30 transition economies, only a few did not experience sharp reduction of the share of government revenues/spending in GDP during transformation – Estonia, Vietnam and Central European countries (Czech Republic, Hungary, Poland, Slovak Republic, Slovenia); less dramatically than in other countries, government expenditure/GDP ratios fell in Uzbekistan and Belarus (fig. 7). It is easy to notice that these countries are precisely the ones that exhibited the most favorable GDP dynamics: in Central Europe the 2000 GDP surpassed the pre-recession level of 1989, whereas Uzbekistan, Belarus and Estonia (exactly in this order) came closer than other Soviet republics to restoring the pre-transition GDP level, and Vietnam did not experience any transformational recession at all.

FIGURE 7
Consolidated government revenues as a % of GDP

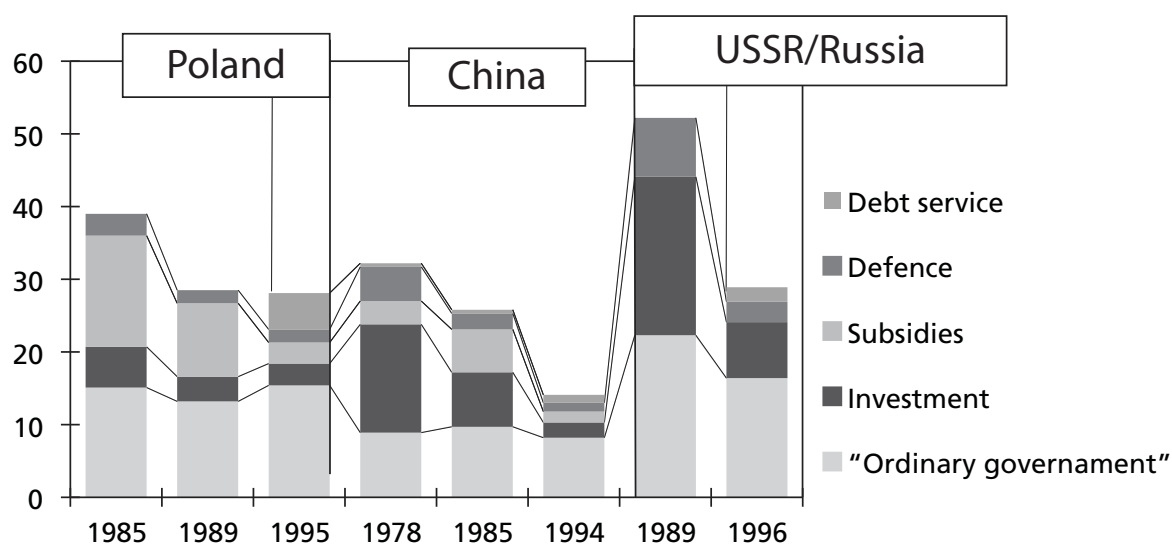


Source: Popov, 2000.

China seems to be an exception to this rule, since there was no transformational recession in China as well, but the share of government spending in GDP fell from 35% in 1978 to 13% in the mid 1990s. However, firstly, the major decrease occurred in the second half of the 1980s, whereas in the first stage of transition government spending grew pretty much in line with GDP. Secondly, the decrease in the share of state expenditure was a controlled process, i.e. it occurred due to the initiative of the government itself, not despite its efforts. And thirdly, the expenditure for the “ordinary government” (excluding subsidies, investment and defense spending) grew in line with GDP. Finally, since 1995 the share of state expenditure in GDP in China has been increasing (about 20% in 2007).

Three major patterns of change in the share of government expenditure in GDP generally coincide with the three major archetypes of institutional developments, and even broader - with three most typical distinct “models” of transition (fig. 8). Under **strong authoritarian regimes** (China), cuts in government expenditure occurred at the expense of defense, subsidies and budgetary financed investment, while expenditure for “ordinary government” as a percentage of GDP remained largely unchanged (Naughton, 1997); **under strong democratic regimes** (Poland), budgetary expenditure, including those for “ordinary government”, declined only in the pre-transition period, but increased during transition itself; finally, **under weak democratic regimes** (Russia), the reduction of the general level of government expenditure led not only to the decline in the financing of defense, investment and subsidies, but to the downsizing of “ordinary government”, which undermined and in many instances even led to the collapse of the state’s institutional capacities.

FIGURE 8
Government expenditure, % of GDP



Source: Popov, 2000.

While in China total budgetary expenditure and that for “ordinary government” were much lower than in Russia and Poland, they were sufficient to preserve the institutions running, since the financing of social security from the government budget was traditionally low. In Russia, however, although ordinary government expenditure seems to have been not that much lower than in Poland, the pace of its reduction during transition exceeded that of GDP: to put it differently, given the various patterns of GDP dynamics, while in Poland “ordinary government” financing grew by about one third in real terms in 1989-95/6 (and while in China it nearly doubled), in Russia it fell by about 2/3! The Russian pattern of institutional decay proved to be extremely detrimental for investment, and for general economic performance.

In most CIS states, reduction of government expenditure occurred in the worst possible way - it proceeded without any coherent plan and did not involve reassessment of government commitments. Instead of shutting down completely some government programs and concentrating limited resources on the others with a view to raising their efficiency, the government kept all programs half-alive, half-financed, and barely working. This led to the slow decay of public education, health care, infrastructure, law and order institutions, fundamental R&D, etc. Virtually all services provided by the government - from collecting custom duties to regulating street traffic - became symbols of notorious economic inefficiency.

Education and health care were free in the Soviet Union, but now these services are provided mostly for a fee and their quality is way below Soviet standards. Life expectancy declined from 70 years in 1987 to 65 years in 2006 (against 73 years in China). Criminalization of the country made a mockery out of the idea of the law and order: the murder rate surged from 10 in the late 1980s to about 30 per 100,000 of the population in the second half of the 1990s, as compared to 1–2 in Eastern and Western Europe, Japan and China, Israel and Mauritius. Only Columbia and South Africa had a higher murder rate than Russia, while Brazil and Mexico had a murder rate of about half Russia's level. Even the US rate, the highest among Western nations at 6–7 per 100,000 of the population, pales in comparison.

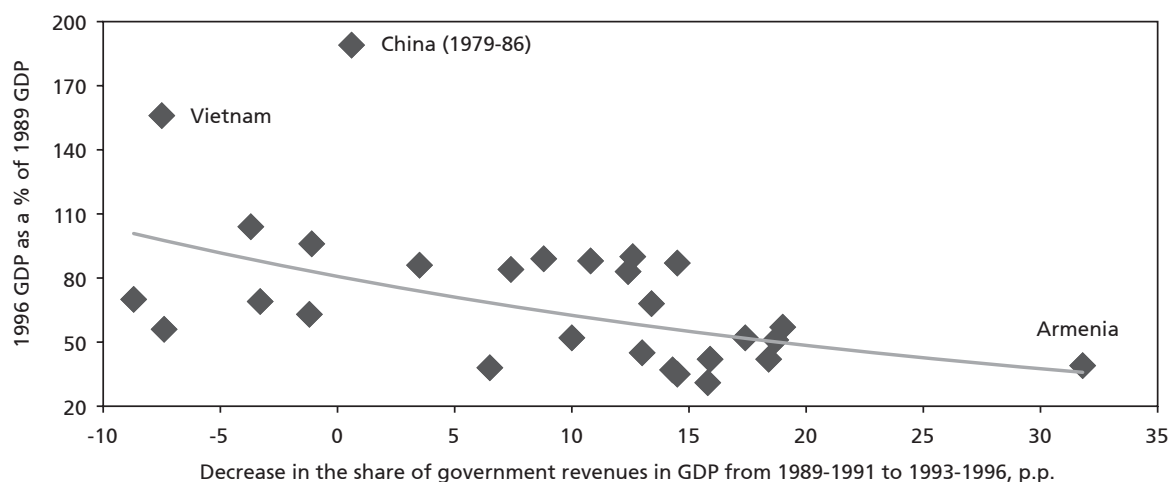
In 1980–85, the Soviet Union was placed in the middle of a list of 54 countries rated according to their level of corruption, with a bureaucracy cleaner than that of Italy, Greece, Portugal, South Korea and practically all the developing countries. In 1996, after the establishment of a market economy and the victory of democracy, according to Transparency International, Russia ranked 48th in the same 54-countries list, between India and Venezuela. In 2005 Russia fell below India. The shadow economy estimated at 10-15% of GDP in the late 1980s expanded to about 40% by the mid 1990s.

