Laurel E. Martin

Determinants of Success In Reform Strategies: A Case Study of Hungary and Poland

The capacity of a post-communist country to minimize social pain is essential to the very existence of the new government. In studying the transitional economies of Eastern Europe, it is important to attempt to determine what factors have lead to a level of success in not only moving towards a market economy, but also in minimizing the social pain of that transition. Hungary and Poland have been cited as two of the most successful nations in moving towards economic success (Slay, 1994). Interestingly, these two countries selected different reform strategies, the gradualist approach and the shock therapy approach respectively. With these different strategies, they have met with similar results, results that are some of the most optimistic in all of Eastern Europe. This study will analyze how two very different reform strategies can produce similar outcomes. The paper will attempt to determine the other factors that have been important to the success of these two case studies.

Successful reform is difficult to measure. However, in this study, success will be measured on two levels. One aspect of success is in basic economic indicators. Thus, in this sense, success in Poland and Hungary will be measured by per capita gross national product (GNP), inflation rates, growth of the private sector, and unemployment rates. These are important economic indicators because they can directly influence the degree of social pain produced by economic transition. However, measuring social pain should not be limited to quantitative indicators. The general population's perception of social pain is also important. It is possible to have success on a number of key economic indicators and still have a high degree of social pain.

Background

For the past several decades, the economies of Eastern Europe have been centrally planned by the communist party. This central planning succeeded in creating a specific set of values, institutions, and attitudes that created a framework in which society functioned. Now, after the fall of communism, the newly democratic governments in Eastern Europe are attempting to change this framework in order to establish a market system. The old system must be cast aside in order to successfully establish the framework for a market economy. But economic change is often accompanied by social pain, and in the Eastern European nations, worker displacement, a changing employment structure, and the problems left by communism, have generated a high degree of social pain. One good indicator of social pain is the average income of workers. Table 1 indicates that compared to Western Europe or Asian newly industrializing economies (NIEs), Eastern Europe lags far behind.

Table 1

Average Monthly Dollar Wage, 1990-93

	1990	1991	1992	1993
Bulgaria	136	63	96	125
Czech*	198	139	169	505
Hungary	214	233	278	298
Poland	139	209	222	235
Romania	176	143	87	102
West Europe**	2037	2120	2293	2127
Asian***	532	608	685	734

- *Source: U.S., Department of Labor, Bureau of Labor Statistics*
- **Data for Czech* Republic
- ***Average of France, Germany, Great Britain, and Italy*
- ****Hong Kong, South Korea, Singapore, and Taiwan*

This has in part lead to a debate concerning what is the best way to make the transition. Governments are faced with two basic policy options, the gradualist or shock therapy approaches. It is important to look at the predicted results of both strategies because the very survival of the new democracies may very well depend on their economic success. The well being of the economy can give legitimacy, satisfaction, and voter trust to the new government. However, if the new government is unable to provide a basic level of economic well-being, much less a successful economy, it faces the chance of being replaced. Indeed, in several East European nations, the socialist party has seen a return to power.

Literature Review

Most economists agree on certain components of overall transitional strategy. They generally agree that in order to establish a private market economy, four goals need to be met (Marer, 1993; Bosworth and Ofer, 1995; Slay, 1993). First, there must be macroeconomic stabilization. This encompasses tight budget and credit policy to head off rising inflation, trade deficits, and growing governmental debt. Second, there must be liberalization. Policies of liberalization can eliminate trade barriers so that cross-border movement of capital, services, technology, and ideas can be maintained. Third, prices must be freed and currency must be devalued. Finally, the exchange rate needs to be flexible and currency has to be convertible.

Economists agree that privatization of the economy is also an essential element to the development of a market economy. This entails the development of a private sector, property rights, land and housing reform, dismantling state enterprises, and commercializing businesses. Finally, most economists advocate polices that develop a market-supporting institutional infrastructure. This includes banking reforms, monetary reforms, legislative action--perhaps constitutional change--and regulatory and insurance reform.

