IN DEFENSE OF SHOCK THERAPY: POST-SOCIALIST TRANSITION OF THE CZECH REPUBLIC

Scott A. Beaulier*, Peter J. Boettke, Leonid A. Krasnozhon*****

Abstract

Popov (2007, 2000), Kolodko (2000), and Stiglitz (1999) argue that a shock therapy approach has a negative effect on post-socialist transition. Their benchmark for shock therapy, however, refers to the debate on the speed of market reforms. We propose that a more meaningful benchmark is the experience of the Czech Republic, Russia, and other transition economies which share similar approach to the market reforms, but have solved political economy problems of credibility and commitment differently. We compare the Czech Republic's economic, political, and social performance to these benchmarks in all other post-socialist countries since they began their transitions. We find that the Czech transition is a consistent success because the Havel shock therapy has solved the political economy problems of reform's credibility and state's commitment to reform****.

JEL classifications: O52, P20, P27, P52

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** Executive Director and Adams-Bibby Chair of Free Enterprise, Manuel H. Johnson Center for Political Economy, Sorrell College of Business, Troy University, Troy, AL, 36082, USA*
*** Corresponding author, University Professor, Department of Economics, George Mason University, Fairfax, VA, 22030, USA*
E-mail: pboettke@gmu.edu
**** Department of Political Science, the University of North Texas, Denton, TX, 76020, USA*
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1 Introduction

Did post-socialist economies that adopted a shock therapy approach to their transition from socialism fail or succeed? A debate on the speed of the liberalization (shock therapy versus gradualism) suggests the former (see Popov, 2007, 2000; Boettke, 2001; Kolodko, 2000; Stiglitz, 1999). Popular accounts of Russia's transition demonstrate that the Yeltsin shock therapy deteriorated economic, political, and social conditions (Hoffman, 2004; Goldman, 2003). Others consider the Czech Republic's transition a disappointment of shock therapy in Eastern Europe (Stiglitz, 2002). Kolodko (2000) writes that the expectations of post-communist reformers were too optimistic and individuals in post-communist countries would have been better off if market reforms had progressed gradually.

Important recent work by Popov (2007) offers an alternative view on the debate between gradualism and shock therapy. Professor Popov argues that the shock therapy has a negative impact on transition economies in the first stage of transition - recession, while the gradual approach has a positive effect on economic performance in the second stage of transition - recovery. His work also performs an important service in shifting focus from the debate on the speed of market reforms to a new debate on a role of political economy forces in post-socialist transition. We agree with Popov (2007) that the current thinking about post-socialist transition is trapped in a mindset of the debate on the speed of the market reforms, while political economy problems are underestimated. We, however, disagree respectfully with Professor Popov that the speed of reform has different effect on transition economies depending on a transition stage. It is not really an issue of gradualism versus shock therapy, but an issue of reform's credibility and commitment to reform. The same speed of reform will have different effects if reform has different levels of credibility and commitment.

Moreover, the issue of speed provides a limited point of comparison for assessment of the market reforms. A more reasonable analysis would be a juxtaposition of the Czech Republic and other post-communist countries which share similar approach to the market reforms, but have succeeded or failed to solve political economy problems of credibility and commitment. It is especially meaningful to use the Czech Republic as a point of comparison because popular accounts call the Czech transition a main disappointment of the shock therapy in Central Europe (Stiglitz, 1999).

In our analysis we focus on economic performance and quality of economic, political, and social institutions in the Czech Republic and other post-communist countries. We also examine political economy forces which drove the transition in the Czech Republic and Russia. We use two important points for a comparison of post-communist countries. First, the Czech Republic was one of the eight post-communist countries which joined European Union (EU) in 2004. The EU membership serves as a very important indicator of economic, political, and social development in post-communist country. To become a member of EU, a country has to comply with the EU principles of freedom, democracy, human rights, and rule of law. In addition, a country has to meet the Copenhagen criteria**,** according to which a candidate country must be a stable democracy with a strong rule of law and working market economy. Second, the Czech Republic is the first and only post-communist country that has graduated from the European Bank for Development and Construction's (EBRD) class of transition economies. The EBRD graduation also serves as important indicator of an advanced level of transition economy.

Our findings show that the Czech Republic had a successful transition from socialism. First, the Czech Republic performed as well as the countries in the post-communist EU group that outperformed the rest of the post-communist countries. Second, the Czech Republic performed well above average even in comparison with the former Yugoslav countries that had already had a more advanced economic system, market socialism, before their transition experiments began. Third, the Havel shock therapy transformed a socialist country into a stable democracy with a strong rule of law and working market economy, while many post-communist countries are still in the gray zone of state-managed economy mixed with incoherent authority regime. The Havel shock therapy was the main political economy force behind the Czech transition. Unlike the Yeltsin shock therapy, the Havel shock therapy was a success because it solved the political economy problem of reform's credibility and state's commitment to reform. Our findings are unapologetic to further criticism of either the Havel shock therapy or the Czech Republic's transition.

The paper proceeds as follows. Section 2 demonstrates how the Havel shock therapy solved the political economy problems of credibility and commitment. Sections 3 and 4 compare the Czech Republic's economic performance, democracy, and social conditions to these benchmarks in other post-communist countries since they began their transitions and until the 2004 EU enlargement and the 2008 EBRD graduation, respectively. Section 5 contains the concluding remarks.

2 The Havel Shock Therapy

It is often pointed out that the former Czechoslovakia had more favorable economic conditions than other post-socialist countries. The former Czechoslovakia, however, had the most socialistic economy of Eastern Europe where 98% of economy was in public ownership (Hazlett, 1996: 98). Freedom of speech and occupational choice were also heavily restricted in the former Czechoslovakia. There were severe shortages of durable goods, and most of the growth in the economy was being driven by military expenditures.

The post-communist countries which had a handicap over other transition countries were the former Yugoslav republics. The former Yugoslavia had already had working market socialism before other post-socialist economies started their transition (Leeson and Trumbull, 2006). Nonetheless, both the Czech Republic and Slovakia have emerged from the transition as upper middle-income countries and became members of the EU in 2004, while the only former Yugoslav republic that joined the EU was Slovenia. The Czech Republic even succeeded in the graduation from the EBRD's class of transition economies. EU membership and EBRD graduation marked the end of the Czech Republic's transition from socialism. The Havel shock therapy that was driving force behind the successful transition deserved the main credit.

