

DISTINCTION BETWEEN ECONOMIC TRANSITION IN CHINA AND RUSSIA (SOVIET UNION)

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Abstract

Two of the most profound communist economies were Soviet Union and China. Both countries were engaged in transition from planned to market economy. However, the results have been almost the opposite. Communism in Soviet Union collapsed while Chinese transition is characterized by rapid emergence of the market economy. The paths of economic transition in these two countries were distinct, especially, the period when reforms started. Notably, many reasons caused the success of China, as well as Soviet crash. Nevertheless, while Russia has fully complied to International Monetary Fund and World Bank shock therapy transition model, China has established innovative gradual approach to the economic reforms and full market economy. In this paper we examine the cause of different success of transition in these countries and point out the key factors which cause it, such as initial conditions, political leadership and empirically-based pace of reforms.

Key words: *economic transition, shock therapy, gradual reforms, China, Soviet Union, Russia*

1. INTRODUCTION

Chinese and Russian history of 20th century was marked by Karl Marx economic approach. Although both countries advocated the same economic thought, the practice was totally different. In theory, socialistic regimes imply state ownership and planned economic systems, among other features. Firstly, after October revolution in 1917 Russia was the pioneer in the field of application of communist ideology in practice. As a result, Russian communism was present much longer than Chinese where in 1949 Communist Party with Mao Zedong came to power. Secondly, reforms in China, as part of transition, started at the end of 1970s, approximately ten years later than in Russian federation (Brown, 2009). Above all, China had more agricultural economy and more stable political system than Russia. Furthermore, reforms in China were gradual and slow and maintained the existing political system, while Russia chose fast and radical reforms in 1990s simultaneously changing political system (Kurkchian, 2007). Besides, Russian transition was followed by the crash of Soviet Union. As a result, the crash caused political instability and consequently economic instability. Political instability was reflected in government shift from totalitarian to democratic and multiparty system in a very short period. In the period of instability when the new government wasn't organised, liberalisation, privatisation and other IMF and WB measures were bad decisions (Stiglitz, 2014). Finally, Russian oligarchy, privileged rich minority, exploited the country by privatizing national recourses. On the other hand, China kept some elements of planned economy like nondemocratic regime. China simultaneously moved from planned economy to market economy and from rural to urban economy (Brækhus & Øverland, 2007). Also, economic transition in China wasn't followed by political. Communist Party, which is still in power today, led the transition and reforms. This, along with other factors, enabled China to avoid negative transition performances. In the end, economic transition led China to one of the fastest growing economies in the world, while Russian economy declines.

The first section of this article compares Chinese and Russian economies during the period of planning and communist leadership. We point out the main differences and similarities. In that way, we can debate if initial conditions and differences before economic transition caused the opposite results of transition in Russia and China. In the second section, we analyse different paths of transition. To demonstrate the successfulness of transition, the efficiency of transition is present trough some indicators like gross domestic product per capita (GDP/pc), foreign direct investment (FDI) and rate of unemployment. Also, we discuss about institutional environment and organisational structure as one of the causes of different paths of transition in Russia and China. Finally, we emphasise the importance of foreign impact in way

of accepting or rejecting IMF and WB propositions also known as “Washington Consensus” values and institutions. To sum up, we outline the main thoughts in the concluding section.

2. INITIAL CONDITIONS - PLANNED ECONOMIES

After October revolution, the development on socialistic basis started in Russia (Soviet Union). The authorities applied planned economic system through fast industrialisation and collectivisation. The amount of production and prices were determined by government plans, truly ignoring market laws. Efficiency, as well as the quality of goods, were low. While low prices ensured products for all social strata, it was unsustainable. Likewise, state resources and reserves of gas and oil potentiated low price on local market. Even if prices and quantities were determined, there was no inflation, but scarcity was an everyday phenomenon. Private agricultural property was collectivised by the government, and farmers were only users of that property (Lekpek, 2012). High rates of growth were the most used argument for maintenance of socialism. In the period after World War II, between 1958 and 1970, Eastern European countries had higher growth rates than the West. High rates of economic progress led them closer to western countries and their development level. Despite high rates (greater than 50%), they were still falling behind. Although they had relatively higher growth rates than the West, in nominal amounts they were much under the western level of Gross Domestic Product. After the period of growth, in the period between 1978 and 1990, Eastern Europe stagnated (Družić, 2006). Although growth rate was impressive during the first phases of communist regimes, planned economies were not suitable for invention and innovation. Thus, lack of invention and innovation, together with other shortages, caused long-term slowdown (Svejnar, 2007). Besides planned economy, which was a crucial factor of low level of economic growth, there were some other factors which assisted bad performances of Eastern European economy. One of them is resource concentration in one sector – hard industry, which caused intersectoral imbalance. To illustrate, before World War II Russia (Soviet Union) exported agricultural products. On the contrary, after the war Russia became importer of agricultural goods because almost all resources were allocated in hard industry. Above all, planned economy caused Russia to lag technologically behind the West. As a result, Russia applied economic reforms. Unfortunately, the reforms were not structural, so there was no progress in economy. Therefore, the crash was unavoidable at the end of 1980s (Družić, 2010). In that way, we can summarize the period of communist regime in Russia in three things - first, nationalization and collectivisation; second, one sector domination – hard industry; and third, unsuccessful reforms. Of course, we need to underline, in its beginning it was a period of growth and catching up with the West.