The issues that economists disagree upon are the speed, the sequence, and the intensity of how these four points should be implemented into the economy. Thus arises the debate between the shock therapy or the gradualist approach to transition. Jeffrey Sachs is perhaps one of the most well-known economists who advocates the shock therapy approach to transition. This approach has been termed a "leap to a market system" (Sachs, 1994). He advocates moving as quickly as possible to a market system. Policy requires simultaneous and fast implementation of transition strategy on all four points. Accordingly, as the population experiences a high degree of social pain, this will be replaced by benefits in the long run.

After the 1989 fall of communism, Poland swiftly embarked upon a transition to a market economy. Leszek Balcerowicz was selected by the Mazowiecki government as the deputy prime minister and finance minister. Balcerowicz, with support from the West, the World Bank and International Monetary Fund (IMF), embarked upon shock therapy. It was decided that the best way to deal with hyperinflation and other economic problems was by making a clean and quick break with the past. This move included balancing the governmental budget, slowing monetary growth, and increasing interest rates (Slay, 1993).

The critics of shock therapy often argue that its intense social pain is too great a price to ask the people to pay. In addition, such social pain can also lead to disillusionment in the government that is implementing the policy. In the new democracies, public support for governmental policy is essential for their subsequent success. Robert Freedman states, "Workers acceptance of transitional costs will have a profound effect on the success of transition programs" (Sachs, 1994: 18).

The gradualist approach is defined by The Economist (21 September 1991) as the strategy that puts the greatest priority on creating infrastructure to support a market economy before making other changes. The gradualist approach also advocates government regulation in the switch from predominately state-owned enterprises to private enterprises. This strategy builds upon the idea that the development of market institutions is a gradual process; attempting to function as a pure market economy without those institutions will only lead to a greater crisis (Slay, 1994).

Hungary has been experiencing a gradual shift in economic structure since 1968 with the implementation of the New Economic Mechanism (NEM). Besides this, Hungary was able to implement several capitalist features despite communist control in return for their cooperation. For example, legislative action in 1984 and 1987 gave way for state enterprises to have a degree of privatization (White, 1993).

Research Design

It has been six years since the fall of communism. Hungary and Poland have seen similar results despite different strategic approaches. These results have been deemed some of the most successful in all of Eastern Europe in that they have progressed the furthest towards the establishment of a market economy. Of course, after only six years,

success is tentative. And by any standard, the success of these countries is only relative. Both countries are still faced with severe economic problems and still have a long road to travel before they are healthy, functioning market economies.

Table 2 demonstrates the similar success levels in Hungary and Poland after six years. These are basic economic indicators that partially demonstrate how the two countries have moved towards a market economy while keeping social pain in check. A high labor force participation rate as well as a growing private sector means more people will have opportunities to work in the private sector.

Table 2

EDIMP's Window into Economic Policy, World Bank

	1990	1991	1992	1993		
Unemployment						
Hungary	1.5%	7.8%	14.0%	13.7%		
Poland	6.1%	11.5%	15.5%	15.0%		
Labor Force Participation						
Hungary	83.0%		74.0%	71.0%		
Poland	76.0%		74.0%	71.0%		
Share of Private Sector Employment						
Hungary	32.0%	34.0%	35.8%			
Poland	33.6%	40.3%	44.4%			
GNP in U.S. Dollars (From 1995 World Tables)						
	1988	1989	1990	1991	1992	1993
Hungary	2750	2830	2920	3030	3210	3350
Poland	2010	1990	1730	1840	1970	2260

Downward trends in unemployment indicate that more people are beginning to find work. A higher GNP at the end of the six year period means that in general the population has seen a higher standard of living. All of these factors indicate relative lessening of social pain.

As can be seen, unemployment rose in both countries during the indicated four year period. However, these relatively close unemployment rates in 1993 have begun a downward trend, compared to several Eastern European countries which are still seeing an increase in unemployment levels. For example, the Slovak Republic experienced a 3% increase in unemployment from 1992 to 1993. Bulgaria and Romania witnessed a 1% growth in unemployment in that time period.