Using Professor Popov's terminology, the Czech Republic's went through a typical two-stage transition: first, recession, and, second, recovery. Economic collapse or supply-side recession following the end of socialism was prominent in every former Soviet and Soviet-bloc countries (Shleifer and Treisman, 2005). Like every one of the former socialist economies, the Czech economy experienced a contraction in the early 1990s. Many critics of the shock therapy were quick to point to the recession stage as evidence of failed transitions. Stiglitz (2002: 186) criticized the Havel shock therapy and pointed out that relative to where the Czech Republic was in 1989 it had fallen behind.

The Czech Republic's contraction was very shallow while many other post-socialist economies like Russia had much deeper contractions. The Czech Republic ended its contraction by 1991, while Russia's continued another seven years (Leeson and Trumbull, 2006). Moreover, the Czech economy returned to pre-transition level twice as much faster as Russia's did. Why did the Havel shock therapy succeed while the Yeltsin shock therapy underperformed? The answer lies in political economy of these reforms. A juxtaposition of the Havel and Yeltsin shock therapies serves as very important point of inference to compare these reforms and explain their different outcomes.

The Havel shock therapy was a genuine legitimate reform lead by Vaclav Klaus and Vaclav

Havel, himself. Unlike any other politicians, Havel and Klaus were outspoken advocates of laissez faire capitalism and liberal democracy. Havel who was a hero of the dissident movement that brought down the communist regime had a very strong public support. Klaus who was the de facto leader of the Czech transition not only cited liberal free market economists like Adam Smith, Friedrich Hayek, Milton Friedman, and James Buchanan in his public speeches but also had good personal relationships with Friedman and Buchanan. Klaus (1997) wrote that the Havel government saw the nature of the reform clearly by accepting "Adam Smith's teaching—his vision of a free, democratic, and efficient society in which the citizen, not an enlightened monarch or an elitist intellectual, is king". The legitimate democratic and free market platform of the Havel shock therapy sent a strong signal to citizens that issues such as corruption, illegitimate reforms, and government interventionism would not be potential stumbling blocks for the Czech transition.[1]

The year 1989 was arguably the most important year of the 20th century. The Soviet bloc was falling apart because the Soviet satellite states were breaking away. Nobody, however, expected rapid change with a stronghold communist regime in control of Czechoslovakia. But, on November 17th, 1989, a student demonstration commemorating the 50th anniversary of the Nazi attack on Czech universities turned into a march for "genuine perestroika" (Wheaton and Zdenek, 1992: 47). The student protest served as a tipping point after which opposition broadened. The Communist regime that was mainly instituted by the 1968 Soviet Invasion desperately clung to power in the remaining weeks of November, but, in early December, the Federal Assembly established a government of National Understanding to preside over the transition period (i.e. December 1989 - June 1990). In one remarkable month, Czechoslovakia went from being a communist country dealing with a minor dissident movement to a non-communist government with liberal democrat and former dissident Vaclav Havel as President and liberal free-market economist Vaclav Klaus as Prime Minister (Dlouhy, 2001).

During the transition period, Vaclav Havel was appointed president of the independent Czechoslovak state. In June 1990, Havel became Czechoslovakia's first post-communist elected president. In January 1993, the former Czechoslovakia disintegrated into two independent countries: the Czech Republic and the Slovak Republic, while Havel remained the president of the former and left the office in 2003. Since Havel was president of both the former Czechoslovakia and the Czech Republic, the Havel shock therapy also affected the Slovak Republic. Thus, the Havel shock therapy had a positive impact on both the Czech and Slovak transitions. Why was the Havel shock therapy a success? The answer lies in the Havel government's ability to solve political economy problems of reform's credibility and states' commitment to the new status quo.

Popov (2007) asserts that the debate on the speed of liberalization underestimated a role of state's institutional capacity for good economic performance. He argues that whether a state's institutional capacity to enforce rule of law is strong or weak can determine a transition success or failure. We argue that, primarily, reform's credibility and state's commitment to reform determined institutional capacity of transition states. At the dawn of transition a regime uncertainty was a central issue of concern with general public (Higgs, 1999). Both authority and economy regimes were uncertain because a politics of discretionary power was unpredictable.

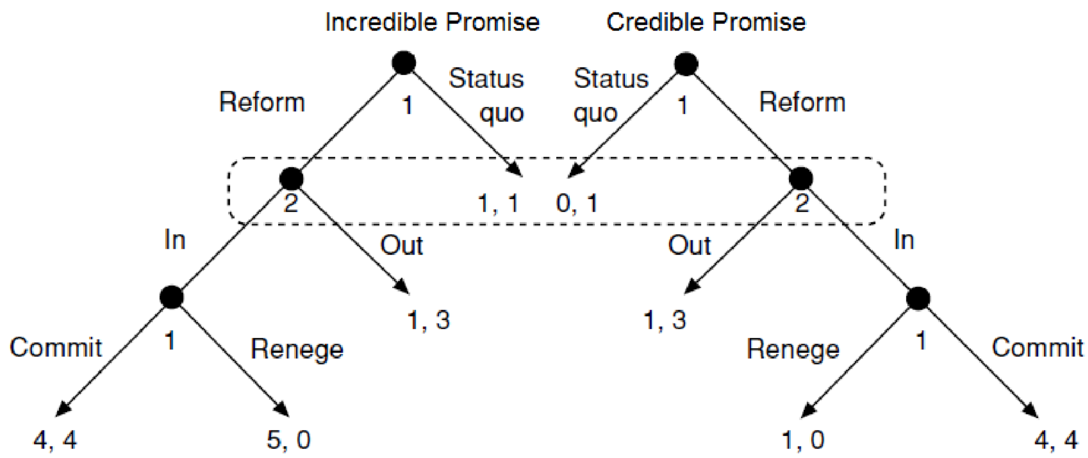
Gorbachev's perestroika that was full of economic zigging and zagging served as a reminder of state's inability to convey any kind of commitment to reform. Liberal intellectuals like Andrey Sakharov expressed their concerns with regime instability. They were uncertain that the zigs permitted today would not be superseded by repressive zags tomorrow. Sakharov warned that "today it is Gorbachev, but tomorrow it could be somebody else. There are no guarantees that some Stalinist will not succeed him" (Kaiser, 1991: 245). The fate of Gorbachev's reforms was sealed by his inability to make credible commitment to the status quo change. The political instability of failed reforms and deflated expectations on the part of the population undermined institutional capacity of the Gorbachev regime (Boettke, 1993). "As Gorbachev moved back and forth from one comprehensive reform to another, he became more and more uncertain about subjecting the Soviet Union to the type of shock therapy such reforms would inevitably necessitate. He also concluded that unless reined in, the reform process would ultimately shrink his powers and those of the Soviet Union over central economic control, thus reducing the Soviet Union to an ineffective economic entity" (Goldman, 1991: 222). The state's failure to convey the credible commitment to economic liberalization that was necessary to reform the Soviet system proved to be perestroika's undoing (Boettke, 2001: 169).