This argument is not about the optimal size of the state (a widely discussed issue in economics). It is about the unprecedented in economic history dismantling of the state that occurred in Russia and some other former Soviet republics in such a short period of time in the early 1990s. Simply put, if crime, income inequality, poverty and corruption are on the rise, the state needs more money, not less, to bring these unfavorable developments to a halt.

In Kolodko's words "there can be no doubt that *during the early transition there was a causal relationship between the rapid shrinkage in the size of government and the significant fall in output*" (Kolodko, 2000, p. 259).

If the indicator of change in the share of state expenditure in GDP is added into regressions explaining output change during transition, it remains statistically significant even after factoring in the conventional variables, such as initial conditions (per capita GDP before transition, distortions in the industrial structure and in trade patterns inherited from central planning), the impact of wars, macroeconomic stability (inflation rates) – see Popov, 2000, 2007a. But even in the chart it is apparent that the decline in the share of government revenues in GDP was correlated with the decline in output during the transformational recession (fig. 9).

FIGURE 9
Government expenditure, % of GDP



Source: Popov, 2000.

Virtually everywhere in the transition world the reduction of government spending was accompanied by an increase in the share of shadow economy. Equally unpleasant was the accompanying increase in income inequalities. Only countries with the lowest decline of the share of state spending in GDP (Central Europe, Estonia, Uzbekistan, Belarus) managed to keep inequality increases within reasonable limits. In turn, the increase in income inequalities had a detrimental effect on economic growth because it contributed to social tensions and worsened the investment climate (Alesina, Perotti, 1996; Alesina, Rodrik, 1994) and because it created lobbies that opposed structural reforms and macro-stabilization (Fernandez, Rodrik, 1991; Persson, Tabellini, 1994). Besides, social inequalities created grounds for macroeconomic populism – redistribution of funds from winners to losers, from competitive to non-competitive sectors, from rich to poor (Kaufman, Stallings, 1991): the greater were income inequalities, the stronger was the lure to redistribute the economic pie instead of increasing it.

In general, from all points of view, the dynamics of government expenditure during transition seems to have been by far the more important factor of successful transformation than the speed of reforms. Keeping the government big does not guarantee favorable dynamics of output, since government spending has to be efficient as well. However, the sharp decline in government spending, especially for the “ordinary government”, is a sure recipe to ensure the collapse of institutions and the fall in output accompanied by growing social inequalities and populist policies.

When real government expenditure falls by 50% and more - as happened in most CIS and South-East Europe states in a short period of time, in just a few years, there are practically no chances to compensate the decrease in the volume of financing by the increased efficiency of institutions. As a result, the ability of the state to enforce contracts and property rights, to fight criminalization and to ensure law and order in general falls dramatically.

Thus, the story of the successes and failures of transition is not really the story of consistent shock therapy and inconsistent gradualism. The major plot of the post-socialist transformation “novel” is the preservation of strong institutions in some countries (very different in other respects – from Central Europe and Estonia to China, Uzbekistan and Belarus⁵) and the collapse of these institutions in the other countries. At least 90% of this story is about government failure (strength of state institutions), not about market failure (liberalization).

6 LONG TERM PERSPECTIVE ON PATH DEPENDENCE: EXIT FROM THE MALTHUSIAN TRAP

Why did China manage to preserve relatively strong institutions during economic liberalization, whereas in Russia state institutions collapsed? Part of the answer is the impact of democratization on the quality of institutions: as argued in previous papers (Polterovich, Popov, 2007; Polterovich, Popov, Tonis, 2007, 2008), democratization carried out in a poor rule of law environment (weak state institutions) is associated with further weakening of institutions and with worsening of macroeconomic policy, which has a negative impact on growth and does not allow the creation of a stable democratic regime, especially in resource rich countries.

This is only part of the answer, however, because there are few examples of fast catch-up development under democratic regimes (Japan after the Second World

5. Countries like Belarus and Uzbekistan fall into the same group with Central European countries and Estonia - with small reduction of state expenditure as a % of GDP during transition, good quality of governance, little bribery, small shadow economy and low state capture index (Hellman, Jones, Kaufmann, 2000). In 2005, Belarus and Slovak Republic were the only two countries out of 25 surveyed in EE and FSU (BEEPS – Business Environment and Economic Performance Survey), where significant improvement was registered in 2002-05 in all 7 areas of economic governance (judiciary, fighting crime and corruption, customs and trade, business licensing and permits, labor regulations, tax administration) – EBRD, 2005.

War, Botswana and Mauritius after gaining independence in the 1960s). Besides, differences in the quality of state institutions among authoritarian regimes are huge – less than 1 murder per 100,000 inhabitants in pre-reform China and over 20 in SSA.

Another and more important explanation is probably the long-term development trajectory of institutions in China and Russia. The Chinese 1949 Liberation was similar to the Russian 1917 Revolution not only because communists came to power in both countries, but because traditional collectivist institutions, ruined by preceding Westernization, were re-established and strengthened. However, in Russia 1917-91 communist regime just interrupted the process of transplantation of Western institutions that was taking place since at least the 17th century, whereas in China the 1949 Liberation just returned the country to the long-term institutional trajectory that was briefly (and only partly) interrupted after the Opium Wars.

To put it differently, Russia had already been westernized before 1917, and collectivist institutions that were introduced in Russia by the 1917 Revolution were largely alien to the previous long-term institutional development. On the other hand, China aborted the unsuccessful attempt at westernization (1840s-1949) and returned to collectivist (Asian values) institutions. What was a passing episode and deviation from the trend in Russia was a return to mainstream development and a restoration of the long-term trend in China. Hence, economic liberalization from 1979 onwards in China, even though accompanied by growing income inequalities and crime and murder rates, did not result, at least not until today, in the institutional collapse.

A conventional interpretation of the role of institutions in the rise of the West is that the destruction of traditional structures since the 16th century unleashed entrepreneurial initiative. “The conventional wisdom, endorsed by many economic historians, most notably by Douglass North, points to a connected set of legal, economic, and social institutions that are thought to be necessary for or at least specially conducive to sustained economic growth. The most important are the rule of law itself, secure property rights, relatively untrammelled markets, and a degree of social mobility. They function by reducing the uncertainty surrounding saving, investment, and entrepreneurial activity, and by sharpening the incentives for able people to devote themselves to economic activity instead of violence and prayer. The Industrial Revolution happened when it did because these background conditions were met as they had not been met before; and England is where they were met soonest and most fully” (Solow, 2007).

New data that appeared in recent years, especially indices of the quality of institutions, triggered new debates not only among economic historians, but among general macro- and growth-economists. In an important paper (Acemoglu,

Johnson and Robinson, 2001), entitled “Colonial Origins of Comparative Development”, the authors used an astute indicator for instrumenting the institutions variable – mortality rate among settlers in the colonies of major European states in the 19th century. The argument was that, if these mortality rates were very high (Gambia, Mali, Nigeria had mortality rates hundreds of times higher than Australia, Bahamas, Canada, Hong Kong, New Zealand, US), the settlers did not bother to set good institutions in those countries.