Private sector growth is one of the most important and effective ways in making a successful transition to a market economy. Poland and Hungary by far have the highest share of private sector employment. In 1992 Russia had 25.9%, Bulgaria had 14.1%, and Romania had only 12%. At the end of the six year period, both Poland and Hungary have a higher GNP than in 1988, despite Poland's dip in between. This dip was the expected result of shock therapy. Many other transitional countries are experiencing either negative or zero growth in GNP levels. Bulgaria, the Slovak Republic, and Romania all had this experience in 1994 (Bosworth and Ofer, 1995).

These results demonstrate that there must have been similar occurrences that either happened before the fall of communism, or during both reform programs, that contributed to the relative success and similar economic conditions. It constitutes an interesting puzzle to consider how Poland, which embarked upon a course of shock therapy, a strategy that is expected to create intense social pain, arrived at the same place as Hungary. The results of Hungary and Poland's transition seem to indicate that the debate between the different reform strategies is unwarranted. Reform success may not only depend on the speed or sequence of reform policies. Rather, other outside factors may be just as important.

The remainder of this paper will explore four variables common to both Poland and Hungary that help explain the similar outcome of their different reform strategies. The variables are previous reforms, the nature of the emerging governments, emphasis on the private sector, and foreign involvement and investment.

Previous Reforms

Previous reforms are an important aspect in determining the success of later reform. Previous reforms can set the stage for capitalist behaviors and institutions that are necessary for a market economy to function. If a nation has had a degree of experience with capitalism, it will have a better chance of adapting to the changes implemented during transition.

Hungary under Janos Kadar was able to form a "social compact" with the Hungarian people and Moscow that allowed it to experiment with different economic and domestic reforms (White, 1993). The Soviet Union was willing to look the other way and give Hungary concessions and flexibility that few other East European nations were able to experience.

The most important early reform was the implementation of the NEM in 1968. The NEM was successful to a degree in loosening state controls on the economy. It allowed for the self-management of collective farming which allowed individuals to begin to experience a market system. One of the most interesting aspects of the NEM was that it allowed factory workers to use state-owned enterprises for private production after regular working hours. This gave way to an emphasis on quality rather than quantity, and to incentives for producing more efficiently. Here began the early development of the culture of private, profit driven endeavors.

The NEM was not able to change the ideological favoritism the heavy-industrial sector saw over other sectors such as services or consumer goods. This kept many of the "unnatural" tendencies of central planning alive in Hungary. Secondly, some of the capitalist features of the NEM disrupted the status quo. Some workers who were not receiving direct benefits of the reform measures began to feel threatened by signs of growing capitalism. Their resentment towards the program added to political tension concerning the reforms (Rothschild, 1993).

But, overall, the NEM was able to give Hungary a head start over most of the other Eastern European nations. In 1989 when countries were just beginning to implement market reforms, Hungary all ready had twenty years experience. After the NEM, there was a move to allow small partially private businesses in 1980. The eighties also saw joint stock companies, share issuing, and even a stock exchange. These reforms were also accompanied by banking reforms which included the establishment of commercial banks free to compete with one another. Bankruptcy regulations forced businesses to become more efficient. The net effect of such policies allowed most of the necessary institutions of a market economy to be established by 1989 (White, 1993).

In Poland, the situation was different politically, but ironically it led to similar results economically. Unlike Hungary, the Poles were never willing to give their acquiescence to Moscow. The difficulties that the Soviet Union experienced in permeating all aspects of Polish society resulted in the agricultural sector never being completely taken over by central planning. Before 1989, 80% of the agricultural sector was privately owned (Shen, 1993). This left a substantial and important economic sector still "marketized."

Besides the largely private agricultural sector, the powerful Solidarity movement enabled Poland to secure some reforms before 1989. Target planning by the central authority was replaced by decision making made by local managers. New initiative systems were implemented that were based on profitability rather than meeting specific quantity requirements. Many of the ministries responsible for central planning were eliminated or reduced. New associations were formed to be accountable to the very enterprises they represented, rather than the central authority. This was hoped to make implementation of policy and distribution of inputs more efficient.

A second stage of reform occurred in 1986 and 1987. The second stage attempted to complete the reforms of the first stage while establishing the foundation for a socialist market economy (Slay, 1993). The development of an Anti-monopoly Bureau, an Export Development Bank, and legislation permitting Polish firms to embark upon large-scale business partnerships with Western firms helped to decrease the number of state monopolies, and increase foreign trade and investment.