Thus, reformers' political economy problem that the Havel government and other post-communist governments faced was far more difficult than signaling a credible commitment to reform to the population. Reformers also had to solve the basic paradox of governance - establishing binding constraints on their behavior. Moreover, reformers

[1] For an alternative and less favorable interpretation of Klaus's tenure, see Sima and Stastny (2000). According to Sima and Stastny, Klaus's libertarian rhetoric did not spillover into libertarian policy. We concur with their main point, but maintain that while Klaus's policies were not ideal from a free market, libertarian standpoint, they were effective in producing economic growth given the transitional constraints placed on any leader.

had to solve these two problems simultaneously. An issue of simultaneity posed the basic reformer's dilemma – solving the paradox of governance and making credible commitment to reform. Figure 1 illustrates the basic reformer's dilemma.

Figure 1. Reformer's Dilemma: Credible Commitment Game with Informational Signal



In Figure 1, player 2 is the citizenry and player 1 is the reformer – government decision-maker. The government announces a new reform to liberalize economy. Player 2 must choose to enter the game, In, or stay Out. The paradox of governance suggests that the state can Renege on made promises and benefit from confiscating the wealth of the citizenry. Since player 2 knows the sequentially rational moves of player 1, player 2 will choose to stay Out. In this case the reform will stall unless the effective binding constraints are in place. Given a weak institutional capacity of transition state, effective binding constraints are very improbable. Popov (2007) argues that, if a rule of law is weak, authoritarian regimes do a better job in maintaining efficient institutions than democracies. It could be a possible solution to the reformer's dilemma, unless player 1 can convey information about his credible commitment to the reform.

The logic and structure of the commitment game gives player 1 two options: make a credible or incredible commitment to economic reform. A choice of commitment has the same payoff if the citizenry choose to enter the official economy. The credible commitment to reform, however, significantly reduces the state's payoff if it decides to renege on its promises. Based on player's 1 signal and prior information about the reformer, the citizenry must decide to enter economy or stay out. If player 1 signals a credible commitment to a status quo change, player 2 will choose to enter the official economy and player 2 will commit to reform as in the case of the Havel shock therapy. In case of incredible commitment, citizens can predict that the state is more likely to renege because there are no significant constraints to reduce the state's payoff from breaking its promise. The citizenry will choose to stay out if the state's commitment lacks credibility like a presence of discretionary policy. It will be the case of the Yeltsin shock therapy.

Thus, the reformer's dilemma suggests that a Pareto-improvement solution is to convey a credible commitment to economic reform and establish binding constraints. Each of post-communist experiments in market reforms discovers the basic point: rules must be established that effectively constrain discretionary behavior. A transparent legal system, independent judiciary, and strong rule of law must be in place before private sector economic experimentation can be expected to yield the promised welfare gains. Without these constraints the government has incentive to use its discretionary power to affect reforms. The discretionary behavior on the part of the government fails to produce the stable regime that is necessary for economic prosperity. Boettke (2001) writes that "whereas the instability of the 1920s in the Soviet Union led to Stalinism, the instability of the late 1980s led to the dissolution of the Soviet Union. The liberalization efforts in the 1950s and 1960s at liberalization failed and were quickly reversed. Even under Yeltsin's experiment in free-market shock therapy, the new government has failed to establish the sort of binding political and legal commitments required".

During reform period political and legal rules must be status quo breaking. Every successful transition from socialism like in Poland shows that restitution and lustration can break the status quo effectively. Both rules establish trust between citizenry and state and bind the latter to the reform effectively. By burning the bridge between the old and new regimes, lustration and restitution commit the state to reform in advance.

Lustration laws are the most commonly used political and legal rules for screening and "prosecuting" former Communist leaders, public employees, and candidates for public office (Ellis, 1996). These laws have several goals: protecting emerging democracy from the old regime, bringing

[11] In October 1991 the Czech Republic and Slovakia were one of the first post-communist countries to adopt lustration. Between 1991 and 1997 total number of people who had been screened was 303,504, while 70 percent of them had been screened by the end of 1993 (Williams, 1999; Ellis, 1996). Five percent of screenings (15,166 people) received certificates with positive results and thus barred their recipients from holding public office (Williams, 1999).

Restitution was also important change in the status quo because it gave private property rights to citizens with the least favorable attitudes towards the communist regime. Moreover, a new propertied class of citizens led to the development of a collective action by those individuals to seek protection from the government interventionism. Thus, restitution reduced state's discretionary power effectively. Between October 1990 and May 1991 the Havel government adopted the restitution laws. By the end of 1996 over 1.2 million hectares of agricultural land, almost a third of the country's total, had been returned to private owners (Dlouhy, 2001). The Havel government also transferred almost one million dollars the Czech Jews who lost their property during the communist regime (Kraus, 1999).

The Russian state's failure to institute restitution and lustration signaled citizens that private and public predation of wealth creation is to be expected, and thus, citizens had to escape to the unofficial economy. Though the Yeltsin government considered restitution and even drafted lustration law, the former was never introduced and the latter was actually reversed. Soon after the failed 1991 *coup d'état*, the Yeltsin government banned the Communist Party. But in November 1992 the Constitutional Court ruled that the Communist Party could be reestablished at local levels in. By the end of 1992 Yeltsin refrained from initial idea of reforming the legal system and kept the ex-KGB agents in the Ministry of Interior, including the most notorious of them, Viktor Cherkesov, who arrested Andrei Sakharov (Goldman, 2003). After Yeltsin finally broke his promise of lustration law, the Russian parliament passed the anti-lustration law that prohibited providing public information about the KGB informants and agents. Galina Starovoitova, the

new ruling elite without the communist past, and establishing accountability of government.

most prominent advocate of the lustration who was the member of the Russian parliament was assassinated in 1998. Rothbard (1995) writes that "in attempting to be congenial statesmen, as opposed to counter-revolutionaries, the reformers not only failed to punish the Communist rulers with, at the least, the loss of their livelihoods, they left them in place, insuring that the ruling "ex"-Communist elite would be able to resist fundamental change."

In contrast, the Havel government promised and adopted both restitution and lustration laws that signaled a credible commitment to the economic liberalization. Klaus (1997) argued that that advocates of the gradualism had never understood that restitution, lustration, and privatization "irrefutably signaled that transformation is a serious thing". Restitution solved the fundamental political economy dilemma of an economic system that was: "A government strong enough to protect property rights and enforce contracts is also strong enough to confiscate the wealth of its citizens" (Weingast, 1995).