Chinese communist path started in October 1949 by Mao Zedong's appearance. Communist empowerment was seen as a way out of the politics of misrule. China was exploited by foreigner's through 19th and the first half of 20th century. In Mao revolutionaries saw an escape from poor economic situation. Although China accepted the superiority of Soviet Union as the first socialist republic, they chose their own way of socialism. They based their path of socialism on their own situation and the environment they lived in, so they rejected Stalin's tendency to force upon them Soviet policy. According to some Chinese scientists, there were a lot of differences between these two systems in the first phase, while Russians reject these ideas. Russians claim that there were no differences between these two systems, accordingly, Chinese system was the same model as the Soviet one. They were the same in the field of politics, economy and social affairs which could be seen in centralism, hierarchical organisation of Communist party, leaders' cult of personality, unlimited power of the leader, supervision of all areas of life – social, political and intellectual, through public institutions, central planning, private property nationalization, hard industry domination and investment in national defence. Likewise, the Chinese school system followed the Soviet one. On the other hand, economic system was different. Mao despised Soviet bureaucracy and rejected any Soviet influence (Brown, 2009). Without a doubt, the initial conditions at the beginning of transition in Russia and China were very different but the system of central planning was similar in all communist regimes and caused related problems in all of them. Certainly, China and Russia had the same root – planned market.

By the end of the 1980s, Russia was mostly industrial economy with an educated, urban labour force while China was dominantly agricultural although its transition started at the end of the 1970s.

Nevertheless, in China, as we can see in *Figure 1*, in 1987 the percentage of employees working in agriculture was 60%. Consequently, China struggled with the problem of overage population relative to available land, but in the 2000s it potentiated a pool of cheap labour and percentage of employees working in agriculture rapidly declined to approximately 5%. On the contrary, in Russia, the percentage of employees working in agriculture didn't strongly oscillate but it declined in the 2000s (*Figure 1*).

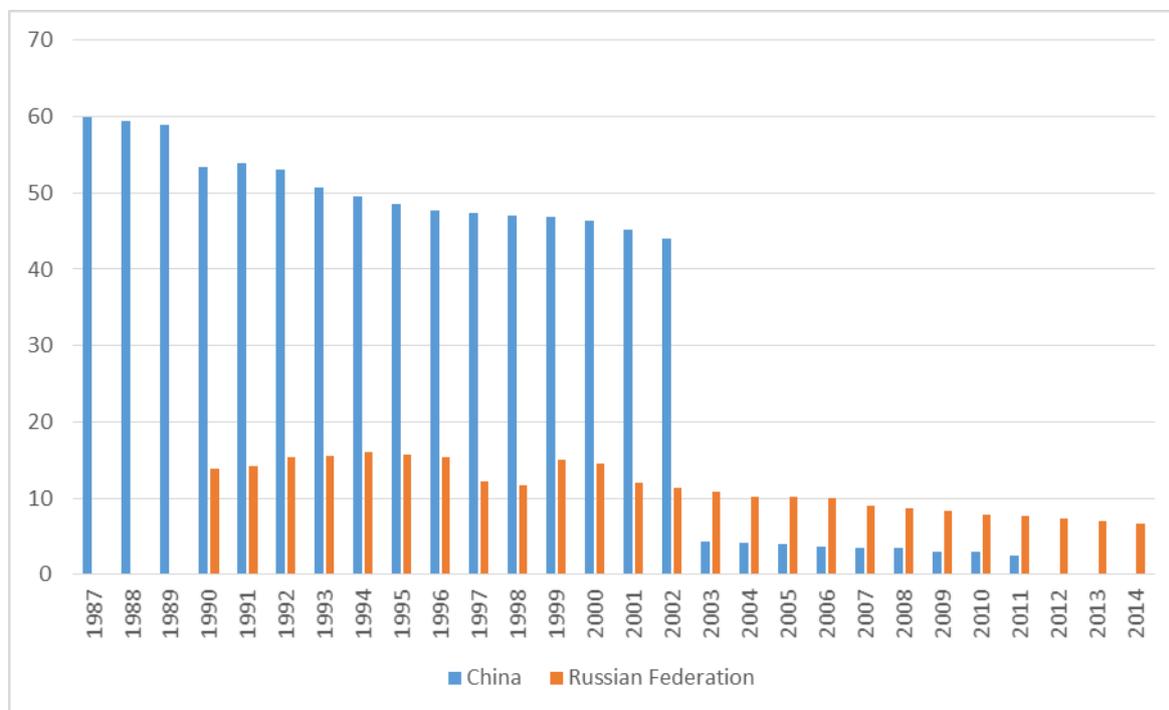


Figure 1. Rate of Employment in agriculture (% of total employment)¹

Source: World Bank Open Data <<http://data.worldbank.org/indicator/SL.AGR.EMPL.ZS>>