Other aspects of the second stage aimed at establishing a structure for a partial market economy to function. Prices were freed, enterprises were expected to be self-financing, and some unprofitable enterprises were eliminated. While these reforms by no means left the Polish economy in a position to switch easily to a market economy, they were able to begin to form a different set of institutions and attitudes than those that predominated under pure central planning.

Emerging Government After the Fall of Communism

The government that emerges after the fall of a long established power is important in that it will guide the course of the country. If the new government is unpopular, political problems may take center stage in the new country. It is difficult for a nation in severe political turmoil to be able to carry out effectively any type of reform, whether it be gradualist reform or shock therapy. Both Hungary and Poland emerged from the fall of communism with a government capable and willing to initiate economic changes. This, in addition to the fact that the emerging government were relatively popular, may have facilitated the acceptability of the different reform strategies.

In Hungary, Joseph Antall was president of the Hungarian Democratic Forum (HDF) party. The HDF was the largest party in parliament. In a coalition formed with the Independent Smallholders Party (ISP) and Christian Democratic People's Party (CDPP) parties, both of which were ideologically similar to the HDF, Antall was able to form a stable government. Antall's coalition was the first such coalition formed without a communist party since before World War I. This was important because with the elimination of the communist influence, the Hungarian government was given a new sense of legitimacy. In addition, Antall was able to secure an agreement with the Alliance of Free Democrats (AFD) party to ensure that his reform legislation would not be blocked. This gave him some power to decide and execute policies.

Lech Walesa, the former leader of Solidarity, became Poland's first popularly elected president after winning 75% of the vote in the elections. After the fall of communism, some Poles were disturbed at the disorganization and inability of the legislature to formulate and implement policy. Thus, they saw a remedy in the creation of a strong executive power. Walesa seemed the perfect candidate to fill this role after spending a decade fighting for the rights of the working people under communism.

The Balcerowicz Plan that was begun under the Mazowiecki government, called for a rejection of the past and swift movement towards a market system. With Walesa in power, there was an added legitimacy for the strategy. Shock therapy necessarily calls for social pain, but believing the future could bring better things and encouraged by a popular leader, the Polish people were willing to undertake shock therapy. Walesa himself was a well-known supporter of rapid economic change. Perhaps the course of Poland's reform would have been significantly different had Walesa not been the first President.

Theoretically, privatization is one of the strongest and most effective means of transforming an economy from central planning to the market. The most basic idea of capitalism is that the means of production should be privately owned. Privatization can bring in public revenues, develop an entrepreneur class, create jobs, and change the attitudes and ideas that have been sustained by central planning. But privatization is a difficult process laced with many hard choices. The development of huge state enterprises is one of the legacies of communism. The average number of employees in these state enterprises was close to 1,200 compared to the Western average near 375 (Sachs, 1994). In converting these giant companies to private companies, often down-sizing or perhaps even phasing out the corporation is necessary.

During communism, there was also an unnatural emphasis on heavy industry, leaving many other sectors of the economy underdeveloped. This creates two problems for privatization. First, while there is needed development in the service or consumer good sector, there is little know- how. Secondly, if the vast number of employees and means of production have been focused on heavy industry, it will be difficult to refocus those on a different aspect of the economy. Workers will need to be retrained, perhaps even relocated. Perhaps most important, workers will no longer have the social safety net that communism provided for them in the past. A centrally planned economy could maintain a surplus of labor simply because its ultimate goal was employing the population. A market economy requires firms to hire according to profitability. All of these problems with privatization give potential for social pain.

Hungary and Poland have both acknowledged the difficult problems that they are facing on the road to complete privatization. Yet, they have both made a commitment to the private sector. Table 3 shows that both countries are leading in the growth of the private sector.

