Sources: Roland, chapter 1; and Shleifer and Treisman book.

1. What we want in the long run is well understood: free prices, openness to world markets, capital markets supporting external finance through banking and equity finance; limited government intervention as regulator; low inflation; private ownership; hard financial constraints.

2. Issue is how to get there.

3. Russian economic reform starts in January 1992. Ten years later the results of the reform are controversial. Privatization, price liberalization and the opening up to world markets have been rapid, broad and sustained. Results of stabilization, development of financial markets and development of market supporting institutions are mixed. Several problems emerge and are persistent and pervasive; taxation of businesses is onerous; stabilization is fragile; privatization is associated with rampant corruption; income distribution is highly inequitable; regions within withold taxes to the federal government; democratic political institutions emerge but are somewhat fragile.

4. Document some of these observations about Russia in the EBRD Transition Report, 2003.

5. Use the EBRD Transition Report to compare Russia with other post-socialist economies. Poland and China are well documented in that report and will be studied later in this course. But, also just skim and check on some more countries.

6. Shleifer and Treisman book: outline a general theory of reform and apply to the case of Russia, and look at the small privatization, large privatization, enterprise reform (hardening of budget constraints, privatization and restructuring); tax reform and emergence of fiscal federalism.

7. Shleifer and Treisman’s keep point: a feasible reform is necessary and is better, than the status quo alternative.

8. Roland, chapter contains a clear elucidation of this status quo bias in post-socialist transition (see also work by Fernandez and Rodrik). In Russia and in socialist economies there - is a status quo bias, i.e. delay massive large-scale institutional reform and keep things basically the same. Why??? There is a great deal of uncertainty about new institutions such as free prices, private property, capital markets. Lots of people stand to lose. Roland denotes this type of uncertainty as “exogenous uncertainty,” i.e. everybody is equally uninformed about just what will happen post-reform, and nobody has particular (individual) knowledge about whether they will benefit or lose from the reform.

9. Roland draws the distinction between ex-ante versus ex-post political constraints. Reform must be designed so that the overwhelming share of people will support it pre-implementation. This is the ex-ante political constraint. Once it is approved and/or implemented, then there should not be groups that emerge who can effectively reverse the reform. This is the ex-post political constraint. The key issue
with the design of large-scale change as observed in Russia and other post-socialist transition economies is that any reform must satisfy the ex-ante and ex-post constraints.

10. Key point is that reforms there were and are still being implemented in post-socialist transition economies are massive and much larger than what have experienced in the USA. For example, consider some of the reforms implemented under President Bush, for example, tax reform (“get your tax refund”), education reform (“no child should be left behind”), medicare reform, etc. versus the extent of reform in the CIS and Eastern Europe.

11. Formal analysis of status quo bias. Suppose that uncertainty is exogenous, and ex ante you know that your probability of benefiting from the reform is \( p \): \( 0 < p < 1 \). Suppose that \( p = .6 \). This means if you flip a coin that it is better than fair odds.

12. You vote tomorrow on whether or not reform happens six months later (mid-June). If you benefit from reform (win) you get \( G =$1,000 \); if you lose you lose \( L = $2,000 \). If there is no reform, then the status quo is maintained and the pay-off is \( 0 \).

13. Suppose the in January the reform is voted through. In particular, we vote for a massive privatization and price control as the Russian did in 1993 when they voted a vote of confidence in then President Yeltsin. It is modified a bit during the fall and in June you vote again on whether or not to implement. And, in June you know whether or not you are a winner or loser. The cost of voting again in January is 5\$ (entrance fee).

14. Some results. TODAY. We do not know whether or not we will be winners. Suppose \( p = .6 \), \( G = 1,000 \) and \( L = 2,000 \). Who votes for and against reform (status quo outcome is 0). For simplicity, suppose that people are RISK NEUTRAL and worry about average/expected pay-offs (will discuss risk aversion later on). The expected pay-off is \( .6 \times 1000 - .4 \times 2000 = -200 \). So, we would predict voting against the reform when we do not know if we are a winner or loser.

15. New numbers. Suppose that \( p = .4 \) (winner), \( G = 5,000 \) and \( L = -1,000 \). Repeat the two period voting experiment. The expected payoff is \( .4 \times 5000 - .6 \times 1000 = $2000 - $600 = 1,400 \). So, ex ante we are fine and the reform should go through in the January vote. Suppose the vote goes through. During the spring information is revealed and by June we know just who are the winners and losers. But, if you do the math you will see that during the June vote the reform will be reversed. In fact, as Roland notes, because a reform passed in January is effectively dead in June, we might not even put the reform up in the first place. So, here the ex ante constraint is fine, but ex post it is not.

16. THE POINT – reforms must satisfy ex ante and ex post feasibility constraints. Ex ante = feasibility constraints that block decision-making and ex post constraints as constraints on backlash and reversal after decisions have been made and outcomes of reform are observed.

17. Feasibility. Shleifer and Treisman identify efficiency enhancing reforms. They note that they threaten the standard of living of “certain powerful social actors” who benefit from existing inefficient arrangements. These are the stakeholders.
19. Stakeholders. Examples 1) State ownership… stakeholder are management who have control of enterprises; workers who have voice in enterprises, regional governments who have taxation power and who can also broker deals for enterprises and industrial ministries, who have limited rights to regulate industries with state quotas, shipments etc. Benefits to these groups of inefficient institutions: managers have freedom to strip assets and divert profits; workers had life time employment and in-kind subsidies and provision of health, housing, etc.; regional governments derived political benefits from low unemployment and standard of living gains for constituents and perhaps bribes; industrial ministries derived benefits from controlling resource allocation to these state owned enterprises.

20. Shleifer and Treismans’ point is that any reform that is ex ante and ex post feasible must somehow deal with these stakeholders. For example, according to Shleifer and Treisman, state ownership is inefficient and private ownership arrangement that link up control and ownership of assets promises efficiency gains. Any attempt to introduce efficient private ownership must the stakeholders from the state ownership system because they have the power to prevent reform “either through centralized action in the political arena to prevent ENACTMENT” or through decentralized efforts in regions, enterprises, etc. to prevent IMPLEMENTATION. The stakeholders thus have formal or informal control rights over how these arrangements (state ownership for example) are either maintained or overhauled. How then to overcome stakeholder resistance???? Either expropriate (i.e. buy out the stakeholder) or co-opt the stakeholder (i.e. persuade him/her to not use his/her power to obstruct).

21. Privatization and stakeholders’ formal and informal control rights. Managers – have strong representation in the Russian parliament and have control over the enterprises; workers – strongly represented in the parliament and have a strong voice in the operation of enterprises; regional govs – can set some tax rates; can take political action (strikes, tax withholding, secessions, etc.); control upper house of parliament; industrial ministries – weak legal rights and presence in cabinet! Privatization, designed to buy these actors out and to co-opt them.

22. Is in fact privatization necessarily efficiency enhancing even if we ignore the problems with stateholders? Aghion, Burgess and Blanchard article in EER (see notes) note that under-developed markets for managers can encourage firms that are being privatized to NOT restructure.

23. Privatization reforms are generally viewed as important, since state ownership can lead to inefficiencies resulting from excess employment, asset stripping, and corruption (e.g., see the notes from Boycko, Shleifer and Vishny, A Theory of Privatization). However, Roland (2000) notes that managers of state-owned enterprises in transition economies have also succeeded in shedding excess labor and restructuring their operations to run more efficiently (Roland, 2000, Ch. 9, and references therein). Moreover, Carlin et al. (2001) examine 3,300 firms in 25 transition countries, and find that ownership per se has no significant impact on firm performance.