Moreover, the Yeltsin shock therapy was never implemented as originally announced (Boettke, 2001). In January 1992 the Yeltsin government under the orchestration of Yegor Gaidar embarked on a liberalization reform that was far more ambitious than the Gorbachev's. From the start the Yelstin government moved towards partial liberalization of prices. For example, sour cream prices were liberalized, but milk prices were not. If in January 1992 only fourteen products were under price and output controls, by the summer of 1992 that figure had risen to twenty-four. In addition to food, a wide variety of other products were under state control, including energy. Moreover, the Yeltsin government continued to provide consumer and producer subsidies while tax revenues continued to slip in the unofficial economy. Partial price liberalization and policy of soft-budget constraints resulted in microeconomic inefficiencies at the enterprise level that in turn generated macroeconomic imbalances in the economy. Continued subsidies and growing unofficial economy swelled the fiscal responsibilities of the Yeltsin government and undermined Russia's fiscal stability. The Yeltsin shock therapy was ill-conceived and contradictory from the start (Boettke, 2001).

The Yeltsin government clearly lacked binding and credible commitment to the status quo change. In the wake of the unexpected election results of December 1993, the Yeltsin government moved toward a more gradual reform program with major concessions to state enterprises and state farms. Economic zigging and zagging of the Yeltsin shock therapy clearly reminded Gorbachev's perestroika. It caused public distrust and regime uncertainty.

[11] For a review of lustration laws implemented in post-communist countries, see Ellis (1996). Lustration requires investigation and removal from public offices of former Communist party officials, members of the former secret police, and collaborators. In the Czech Republic and Slovak Republic the lustration law banned former Party officials, members of Czechoslovak Secret Police (StB), the People's Militia, the National Security Corps, and collaborators from holding a wide range of public offices (Leff, 1996). Lustration could also solve another political economy problem - Rousseau paradox: good law needs good people and good people need good law

Rothbard (1995: 396-397) writes that "in other words, except for the Czech Republic, where feisty free-market economist and Prime Minister Vaclav Klaus was able to drive through rapid change to a genuine free market, and, to some extent, in the Baltic states, the reformers were too nice, too eager for "reconciliation," too slow and cautious. The result was quasi-disastrous: for everyone gave lip-service to the rhetoric of free markets and privatization, while in reality, as in Russia, prices were decontrolled while industry remained in monopoly government hands". The fate of the Yeltsin shock therapy was sealed by his inability to solve the political economy problem of reform's credibility and state's commitment to reform. The political instability, public distrust, and growing unofficial economy undermined institutional capacity of the Russian state.

Finally, a phasing-in of reforms was another important political economy issue because it raised an issue of reform's credibility and state's commitment to reform. Unless reformers moved quickly without phasing-in, problems of credibility and commitment would halt the reform process (Boettke, 2001). The phasing-in approach that reminded the Soviet-style economic planning caused public distrust towards market reforms. A rapid transition without phasing-in sent a strong signal to citizens about a degree of discretionary policy. Boettke (1993) argues that the most successful transition economies will be the ones who minimize the omnipresence of state the most. If state's role in economy becomes weaker, it leaves more economic freedom for private sector.

The Czech privatization that went without phases signaled that government interventionism would be limited. And the Czech economy greeted the status quo change by a quick recovery in the middle of the 1990s. In contrast, the Yeltsin shock therapy, including privatization, had several official phases. The phasing-in of the Russian privatization signaled that the government intervention would be unlimited. To avoid government embezzlement, the Russian economy mainly moved to the black market. Rothbard (1995) writes that "the reformers didn't move fast enough, worrying about social disruption, and not realizing that the faster the shift toward freedom and private ownership took place, the less would be the disturbances of the transition and the sooner economic and social recovery would take place."

By the middle of the 1990s a great divide between the Havel and Yeltsin shock therapies was obvious. The former solved the political economy problems of credibility and commitment, but the latter failed. While the Czech Republic appeared to be one of the successes among the transition countries, with the start of recovery in 1993, rapid growth by 1995, and very low unemployment, Russia's economy went in a deep recession (EBRD, 1999). Between 1991 and 2010 the Czech economy grew at an average rate of 1.8 percent, while Russia's average rate of economic growth was .63 percent (WDI, 2011).

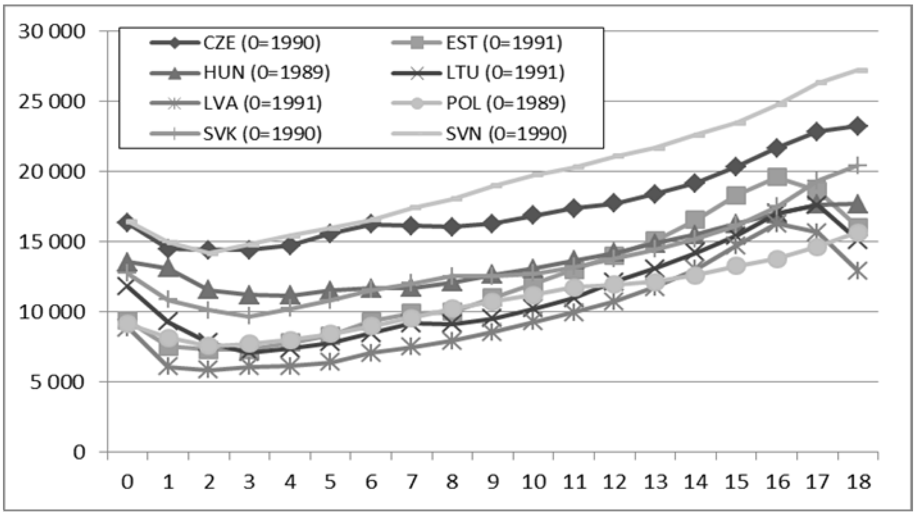
3 The 2004 EU Enlargement

The EU membership is a very important indicator of economic, political, and social development in post-communist country. It is reasonable to assume that each post-communist country which is located in Europe pursues the EU membership as a political economy objective of transition. To join EU, every country must meet the EU standards of freedom, democracy, human rights, and the rule of law. In addition, each country has to meet the Copenhagen criteria, according to which a candidate country must be a working market economy with a stable democracy and strong rule of law.

In 2004 EU welcomed eight post-communist countries to become EU members. The post-communist EU group included three former Soviet republics (Estonia, Latvia, and Lithuania), four former satellites of the USSR (Poland, the Czech Republic, Hungary and Slovakia), and a former Yugoslav republic (Slovenia) (EU, 2004). We use the 2004 EU enlargement as a meaningful point of comparison between the Czech Republic and other post-communist countries of the EU group.