The alternative interpretation of the role of institutions in the rise of the West and of the genesis of the institutions in colonized and non-colonized countries is the continuity perspective. All countries had traditional community structures in the past; everywhere before Reformation, under the Malthusian growth regime, the law of the land was what we now call “Asian values” – the superiority of the interests of the community over the interests of individuals. The Malthusian growth trap emerged due to the inability to mobilize savings from the low-income population. Lack of savings/investment did not allow an increase of the capital labor ratio ($K/L = k$) because population growth rates were relatively high and all investment went to create jobs for the new entrants into the labor force; nothing was left to increase k . Moreover, population growth rates depended on y , productivity (output per employee), so when y increased due to technical progress, A , population growth rates, n , grew as well, eating up all increases in y , achieved due to increases in A .

In the Solow growth model, labor productivity can increase due to technical progress A and due to the increase in capital/labor ratio, $k=K/L$:

$$y = A * k^{\alpha}$$

The needed investment per employee (I_n) – to create jobs for the new entrants into the labor force and to replace retiring elements of capital stock (d – the share of the capital stock that retires annually) is equal to:

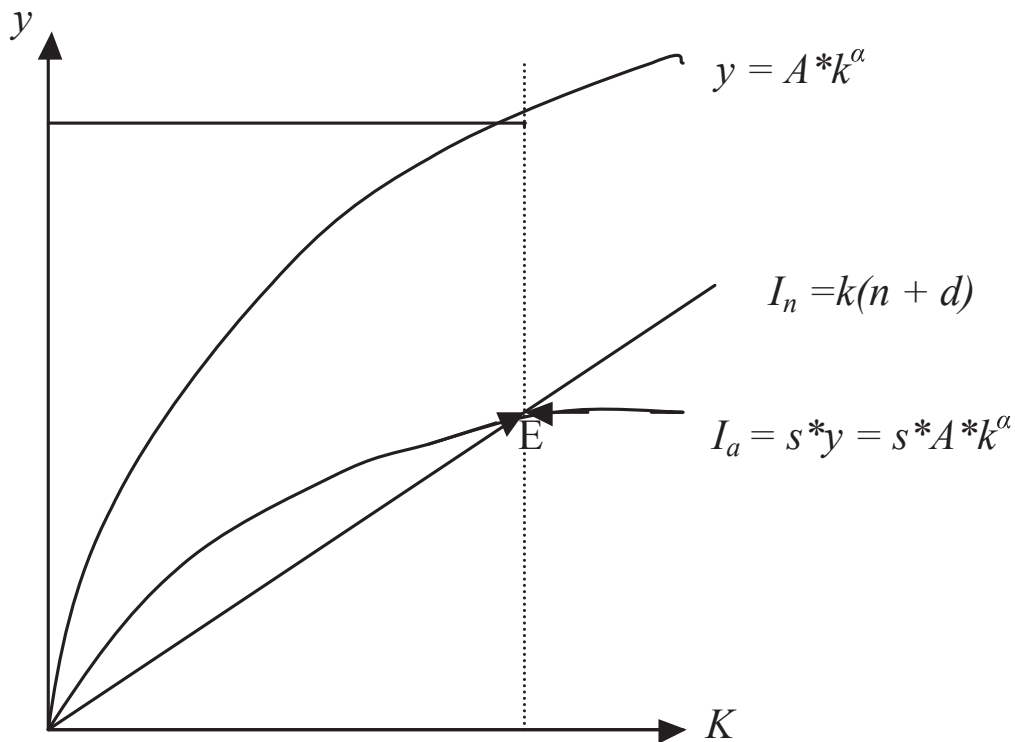
$$I_n = k(n + d)$$

The actual investment per employee, I_a , is equal to savings rate, s , multiplied, by output per employee, y :

$$I_a = s * y = s * A * k^{\alpha}$$

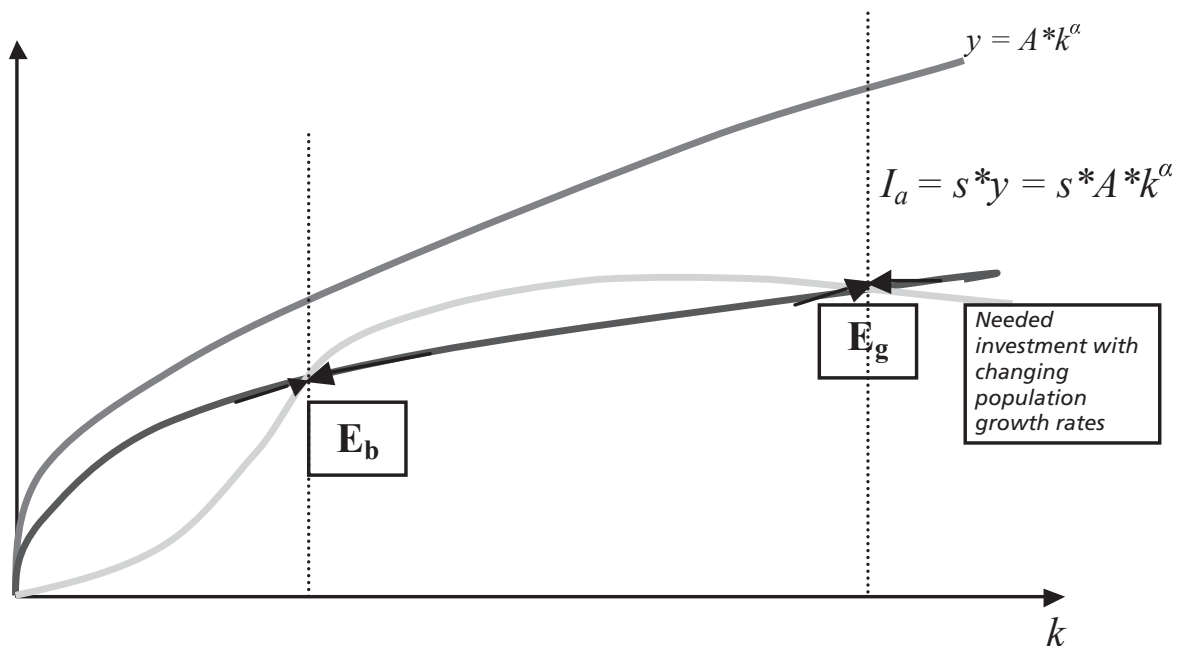
The equilibrium emerges at a point E, where needed investment, I_n , are equal to the actual investment, I_a , see scheme 1.

SCHEME 1
Equilibrium in the Solow model with fixed growth rates of the population



However if population growth rates are not constant, but change with the increase in productivity (and GDP per capita) – first rise with acceleration, then slow down, we get two stable equilibriums – one at a low level of income (bad equilibrium, E_b , growth trap) and another – at a high level of income (good equilibrium, E_g) – scheme 2.

SCHEME 2
Malthusian trap in the Solow model (with changing population growth rates)



In a Malthusian growth regime, before the transition to modern industrial growth, all countries were in bad equilibrium, E_b , so that increases in productivity and per capita GDP, wherever they came from, were quickly absorbed by rising population growth rates, and per capita income declined. Countries had roughly the same productivity and competed on the basis of population: the might of the country was determined by the number of people within its borders and the number of soldiers that the country was able to mobilize in case of the war. Success in technical progress led to the growth in population (like in China before the Opium Wars), not to the growth of per capita income.

Attempts to break this vicious circle were probably taken more than once (Greece, Rome, Byzantine), but all ended up in losing wars with foreign invaders. Countries that tried to eliminate collectivist institutions and to put the interests of the individual ahead of the interests of the community, experienced growth in income and wealth inequalities, which allowed increased savings and investment, but only at a cost of undermining their population growth that was crucial for maintaining the military might of the empires. When income levels were about \$500 per capita (in 1995 dollars), increased income inequalities pushed too many people below the subsistence minimum and led to increased mortality.