Table 3

Share of Private Sector Employment

	1990	1991	1992
Bulgaria		10.1%	14.0%
Czech Rep.	8.1%	19.9%	
Hungary	32.0%	34.0%	35.8%
Poland	33.6%	40.3%	44.4%
Romania		6.9%	12.0%
Russia	11.0%	18.3%	25.9%
Slovak Rep.	4.9%	12.8%	17.0%

Source: EDIMP's Window into Economic Policy, World Bank

It is interesting to compare this share of private sector employment with overall unemployment rates. Poland, which has the highest share of private sector employment, also has one of the highest overall unemployment rates. Hungary has also seen this positive relationship. The reason for this could be because of what economists have termed "labor shedding" in the conversion of state-owned enterprises to private enterprises (Blanchard, 1995). Labor shedding is another aspect of social pain seen in transitional economies.

Legislation dating back to 1982 has demonstrated that the Hungarian government demonstrates the development of a private sector as an essential part of economic success. Since then, the most important legislation occurred in 1988 and 1989 with the Company Law and the Law of Transformation (Sachs, 1994). These two laws allowed for new forms of businesses to be established, including limited liability companies and stock companies. The development of these two types of companies is important because economists believe they are good indicators of private sector development (Sachs, 1994). In Hungary, there have been 52,000 new businesses of this type incorporated since 1991 (Sachs, 1994).

Hungary has also imposed special tax advantages for private firms. The tax system allows for private businesses to reduce the amount of taxes paid by up to 50% on their net profits (Sachs, 1994). There have also been several programs in Hungary aimed at privatizing state-owned businesses and shops. Despite some criticism of the over-all program, the Pre-privatization Law allowed for individuals to buy state-owned equipment, company stock, and real estate. The Self-Privatization Program, started in 1991, gave the State Property Agency the ability to use consulting companies to facilitate the buy out of up to 600 small and medium sized companies (Sachs, 1994).

In Poland, there are also many programs aimed to returning the means of production back to the private individual. Despite obvious problems, the greatest trend has been restitution, an attempt to give back former owners their real estate. Other modes of restitution included vouchers or monetary compensation. There have been two main privatization programs implemented in Poland, small and large scale. Small scale privatization applied to small business that could be sold to individual buyers. These were mainly restaurants, small shops, and service-oriented businesses. Large scale privatization applied to the large state-owned enterprises that were generally too large for an individual buyer to purchase. In order for these types of enterprises to qualify for privatization, they have to met certain requirements determining their potential to function efficiently and profitably. Those enterprises that were determined to be unable to function in a market economy would be allowed to die out (Shen, 1993).

There also have been new initiatives for individuals to start new business, not only to acquire previously state-owned businesses. It is necessary to register new business in Poland, but the registration process for individual business is surprisingly simple, taking only a few days to complete, compared with complicated registration process for larger multi-owned businesses (Sachs, 1994). There are also fewer taxes on individual firms and in 1990 there was a tax holiday for some individual firms. Table 4 shows the increase in the number of individual firms as well as the number of employment opportunities they provide. Overall, both Hungary and Poland have been successful in creating new private businesses as well as converting previously owned state enterprises into private corporations. These have been the key determinants of their success. In spite of different reform strategies, both have focused on the need to develop the private sector.

Table 4

Number of Individual Firms in Poland

	1990	1991	Total Emp.
Industry	334,613	348,803	826,658
Construction	165,541	170,618	392,575
Transportation	61,368	60,203	74,575
Trade	346,294	514,778	797,772
Food Service	22,511	34,845	83,981
Other Services	122,099	124,768	143,953
Nonmaterial Services	83,066	111,629	159,552

Source: Polish Central Statistical Office (Table from Sachs, 1994)

Foreign Involvement and Investment

Foreign involvement and investment is extremely important for easing the pains of transition. Sachs has written extensively on this aspect of reform. Throughout history international financial support has enabled reformist governments, and their reform programs, to surmount the twin challenges of deep institutional change and day-to-day political survival. The real contribution of foreign assistance is to help cushion the burdens of reform, especially for vulnerable groups, and to give hope to the population that the reforms will pay off in the medium term (Marer, 1993).

While foreign involvement cannot replace the role of the individual country, it can have a positive effect on the effectiveness of market reform, either by increasing levels of capital and technology or by augmenting levels of knowledge.