Figure 2 shows the EU group's per capita GDPs in 2005 purchasing power parity (PPP) dollars as compiled by the World Bank (2011). Leeson and Trumbull (2006) recommend using the year just prior to transition as the base year to control for dates of transition start. Here we follow Roland (2000) in dating transitions. Thus, the base year for Hungary and Poland is 1989, for the Czech Republic and Slovakia is 1990, for the FSU group is 1991, and so on. Overall, Figure 2 describes a change in per capita income in the first eighteen years of transition.

Figure 2. GDP Per Capita in the EU Group, First 18 Years of Transition (*constant prices*)

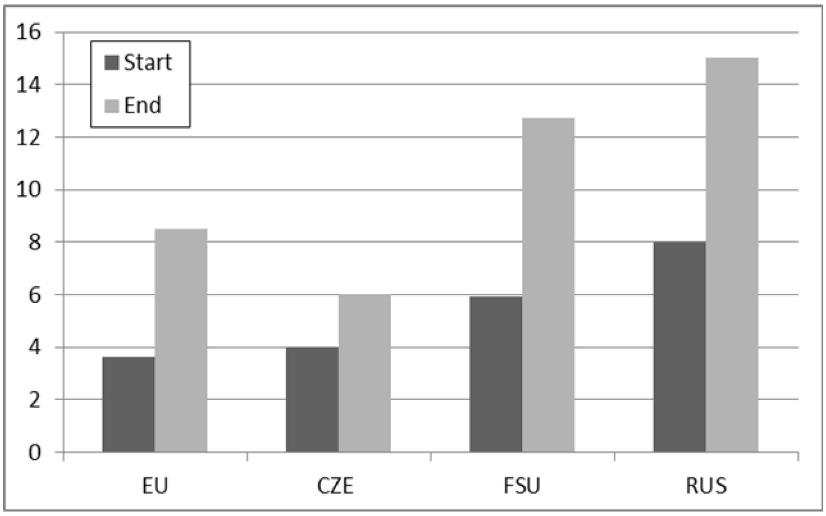


Sources: Calculated from World Bank, *World Development Indicators* 2011.

From Figure 2 we can draw a number of insights. First, the Czech Republic started transition with the second highest per capita income, second only to Slovenia, and joined the EU in the same position. Second, the Czech Republic's and Slovenia's contractions were very shallow while other post-socialist economies like the Baltic States had much deeper contractions. It is very important fact that the Czech economy holds up quite well in comparison with Slovenia's economy because the latter had much more advanced economic system (i.e. socialist market economy) before the start of transition.

Figure 3 summarizes data about start of recovery and return to pre-transition level. Presented data include not only the EU group but also the former Soviet Union (FSU) countries. Here we follow Popov (2007) in dividing transition in two stages: recession and recovery, but we separate between start of recovery and end of recovery - return to pre-transition level. We can also make several important observations from Figure 3. First, soon after the shallow contraction, the Czech economy started recovering on the fourth year of the transition. Second, the Czech economy returned to the pre-transition level on the sixth year of transition. As compared to the Czech Republic, Russia had much deeper contraction. It took Russia's economy eight years to reach the second stage of transition and another seven to reach pre-transition level. Thus, the Czech economy returned to pre-transition level twice as much faster as did Russia's.

Figure 3. Economic Recovery of Post-Communist Countries (*years after transition start*)



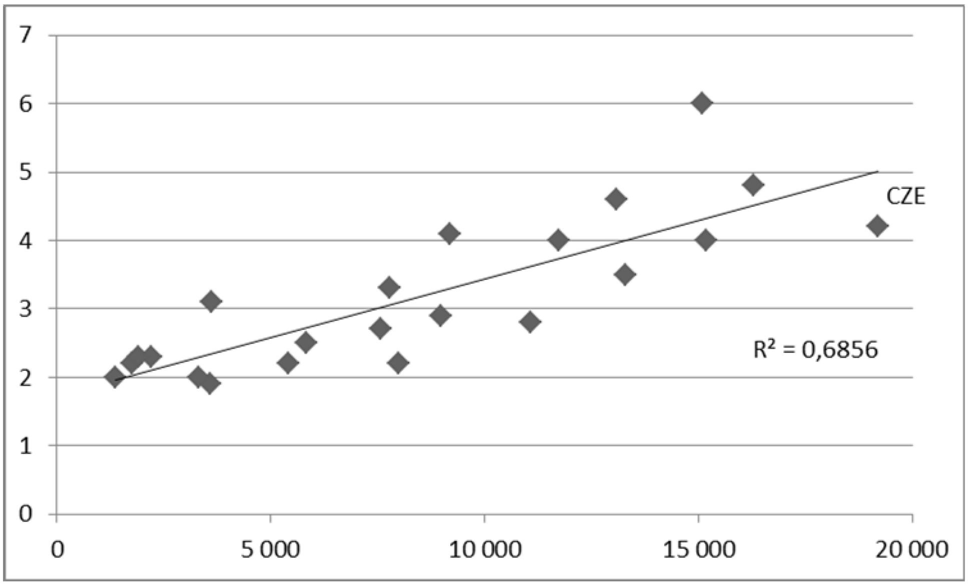
Sources: Calculated from World Bank, *World Development Indicators* 2011.

Figure 3 also shows that, on average, the countries in the EU group started their economic recoveries after almost four years of transition and reached pre-transition levels in eight and a half years. It took the countries in the FSU group almost six years to enter the second stage of transition. Some of them completed the economic recovery after almost thirteen years of transition, while few of them like Georgia and Ukraine have not fully recovered yet. Thus, Figures 2 and 3 clearly show that the Czech Republic's transition is a success, while Russia's is well below average.

Another very popular benchmark for comparison of the transition countries is the level of corruption. While most FSU countries remain highly corrupt at both economic and political levels, the Czech government managed to create and secure favorable and relatively corruption-free conditions for the development of private sector. Nonetheless, mass media sources like the *International Herald Tribune* still emphasized the corruption in Vaclav Klaus's economic transition and blamed it for the failure of the Czech transition (Green, 1999). Popular outcry over shock therapy's supposed failures led to political turmoil in several post-communist countries. For example, Hungary's conservative prime minister, Viktor Orban, was nearly ousted by opposition socialists in 2002 because Hungary's reforms had widened the gap between rich and poor (Szamado, 2002). Thus, an issue of corruption deserves more analysis.

The Transparency International that studies changes in the corruption perception index (CPI) in the post-communist countries defines a rampant level of corruption as a score of three or less than three on a one to ten scale. Figure 4 demonstrates a correlation between per capita income and corruption for every post-communist country in 2004. We can see that most FSU countries had rampant corruption in 2004 but the level of corruption was one of the lowest in the Czech Republic. The countries which had a lower level of corruption were Estonia, Lithuania, and Hungary. Those countries, however, had lower GDP per capita than had the Czech Republic.