The West was the first to exit the Malthusian trap without being conquered by the neighboring countries with collectivist institutions. Making individual rights and freedoms sacred resulted in the growing income inequalities and increase in mortality, but allowed increased savings and investment and K/L ratio, overcoming the limits of the two-dimensional Malthusian world (more population => more GDP). The statistics available on Britain tell the story of huge costs of transition to modern industrial growth in the 16-19th century. The enclosure policy and the Industrial Revolution resulted in a dramatic increase of income inequalities, a rise in mortality and weakening of the institutions.

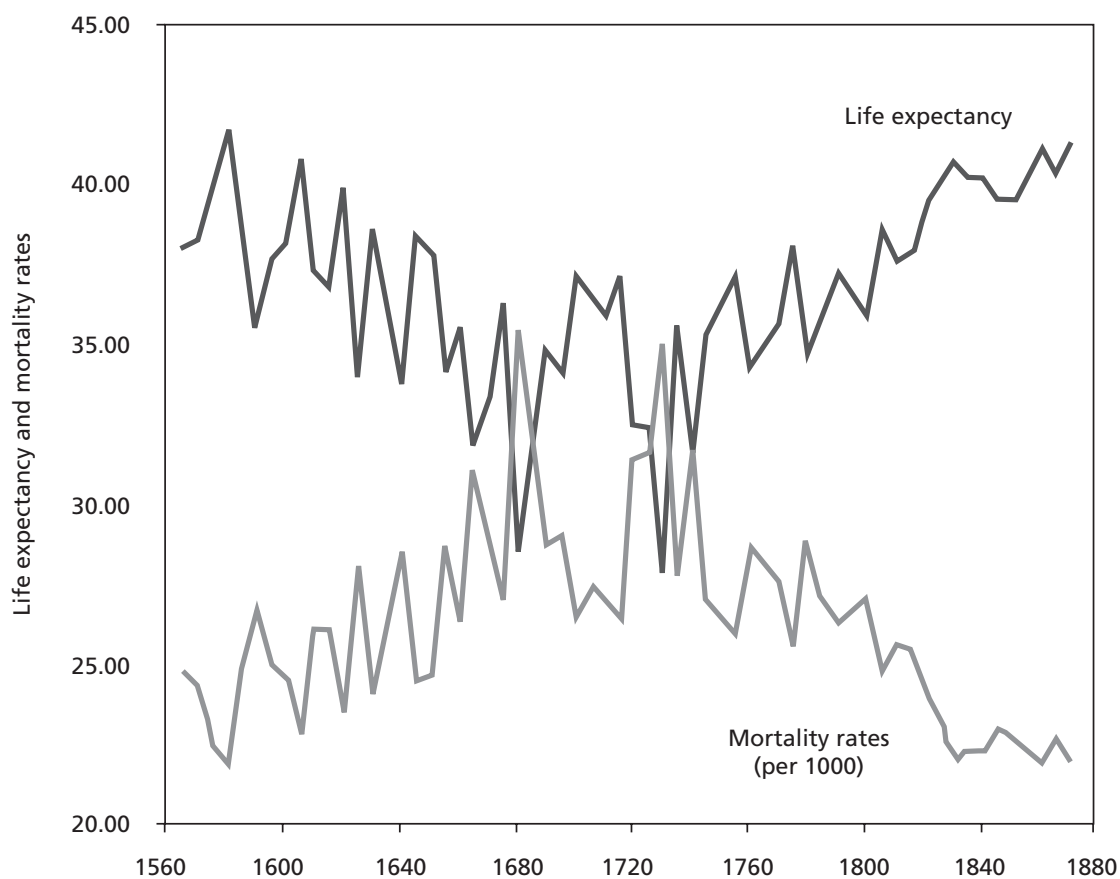
Despite the acceleration of productivity growth in 1500-1800 in the UK (to about 0.2% a year, so that GDP per capita in the UK more than doubled over three centuries⁶), the living standards of workers did not improve. "The single most important fact is that there is no evidence of any significant rise in material living standards for average workers in any societies before 1830" (Goldstone, 2007). This is consistent with the story of rising income inequalities, accumulation of wealth in the hands of a few, and increasing savings and investment rate (the latter increased during the Industrial Revolution from a mere 6% in 1760 to 12% in 1831 – Galor, 1998).

6. GDP per capita in the UK increased in constant 1990 international Geary-Khamis dollars from \$714 in 1500 to \$974 in 1600 to 1250 in 1700 to 1706 in 1820 (Maddison, 2008).

To put it differently, the escape from the Malthusian trap and the transition to the modern growth regime in Britain and later in other western countries became possible not so much due to the acceleration of technological progress and the increase in productivity growth rates. The necessary component of the transition was the elimination of collectivist institutions and the resulting increase in inequality that allowed increasing savings and investment to the point that the accumulation of physical capital started to exceed population growth and capital/labor ratio started to rise. The costs of this transition were extremely high – rising income inequalities and weakening of institutional capacity (high murder rate) leading, among other factors, to a decline in life expectancy from about 35-40 years to about 30-35 years in 1560-1730 (fig. 10).

The other regions of the world, including the most advanced regions, like China, stayed on a different trajectory of development – preservation of “Asian values” and slow, simultaneous growth of productivity and population. We can only speculate now what could have been the outcome of this other trajectory, where population size was the major determinant of competitiveness. The colonial expansion of the West interrupted the logical development along the second trajectory.

FIGURE 10
Mortality rates and life expectancy (at birth) in the course of early urbanization:
England 1540-1870



Source: Galor and Moav, 2005, citing Wrigley and Schofield, 1981.

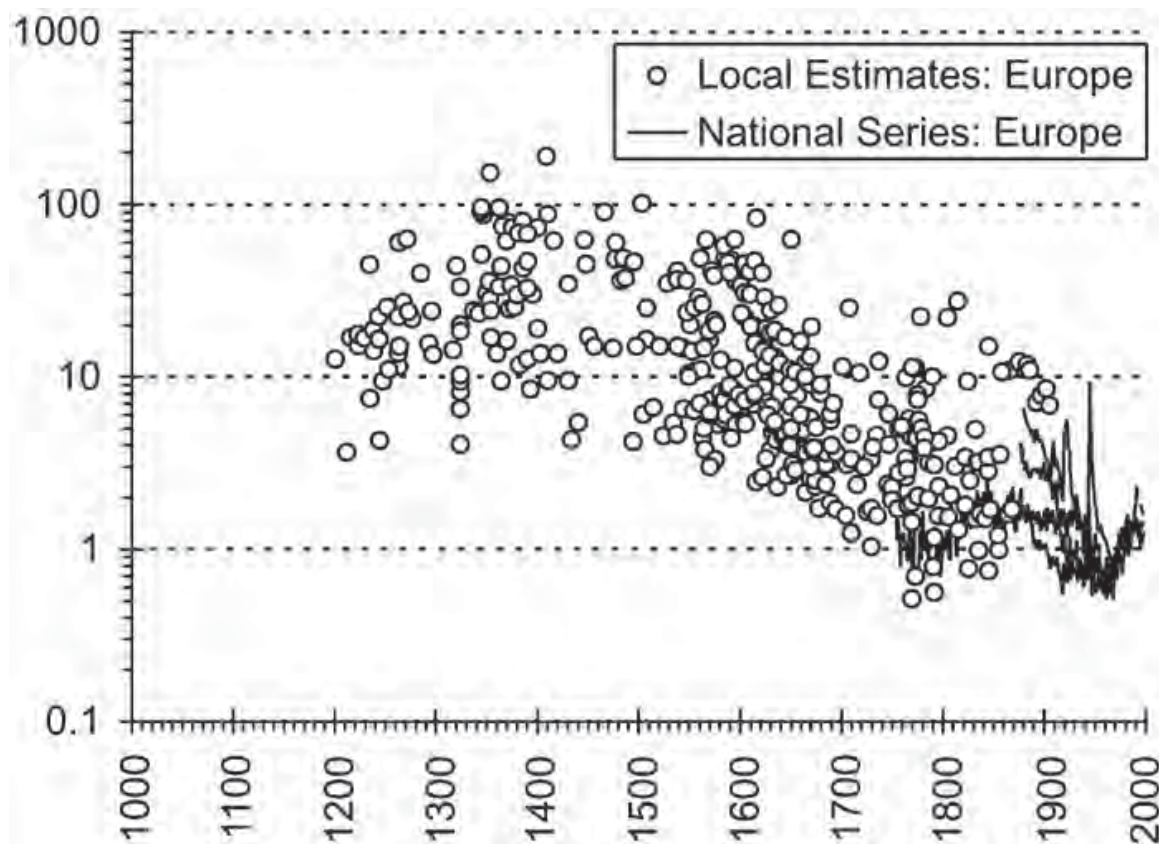
7 ASIAN VALUES VERSUS WESTERN VALUES (INSTITUTIONAL CONTINUITY VS. TRANSPLANTATION OF FOREIGN INSTITUTION)