Both Hungary and Poland have significant ties to Western Europe. Their close proximity is an advantage both have over many other former Soviet states. They also have economic ties to the rest of Europe as well as other developed nations. Because of their progress in economic reform as well as their initial economic status, both countries hold attractive investment possibilities for foreign investors. Table 5 shows the increase of joint business ventures with foreign investors. The number in Poland and Hungary are significantly higher than several other Eastern European nations.

Table 5

Joint Ventures 1989-1991

	Poland	Romania	Hungary	Bulgaria
1989	867	5	180	30
1990	2,799	1,502	4,400	140
1991	4,000	2,665	2,420	366
Total	7,666	4,172	7,000	536

(Table from Sachs, 1994)

The IMF and the World Bank also have been involved in the transition of both economies for many years, dating back even to before the fall of communism. This is helpful because the IMF and World Bank have been effective in setting goals for the countries that they themselves either may not have been aware of or are hesitant to embark upon. Hungary, in 1982, was the first Eastern European country to become a member of the IMF and World Bank. Several times IMF and World Bank involvement prevented debt crisis in both Poland and Hungary. For example, in 1990 after the formation of the Antall government, Hungary came close to a foreign exchange and currency crises. However, with the help of the IMF, the problem was averted and Hungary was able to continue its reforms (Slay, 1994).

Hungary was successful in attracting foreign investment because its economy was farther along the road of market

development than any other Eastern European nation before 1989. Foreign investment in Poland was limited before1988. In fact, it was restricted to small firms with under 200 employees. New laws in 1988 and 1991 removed most of the restrictions concerning foreign investment, including restrictions on importing and exporting, profit sharing, and foreign exchange--all of which made investment in Poland much more attractive (Sachs, 1994). Poland has also made a move to model the regulations and laws that affect foreign investment to be more like those in the West. These include changing bank regulations, accounting practices, and taxation processes. Before the fall of communism, Eastern bloc countries were mainly tied to trading with other countries in the Council for Mutual Economic Assistance (CMEA). But by 1992, nearly 72% of Poland's trading was already with other developed nations. Only 16% was still with the former CMEA (Slay, 1994).

Conclusions and Implications

More factors than just the chosen reform strategy determine the capacity of a post-communist country to minimize social pain. If, within different reform policies, certain criteria are met, it is likely the nation will have a greater chance of being successful in that policy. The cases of Poland and Hungary have demonstrated that either policy can be appropriate depending on other factors such as previous reforms, emerging governments, a successful development of the private sector, and foreign investment. Again, the debate over whether shock therapy or the gradualist approach is false and unproductive.

Hungary and Poland have reached similar levels of success on one set of economic indicators, yet both have suffered certain consequences of the market transition. Both nations are still dealing with severe economic problems as well as mounting political tensions. It is very well possible that the future will bring unsuccessful attempts to met the challenges that transformation has presented. Already there are signs that the initial steps towards marketization may not be as positive as initially hoped. Hungary and Poland are not healthy market economies and the day that they will achieve such stability is still far down the road.

Even with the economic success in these two countries, the population's perception of social pain is still important. Despite Hungary and Poland's comparative economic success within the Eastern European region, they have not been entirely successful in dealing with social pain. Declining social welfare policies, shrinking pensions, and rising prices make the every day citizen aware of the negative aspects of transition. In 1991, in both Poland and Hungary, over 60% of public opinion reported the present economic situation worse than under communism (Reinicke, 1992). The working people are obviously perceiving a degree of social pain.

However, as two of the most successful of the transition economies, it is important to realize what has brought Poland and Hungary at least this far. There are certainly many contributing factors to their relative success. Implications of the determinants of success are hard to quantify. Two of the factors that have been presented in this study are impossible to implement. A nation can not engineer a history of reformism that does not exist nor can it entirely control the character of the government that emerges after transition. The only current option is to attempt to implement certain measures that will help to ease the way into a market system.

Above all, because each nation has a unique set of circumstances, we must be cautious in drawing implications. The combination of economic and political policy is difficult to hold constant in a world of turmoil and change. Tentatively, it can be suggested that a continued emphasis on the private sector as well as international involvement should be encouraged in Eastern Europe.

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