Figure 4. Corruption and GDP per Capita in Post-Communist Countries, 2004



Sources: Transparency International, *Global Corruption Report*, 2004; WDI, 2011. Data are unavailable for Serbia and Turkmenistan.

Furthermore, Table 1 summarizes average economic and political performance of transition countries between 1991 and 2004.[12] Here we compare the Czech Republic's quality of economic and political institutions to these benchmarks in Russia and other post-communist countries. The EBRD's *privatization* and *infrastructure reform* scores measure advancement of the market reforms. The former evaluates privatization and the latter assesses liberalization, commercialization, and decentralization. The Heritage Foundation's *index of economic freedom* and the *polity score* measure a quality of economic and political institutions, respectively.

As shown in Table 1, the Czech Republic had much more successful transition than had the rest of post-communist countries, including Russia. And these differences are statistically significant. On average, the Czech Republic's per capita income was twice as much as per capita income in post-communist countries. The Czech economy's average

[12] For a description of variables, please, see Table 2 in the Appendix.

rate of growth exceeded the post-communist average by almost one percent, while Russia's economy contracted.

Table 1. Transition in Post-Communist Countries, 1991-2004

	Post-Communist	The Czech Republic	Russia
Indicators	Mean	Mean	Mean
Infrastructure reform score	1.86	2.55	1.95
Index of economic freedom	2.59	3.69	2.32
Polity IV score	13.4	19.7	14.9
Privatization score	2.90	3.85	3.23
GDP per capita	6,232	14,896	7,360
Economic growth rate	.35	1.23	-.62

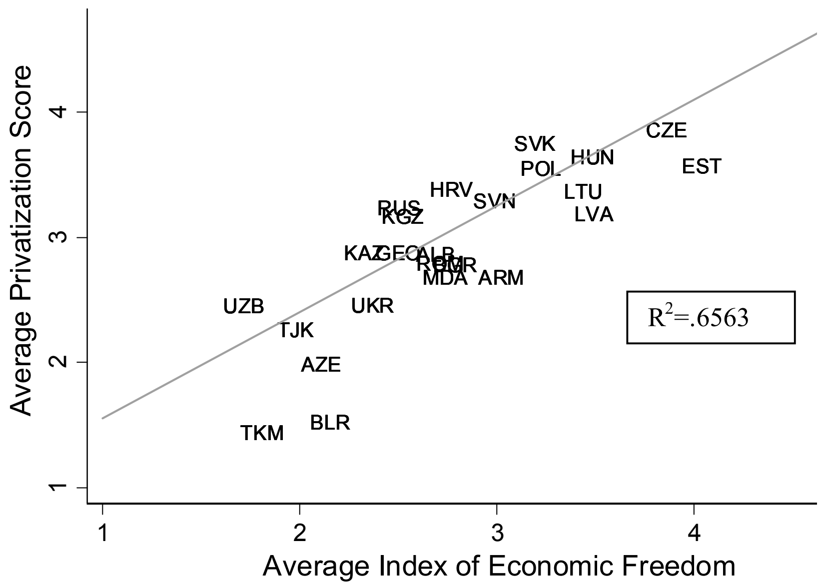
Note: The means of variables are different at 1% significance level.

Table 1 also shows that the Czech Republic had a significantly higher quality of political institution and rule of law as compared to the post-communist average level. In terms of political regime, the Czech Republic had already been a consolidating democracy, while, on average, post-communist countries like Russia were anocracies (i.e. incoherent and unstable authority regime).

Moreover, the Czech Republic had one of the most advanced transition economies. EBRD's transitional indicators show that the Czech Republic's privatization and infrastructure reform were significantly higher than the post-communist average. The Czech Republic had one of the highest scores for infrastructure reform among post-communist countries. The countries that had a more advanced infrastructure reform were Hungary, Poland, and Estonia.

Figure 5 shows a correlation between economic freedom and privatization in post-communist countries. The Czech economy also experienced much higher level of economic freedom than the rest of post-communist countries, while Russia's level of economic freedom was below average. We can see that the Czech Republic had the highest level of privatization and the second highest level of economic freedom among all post-communist states. The index of economic freedom shows that Czech Republic had the second highest quality of economic institutions among post-communist countries.

Figure 5. Privatization and Economic Freedom in Post-Communist States, 1991-2004.



Sources: Heritage Foundation, 2011; EBRD, 2011.

The last but not the least indicator of the transition economy is social conditions. We use both life expectancy at birth and infant mortality to estimate level of social conditions in post-communist countries. In the Czech Republic life expectancy increased from 72 to 76 years between 1990 and 2004, while it increased from 71 to 74 years in Slovakia in the same period (WDI, 2011). Moreover, Hungary is the only post-communist country that had a larger increase in the life expectancy than had the Czech Republic. The fact that life expectancy increased in the Czech Republic, while it declined in six post-Soviet countries such as Russia and Ukraine, is important. Furthermore, infant mortality rates per 1,000 live births dropped from ten to four in the Czech Republic between 1990 and 2004 (WDI, 2011). In Slovakia infant mortality rates declined from fourteen to six in the same period of time. Overall, we can see that the Czech Republic had the second highest life expectancy and the lowest rate of infant mortality among post-communist countries.

The improvements in living conditions are also impressive when we look at qualitative improvements in consumer goods. For example, passenger car ownership grew in the Czech Republic significantly. There were 228 and 163 passenger cars per 1000 people in the Czech Republic and Slovakia in 1990, respectively. In 2002 there were 356 and 247 passenger cars per 1000 people in the former and the latter, correspondingly. Likewise, quantity of television sets increased in the Czech Republic. If there were 284 and 340 television sets per 1000 people in the Czech Republic and Slovakia in 1991, respectively, there were 538 and 409 television sets per 1000 people in the former and the later in 2001, correspondingly.