Colonization of Sub-Sahara Africa, North and South America, Australia and to a lesser extent – South Asia led to complete or near-complete destruction of traditional (community) structures that were only partially replaced by the new Western-style institutions. Among large geographical regions, only East Asia, MENA and to an extent South Asia managed to retain traditional community institutions despite colonialism. It could be hypothesized that those countries and regions that preserved traditional institutions in difficult times of colonialism and imposition of Western values retained a better chance for the catch-up development than the less fortunate regions of the world periphery, where the continuity of traditional structures was interrupted. Transplantation of institutions is a tricky business that works well only when tailored to local traditions, so that it does not interrupt institutional continuity (Polterovich, 2001). Otherwise it leads either to complete elimination of the local structures (US, Canada, Australia) or to a non-viable mixture of old and new institutions that is not very conducive to growth.

If institutional capacity of the state is defined as the ability of the government to enforce rules and regulations, one of the natural measurement indicators is the murder rate. Crimes are registered differently in different countries – higher crime rates in developed countries seem to be the result of better registration of crimes. But serious crimes, like murder, appear to be registered quite accurately even in developing countries, so international comparison of the murder rates is well warranted.

It took Western countries 500 years to bring the murder rates from about a hundred to just several (1 to 3) per 100,000 inhabitants (fig. 11). Even in the 17th century the murder rates in Western Europe were generally exceeding 10 per 100,000 of inhabitants – more than in many developing countries with the similar level of GDP per capita today. In fact, among developing countries today we find two major patterns – low murder rates (1-3 per 100,000 inhabitants) in Eastern Europe, China and MENA countries (fig. 12), and high murder rates (15-75 murders per 100,000 inhabitants) in FSU, Latin America and Sub-Sahara Africa (fig. 13). India (5.5 murders), South East Asian countries (about 10 murders, with the exception of Philippines, where the rate is 21) fall in between the two groups. The argument is that countries that preserved collectivist institutions (East Asia, MENA countries, India) were able to retain institutional capacity of the state, whereas countries that eliminated these institutions while only partly replacing them with an individual accountability system (FSU, Latin America and Sub-Sahara Africa) paid a high price in terms of diminished institutional capacity. Eastern Europe (with the exception of FSU states) could be the exception that proves the rule – it went through a period of low institutional capacity – high murder rates in the 15-17th century, like Western Europe (although direct evidence here is lacking – all observations for fig. 6 are from Western Europe – England, Belgium, Netherlands, Scandinavia, Italy).

FIGURE 11

Long term homicide rates in Europe per 100,000 inhabitants⁷

Source: Eisner (2003).

Note: ¹ All 398 local estimates of the database of the history of homicide. National Series for Sweden, England and Wales, Switzerland and Italy.

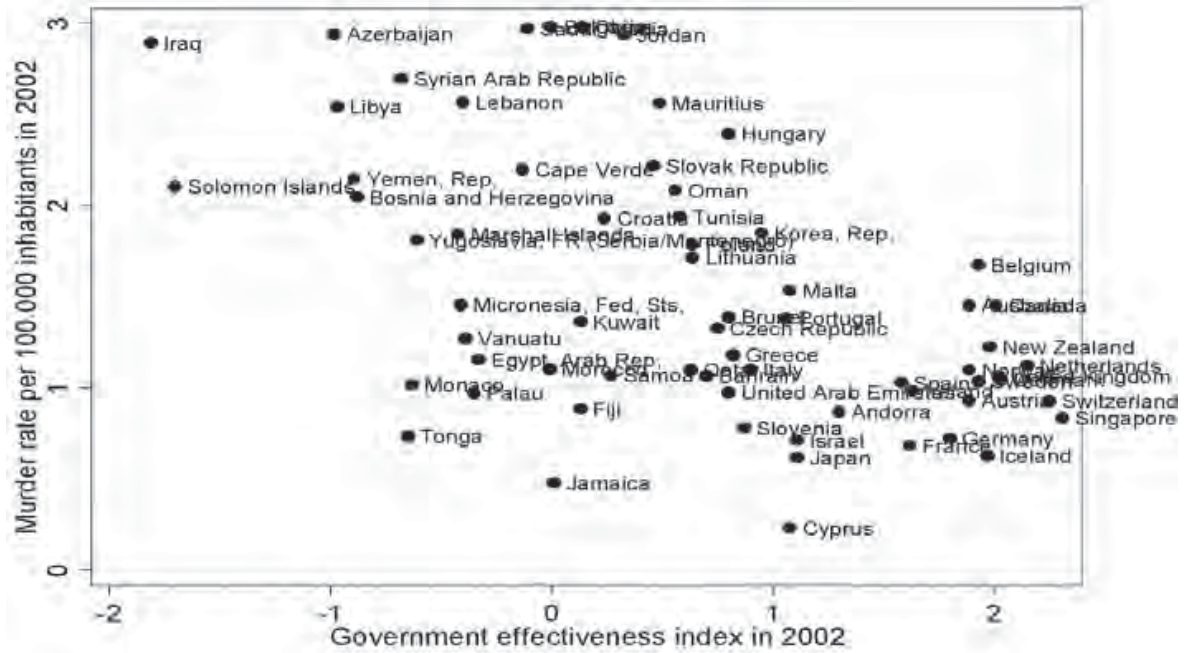
² Overall trends in homicide rates. All pre-modern local estimates and four national series.

Another evidence of the cost of breakdown in institutional continuity comes from data on income inequality in pre-modern societies. The destruction of communal, collectivist institutions that was first carried out in Western countries in the 16-19th century was accompanied by an increase in income inequalities (fig. 14). The available data (Milanovic, Lidert, Williamson, 2007) suggest that in England, Holland and Spain in the 18th century Gini coefficient of income distribution was at a level of 50 and even 60% - an extremely high level according to today's standards and, most probably, according to the standards of the distant past (35-40% in Rome in the 1st century and in Byzantine in the 11th century – fig. 14)⁸.

7. Overall trend in homicide rates, all pre-modern local estimates and four national series. Note: All 398 local estimates from the History of Homicide Database; national series for Sweden, England and Wales, Switzerland, and Italy.

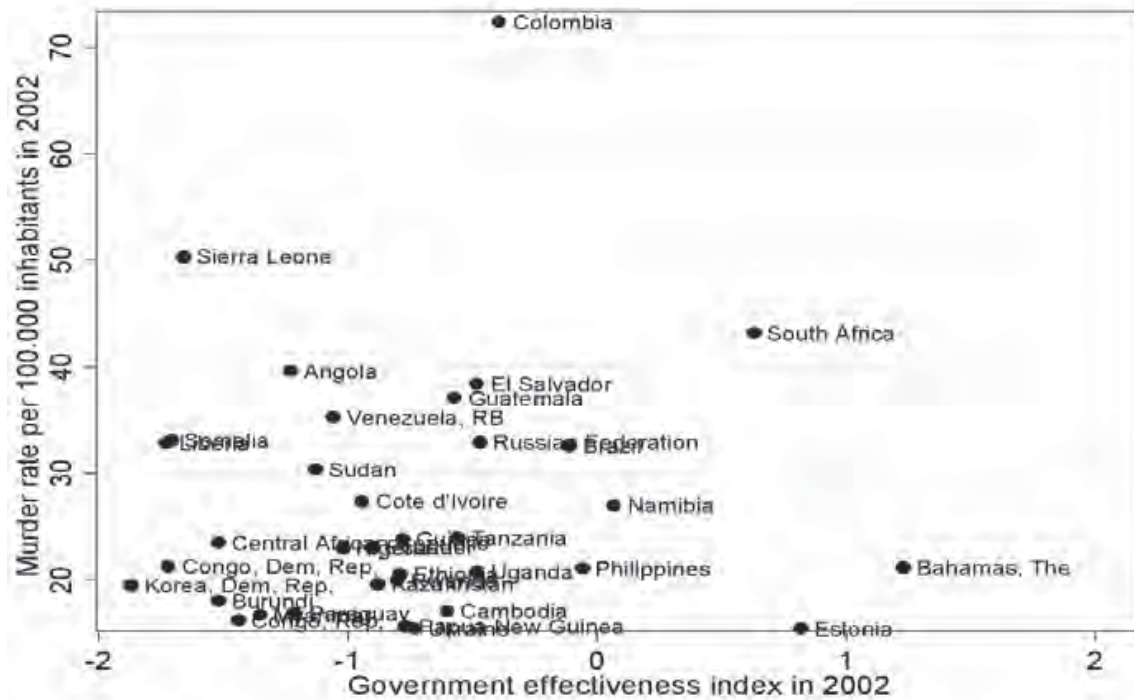
8. Very high income inequalities in low-income countries mean that a lot of people find themselves in extreme poverty, below subsistence level, which leads to high mortality.

FIGURE 12
Murders per 100, 000 of inhabitants and government effectiveness index in 2002 – countries with 1 to 3 murders per 100,000 inhabitants



Source: World Bank; WHO.

FIGURE 13
Murders per 100, 000 of inhabitants and government effectiveness index in 2002 – countries with 15 to 75 murders per 100,000 inhabitants

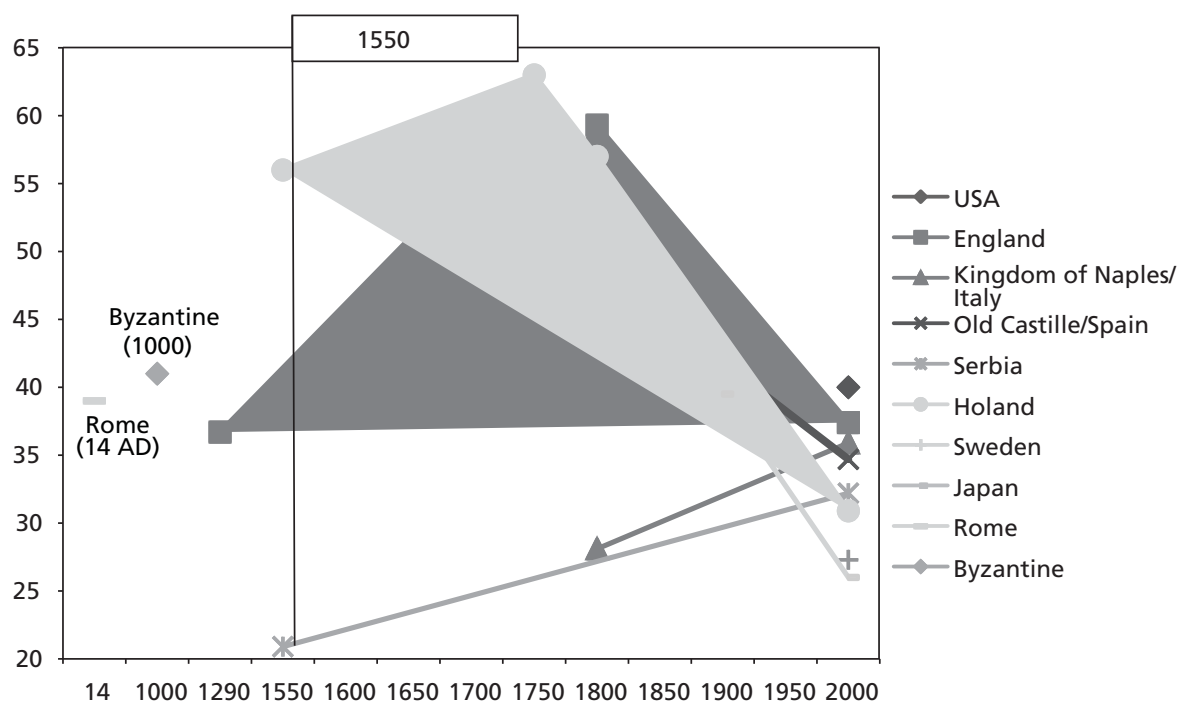


Source: World Bank; WHO.

The income inequality story for developing countries is quite consistent with the dynamics of institutional capacity: in SSA, LA, FSU, where institutional continuity was interrupted and institutional capacity weakened, inequalities increased and remain high today, whereas in MENA, EE, India and East Asia (especially until the 1990s) inequalities are noticeably lower (fig. 15).