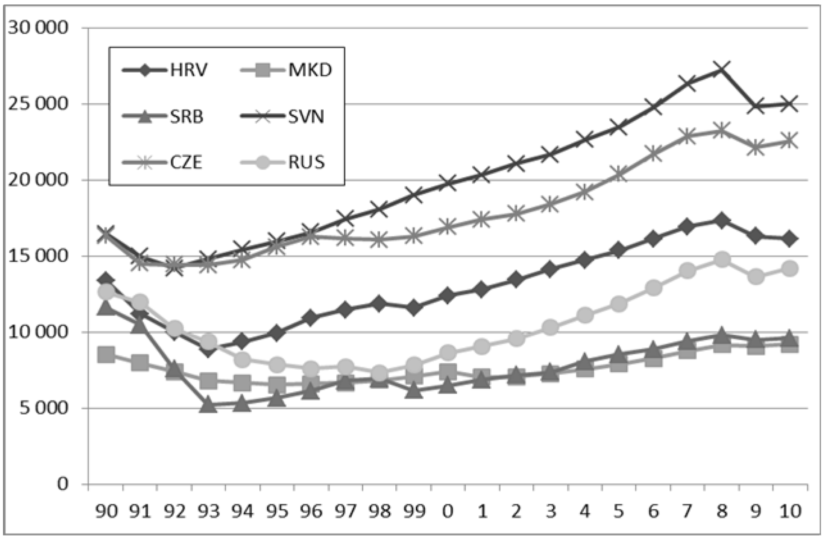
4 The 2008 EBRD Graduation

So far we have restricted our discussion to a comparison between the Czech Republic and other post-communist countries, mainly the EU group, between their start of transition and the 2004 EU enlargement. Perhaps the Czech Republic's transition has not been that impressive since 2004 or versus some post-communist countries which we have not considered yet. The evidence, however, suggests otherwise. The main economic success of the Czech Republic that was the 2008 EBRD graduation came soon after the EU membership.

In 2008 the Czech Republic became the first post-communist country to exit from the EBRD's list of transition economies. The 2008 EBRD graduation that marked eighteen years of the Czech transition from socialism reflected "the advanced state of transition achieved by the Czech people" (EBRD, 2007). Moreover, the Czech Republic was and remains the only country from the EU group of post-communist countries to complete transition though the EBRD anticipated all eight countries to graduate by 2010. Jean Lemierre, the president of the EBRD, described the Czech transition as "extraordinarily successful journey that the Czech authorities and the Czech people have taken to build a thriving market economy anchored by the democratic institutions that bolster a sustainable, strong economy" (EBRD, 2007).

Figure 6 compares the Czech Republic's per capita income to this benchmark in the former republics of Yugoslavia and Russia between 1990 and 2010. Leeson and Trumbull (2006) and Roland (2000) argue the transitions of the former Yugoslav republics is different in some ways from the Czech Republic or the other countries discussed above because the former Yugoslavia was a market socialist economy. Nevertheless, these countries have struggled with many of the same issues, such as privatization, as the other transitional economies. So it is interesting to see how the Czech Republic performs relative to them.

Figure 6. GDP Per Capita in the Czech Republic, the Former Yugoslavia, and Russia, 1990-2010 (*constant prices*)

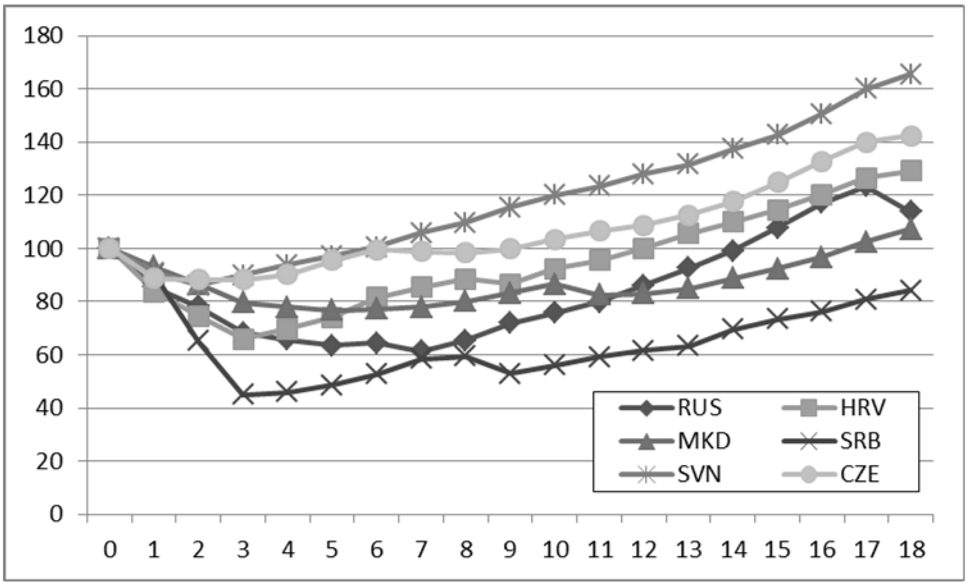


Sources: Calculated from World Bank, *World Development Indicators* 2011. Data for Bosnia, Herzegovina, and Montenegro are not available for a whole period.

We can draw several insights from Figure 6. The only economy that outperformed the Czech economy is Slovenia's. Russia again had the longest and most severe contraction, and nearly ties with Serbia and Macedonia for last place in terms of the extent of its economic recovery since transition began. It is also interesting that Russia's per capita income was higher than Croatia's in 1991, but the latter still outperformed the former.

Furthermore, we agree with Popov (2007) that initial conditions can be favorable towards transition. To control for differences in initial incomes and transition start dates, we demonstrate the same information from Figure 6 in the form of a GDP index in Figure 7. The base year is still the year prior to transition. As shown in Figure 7, the transition economies, except Serbia, surpassed pre-transition levels in eighteen years of transition.

Figure 7. Index of PPP Estimates of GDP Per Capita: the Czech Republic, the Former Yugoslavia, and Russia, First 18 Years of Transition (%)

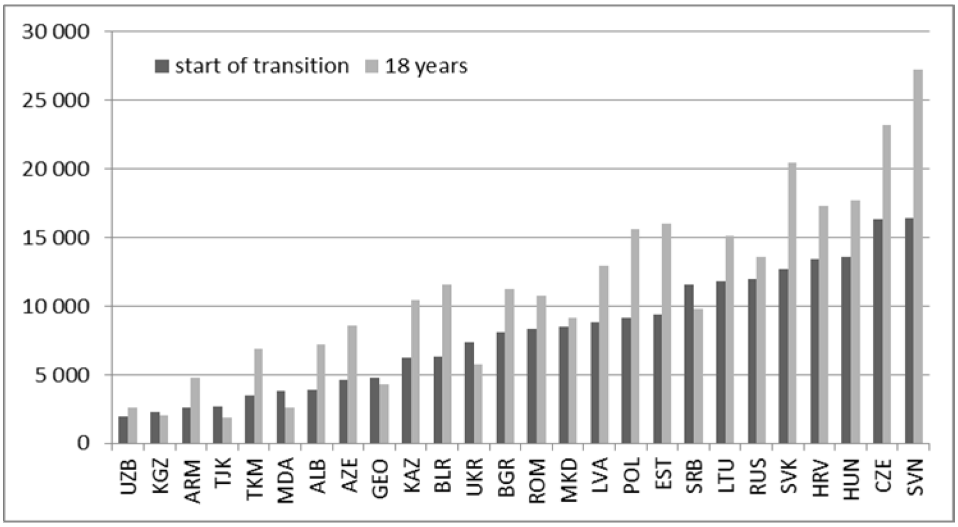


Sources: Calculated from World Bank, *World Development Indicators* 2011. Data for Bosnia, Herzegovina, and Montenegro are not available for a whole period.