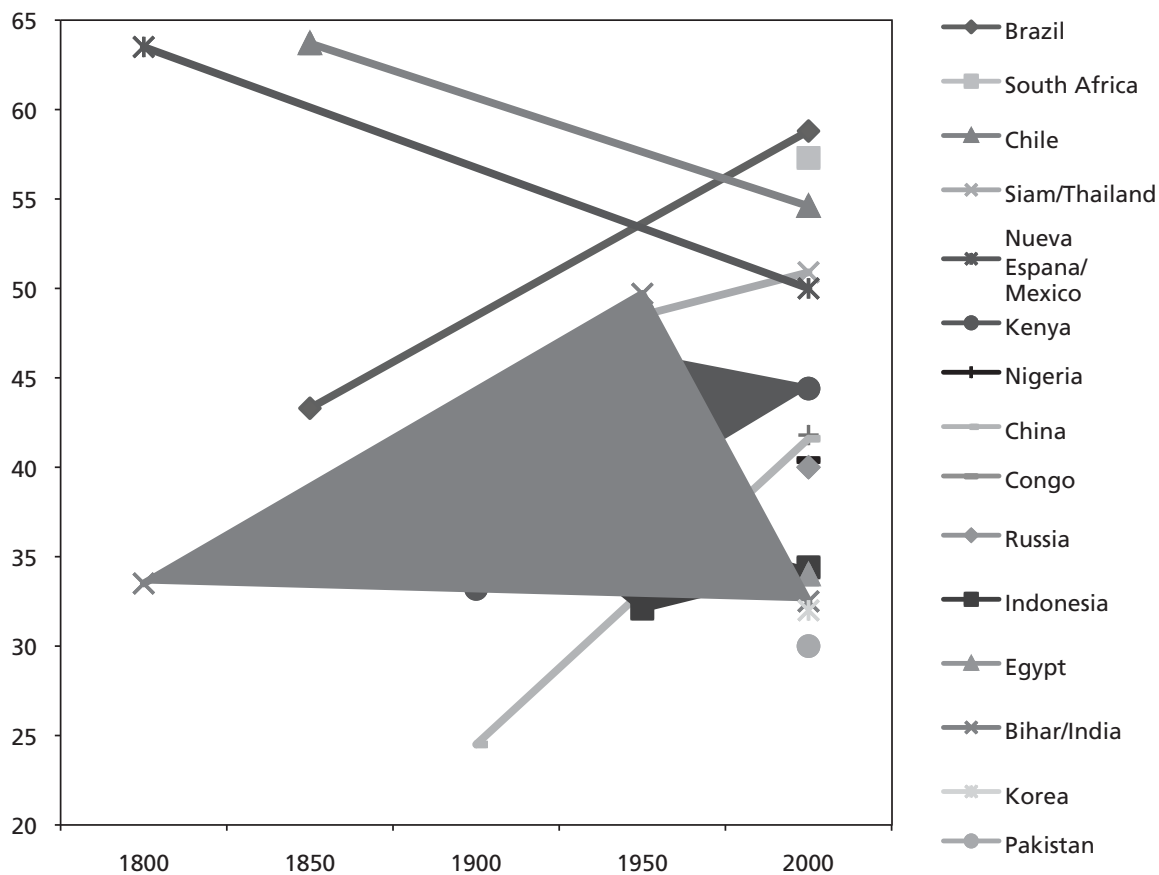
To summarize, there are two ways to escape the Malthusian trap: (1) eliminating collectivist institutions and allowing for the costly increase in income inequalities at the very early stage of development; (2) maintaining collectivist institutions and keeping income inequalities relatively low until slow technological progress and rise in productivity allows accumulating capital at a pace that surpasses population growth rates. The first way was taken by countries that are now called Western and was associated with dramatic social costs in the 16-18th century. Moreover, it was imposed on part of the developing world in the 19-20th century during the era of colonialism. Those developing countries that managed to resist and to preserve institutional continuity as well as relatively low inequalities (East Asia, MENA countries, India) did not gain much in terms of economic growth before the mid-1900s, but were better positioned to take advantage of growth opportunities as soon as natural increases in productivity allowed exiting the Malthusian trap. The other countries that destroyed their egalitarian institutions prematurely (replicating the Western path) experienced tremendous declines in institutional capacity and rise in inequalities.

FIGURE 14
Gini coefficient in developed countries, 1550-2000



Source: Milanovic, Lindert, Williamson, 2007

FIGURE 15
Gini coefficient in developing countries, 1800-2000



Source: Milanovic, Lindert, Williamson, 2007.

In India and SSA, this path was associated with periodic mass famines, which did not happen before colonialism due to even distribution of limited food resources by the community institutions⁹. In more developed LA countries, the growth rates in the XX century did not allow bridging the gap with the West (Argentina, a developed country in between the two world wars, even fell out of the club after the Second World War).

In short, premature dismantling of collectivist institutions, although it allowed escaping the Malthusian trap, did not allow for healthy growth. "The frequent claim that inequality promotes accumulation and growth does not get much support from history. On the contrary, great economic inequality has always been correlated with extreme concentration of political power, and that

9. "... Even before the onset of the Victorian famines, warning signals were in place: C. Walford showed in 1878 that the number of famines in the first century of British rule had already exceeded the total recorded cases in the previous two thousand years. But the grim reality behind claims to "good governance" truly came to light in the very decades that Ferguson trumpets. According to the most reliable estimates, deaths from the 1876–1878 famine were in the range of *six to eight million*, and in the double-barreled famine of 1896–1897 and 1899–1900, they probably totaled somewhere in the range of *17 to 20 million*. So in the quarter century that marks the pinnacle of colonial good governance, famine deaths average at least a million per year (Chibber, 2005).

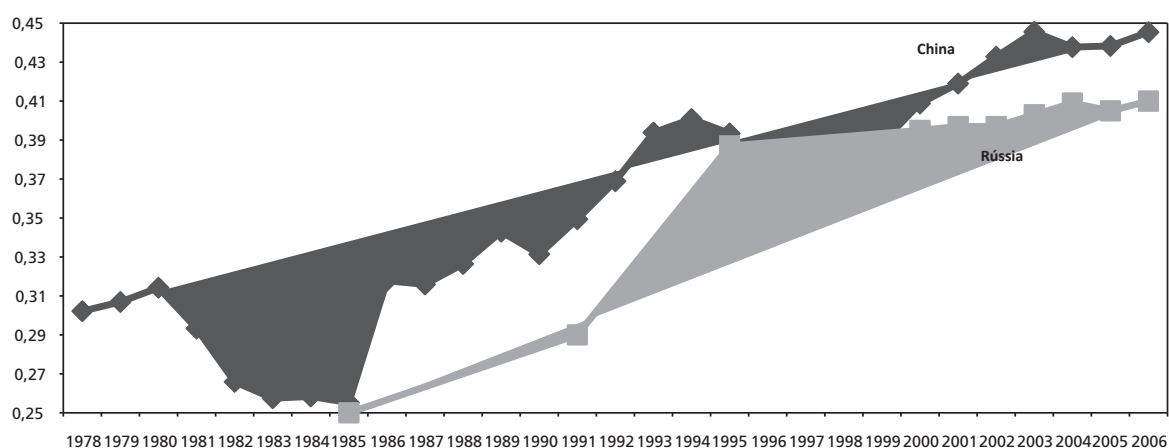
power has always been used to widen income gaps through rent-seeking and rent-keeping, forces that demonstrably retard economic growth” (Milanovic, Lidert, Williamson, 2007).

Unlike Russia after 1991, so far it seems like China in 1979-2009 managed to better preserve the strong state institutions – the murder rate in China is still below 3 per 100,000 inhabitants as compared to Russia with about 30 in 2002 and about 20 in 2008 (Popov, 2007c). True, in the 1970s, under the Maoist regime, the murder rate in the Shandong province was less than 1 (Shandong, 2005), and in 1987 was estimated at 1.5 for the whole of China (WHO, 1994). The threefold increase in murder rates during the market reforms is comparable with the Russian increase, although the Chinese levels are nowhere near the Russian levels.

There is, however, a major threat to China’s seemingly flawless development path – growing inequality in income distribution (fig. 16). Unlike in the initial years of economic reforms (1979-85), inequalities have been growing since the mid-1980s, exceeding the level of Japan and South Korea and even the level of Russia, and approaching Latin American and African levels.