On average, the only economy that outperforms the Czech Republic's index (108%) is Slovenia's (119%). Both the Czech Republic and Slovenia have returned to their pre-transition levels of economic performance in six years. Another former Yugoslav republic that is clearly enjoying a successful transition is Croatia. Nonetheless, the Czech Republic's economy still outperforms Croatia's economy. Serbia and Macedonia are clearly experiencing very troubled transitions, no doubt in large part because of the Balkan war conflict that plagued the region since its breakup. While Serbia is so far a failed transition, Macedonia has finally returned its economy to pre-transition level. On average, Macedonia's index (87%) even outperformed Russia's (84%) in eighteen years of transition. In fact, the only economy that performed worse than Russia's economy is Serbia (per capita income index = 63%).

Figure 8 presents initial per capita income and its value after eighteen years of transition for all post-communist countries. As shown in Figure 8, the Czech Republic started transition with the second highest per capita income among post-communist countries and completed transition with the second highest per capita income among all post-communist countries. If the initial economic conditions matter for future economic performance, it is important fact that none of the post-communist countries with less favorable initial conditions outperformed the Czech economy. By contrast, many post-communist countries with less favorable initial conditions outperformed others with the more favorable ones. A case in point is Russia that lost its economic position in eighteen years of transition from the sixth to the ninth highest per capita income among the transition economies. Poland, Lithuania, and Estonia outperformed Russia while their initial per capita income was much lower than Russia's.

Figure 8. GDP Per Capita in Post-Communist Countries After 18 Years of Transition



Sources: Calculated from World Bank, *World Development Indicators* 2011.

Moreover, after eighteen years of transition several post-communist countries like Serbia, Georgia, and Ukraine had their per capita income below the initial levels. Of course, economic performance of several post-communist countries was distorted by civil wars because civil conflicts put severe constraints on post-socialist economies (Leeson and Trumbull, 2006). For example, Georgia's economy was severely devastated by the civil war. As it was mentioned earlier, the Balkan war conflict also had a devastating economic effect on several countries of the former Yugoslavia. Thus, initial economic conditions can only partially explain differences in transition economies after eighteen years of transformation. Weak rule of law, civil conflict, and other political economy factors have a significant effect on a path of economic development. If the Havel shock therapy failed to solve the political economy problems of credibility and commitment, the Czech Republic would be on the less favorable path of transition.

6 Conclusion

The collapse of communism was celebrated throughout the West. The era of tremendous optimism, however, ended shortly. Since the mid-1990s popular accounts of the post-communist transitions have become very negative. The debate on the speed of the market reforms (shock therapy versus gradualism) has become more negative for the former and more laudable for the latter (see Popov, 2007, 2000; Boettke, 2001; Kolodko, 2000; Stiglitz, 1999). Many economists have criticized the shock therapy efforts of the early reformers like Havel and Yeltsin. Popov (2007) argues that the shock therapy had a negative impact on economic performance in the beginning of transition, but the gradual approach had a positive effect on the rest of transition period.

We defend the shock therapy approach by a juxtaposition of the Czech Republic and other post-communist countries. We argue that the Czech transition is a consistent success because of the Havel shock therapy. We use several facts to corroborate our argument. First, the Czech Republic was one of the eight post-communist states which were a part of the 2004 EU Enlargement. The EU membership clearly indicated an advanced level of economic, political, and social development. Second, the Czech Republic was the first and only post-communist country to graduate from the EBRD's class of transition economies in 2008. The EBRD graduation demonstrates an advanced level of the Czech economy. Third, unlike the Yeltsin shock therapy, the Havel shock therapy was a successful reform because it solved the political economy problems of reform's credibility and state's commitment to reform.

Our findings show that the Czech Republic is a successful transition from socialism. First, the Czech Republic performed as well as the countries in the post-communist EU group that outperformed the rest of the post-communist countries. Second, the Czech Republic performed well above average even in comparison with the former Yugoslav countries that had already had market socialism before their transition experiments began. Third, the Havel shock therapy transformed a socialist country into a working market economy with a stable democracy and a strong rule of law, while many post-communist countries are still in the gray zone of transition economy and incoherent authority regime. Our findings are unapologetic to further criticism of either the Havel shock therapy or the Czech Republic's transition.

We have attempted to set the record straight on the Czech transition from socialism to capitalism. The genuine shock therapies succeeded in countries like the Czech Republic and Poland. The shock therapies which could not solve the political economy problems of credibility and commitment failed in post-communist countries like Russia. It is not really an issue of gradualism versus shock therapy, but an issue of reform's credibility and commitment to reform, that determines a success of transition. The same speed of reform will have different effects if reform has different levels of credibility and commitment.

It is unfortunate that the Havel shock therapy has received so much criticism prematurely. Other transition economies could have gained valuable insights by looking at the Czech experience when making decisions about their reforms. Instead, a crucial misunderstanding of the shock therapy political economy discredits this approach to market reforms. The debate on the speed of the market reforms has been a disservice to both the Havel shock therapy and the millions of individuals looking for viable reform options.

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Appendix

Table 2. Description of Transitional Indicators

Description
Privatization score measures level of privatization, on a scale from 1 to 5, where: 1 means little progress and little private ownership and 5 means standards and performance typical of advanced industrial economies: more than 75% of enterprise assets in private ownership with effective corporate governance, no state ownership of small enterprises and effective tradability of land. Source: EBRD.
Infrastructure reform score measures average of five infrastructure reform indicators covering electric power, railways, roads, telecommunications, water and waste water on scale from 1 to 5 with higher score meaning higher degree of decentralization, privatization, liberalization and commercialization. Source: EBRD.
Index of economic freedom measures level of economic freedom, on a scale from 1 (repressed) to 5 (free). Source: Heritage Foundation.
Polity score measures quality of political institutions and rule of law, on a scale from 0 to 20, with higher score meaning higher degree of democratization. The regime categories are the following: autocracy (0-4), *anocracy* (5-15), and democracy (16-20). Anocracy is a mixed or incoherent authority regime. Polity score for Bosnia and Herzegovina is mainly unavailable. Source: Polity IV project.