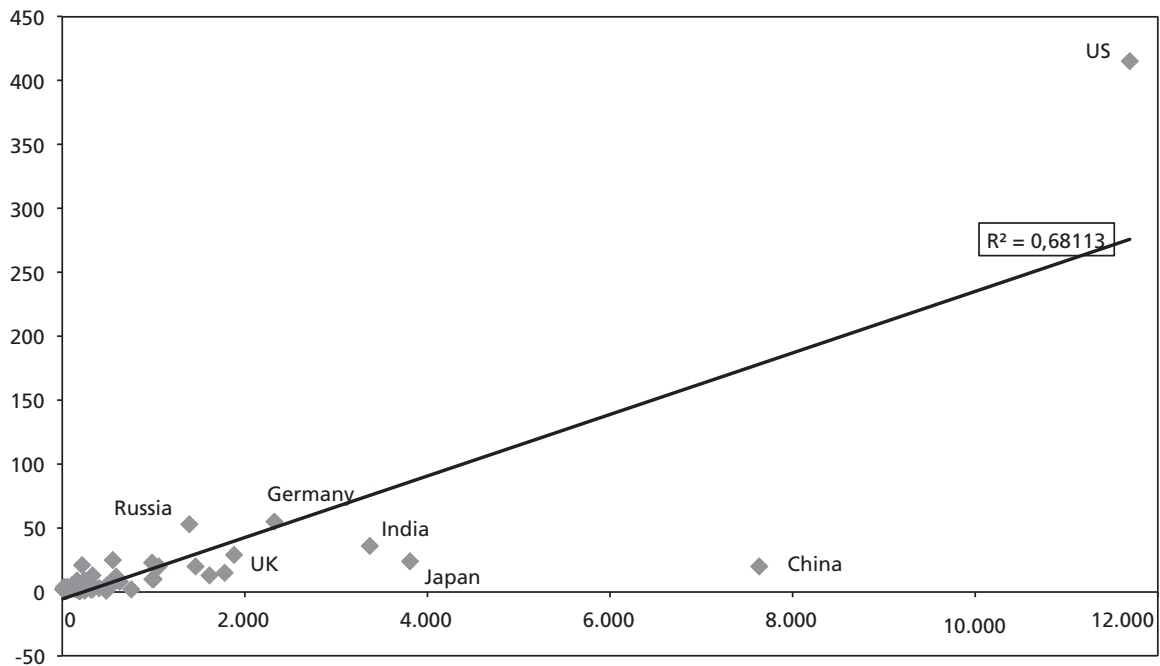
The number of billionaires in China is also growing fast: in April 2007, according to the Forbes list, China had 20 billionaires (fig. 17); in April 2008, before the collapse of stock prices, this number doubled, reaching 40. This was still below the Russian number (53 in 2007 and 87 in 2008), but if the trend continues, China may replicate Russia in the “privatization of the state” pattern.

FIGURE 16
Gini coefficient of income distribution in China and Russia, 1978-2006)



Source: Chen, Hou, Jin, 2008; Goskomstat.

FIGURE 17
Number of billionaires in 2007 and PPP GDP in 2005 (billion \$) by country



Source: <<http://www.forbes.com/Forbes>>.

8 CONCLUSIONS

To summarize, there are at least three reasons why many transition economies succeeded by pursuing policies that are so different from radical economic liberalization (shock therapy) that is normally credited for the economic success of Central European countries.

First, optimal policies are context dependent, they are specific for each stage of development and what worked in Slovenia cannot be expected to work in Mongolia. *Second*, even for countries at the same level of development, reforms needed to stimulate growth are different; they depend on the previous history and on the path chosen. The reduction of government expenditure as a share of GDP did not significantly undermine the institutional capacity of the state in China, but in Russia and other CIS states it turned out to be ruinous. It is the growth diagnostics that should reveal the missing ingredient for economic growth. And most important, introducing this “missing ingredient” should not result in the destruction of other pre-conditions for growth. The art of the policymaker is to create markets without causing government failure, as happened in many CIS countries. Finally, *third*, and probably most important, countries that until today have never really departed from the collectivist institutions were able to maintain low income and wealth inequalities. These are China (the short-lived westernization attempt of 1840s-1949 was aborted) and East Asia in general, India and MENA. On the contrary, countries that willingly and unwillingly

(colonialism) transplanted Western institutions (LA, FSU, SSA) chose to replicate the Western exit from the Malthusian trap and ended up with high income inequalities and apparent lack of institutional capacity.

In a sense, China found another and more painless exit from the Malthusian trap. Western countries broke traditional collectivist institutions at the low level of development (16-18th century) and experienced a painful redistribution of income in favor of the rich (rising income and wealth inequalities) – this allowed raising the share of savings and investment in income, K/L ratio and productivity, but only at a price of high income inequalities that were extremely costly for low-income countries (increase in mortality). China retained traditional institutions and low income inequalities for nearly 500 years more than the West – until technical progress allowed increasing productivity and the share of investment in income without causing mass deprivation of the masses.

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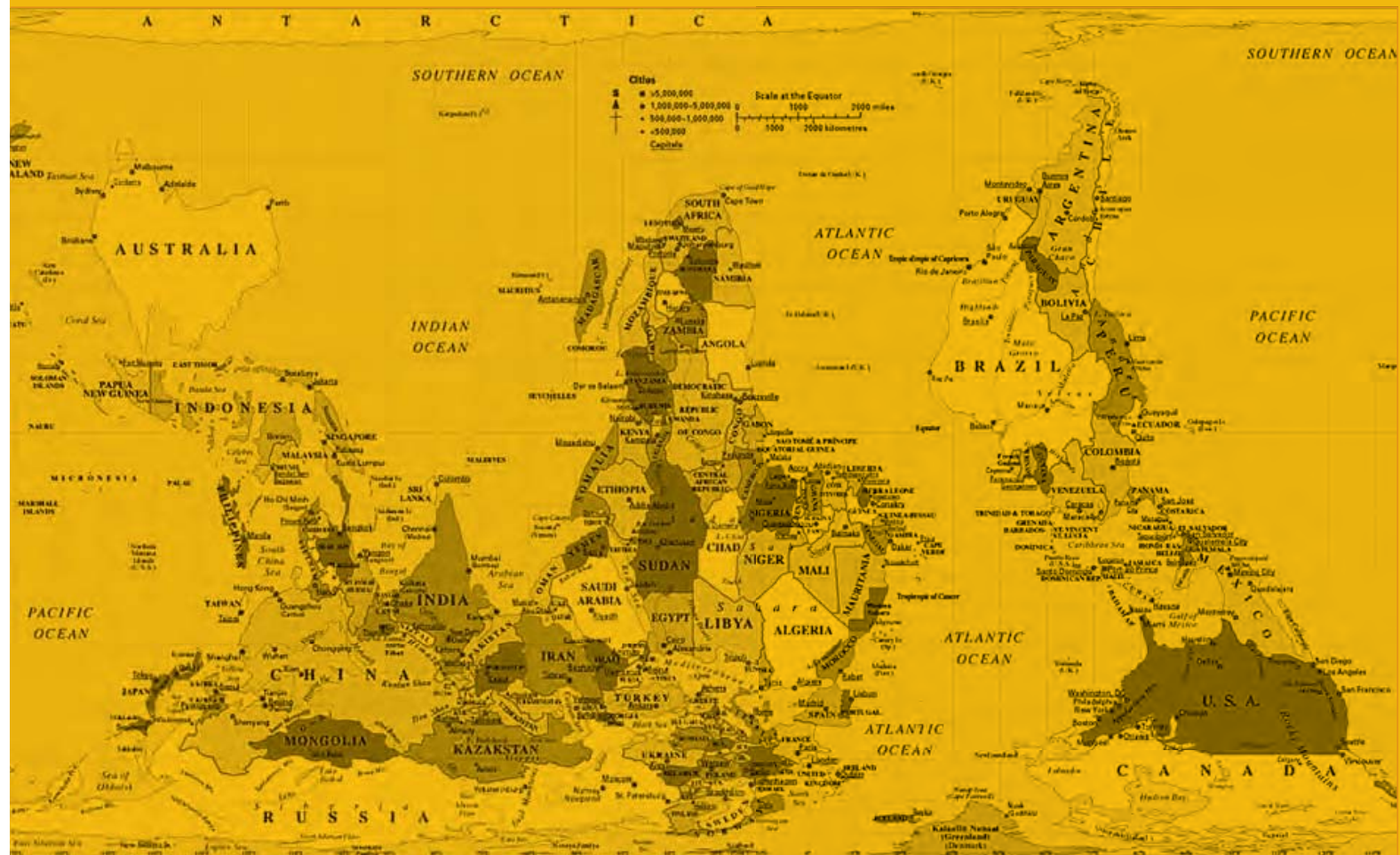
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