The end of communist period was different in these two countries. In Russia the economic transition was followed by the Soviet Union split where the Soviet Union lost half of its territory and population. Russia, which was part of the Soviet Union, was disturbed. It was a period of economic recession, an uprising criminal, lawlessness, a negative demographic trends and war in Chechnya. On the contrary, Chinese leadership held the rule (Rutland, 2009). While transition in both countries followed after years of unsuccessful economic performance, there were two main differences in the transition itself. First, in China, the results of reforms exceeded proposed plans from the very beginning of the transition process, while in Russia the first years of transition were noted as very unsuccessful. Second, the pace of adopting reforms was different. China adopted gradual reforms and held old leadership which ensured the absence of adverse shocks. On the other hand, Russia adopted rapid transformation from planned to market economy without strong leadership (Svejnar, 2007).

¹ International Labour Organization: „Employment is defined as persons of working age who were engaged in any activity to produce goods or provide services for pay or profit, whether at work during the reference period or not at work due to temporary absence from a job, or to working-time arrangement. The agriculture sector consists of activities in agriculture, hunting, forestry and fishing, in accordance with division 1 (ISIC 2) or categories A-B (ISIC 3) or category A (ISIC 4).”

3. PATHS OF TRANSITION

Economic transition requires structural reforms which are characterized by modernisation and sustainability. The most important goal of transition is catching up with the developed economies. Economic transition contains transfer of technology which can enable poorly developed economies to increase productivity by adopting modern technologies. In that way they shift to a higher stage and economize research and development costs. Although transition means changes and reforms, it is not a warranty for success. Some countries do not utilize their economic potentials (Reosefielde, 2013). In that way, we can observe Russian and Chinese transition. Although both countries were going through economic transition, China emerged from it successfully, while Russia did not. Consequently, we can find some of the reasons for different success by analysing and comparing the paths of transition of these two observed countries – Russia and China.

Even though China was devastated throughout the past by radical reforms with chaotic consequences, China had a great advantage because of its occurrence on the world market earlier than Russian. Besides that, Chinese reforms were gradual, while Russian market liberalization was characterized by taking actions in a short period of time. While Russia was finding its position on the world market, China had done it a decade earlier and withdrew foreign capital which was transferred to countries with low cost production. Therefore, paths of transition in China and Russia were almost entirely different. Russian path is characterized by the rejection of communist past and all institutions connected with it in a short period of time. The transition in Russia brought new legislation and institutions based on democratic principle. That transition path is also known as “Shock therapy” (Kurkchian, 2007). Political conditions also had an important role in determining the path of transition in these two countries. In that way, in China, before and after the transition, Communist party was in power with all the power in its hands. On the other hand, Russia experienced both economic and political transition which meant market liberalisation and shift to democratic multiparty system. In fact, government in Russia was unable to control monetary and fiscal deficits and final result was high inflation and macroeconomic instability. China started with gradual reforms since 1978 by freeing peasant farmers from plan controls through the household responsibility system while Russia had a sudden turnover named “Shock therapy” in 1992 (Kim, 2015). Without a doubt, the political leadership of Russia and China applied totally different transition strategies. The Russian leadership applied radical reforms in 1992 while China’s reforms were middle-up, where the centre accepted initiatives from below. In any case, China used reforms to increase the state’s capacity to rule and led the transition successfully. (Ruthland, 2009) Moreover, China had its own experimental way of transition which included bottom-up approach. On the contrary, Russia used comprehensive and top-down approach - “Shock therapy” that characterizes the transitions in Eastern Europe. But some economists doubt if gradualism and experimentation brought China success. There are some claims that large agricultural labour force, low subsidies to the population and decentralized economic system contributed to China’s success (Lin, Cai & Li, 1996). Undoubtedly, China initiated the transition as a more decentralised country in the economic and political way than Russia. As we said in the previous section, the percentage of employees working in agriculture was greater. All those facts gave China a bigger potential for higher growth rates during and after the transition. Furthermore, we will analyse some indicators of the successfulness of the transition.

3.1 *Gross domestic product per capita*

Economic liberalization and privatisation, which were the outcomes of transition, produced chaos, hyperinflation and industrial collapse in Russia and economic growth in China, both visible in their economic standard (Galbraith, Krytynskaia & Wang, 2004). The most important cause of high inflation level was declining level of standard of living. The government was trying to settle it through macroeconomic stabilisation – liberalisation of prices, fiscal consolidation and tightly control of money emission which were the IMF (International Monetary Fund) and the WB (World Bank) proposition (Ilić & Prvulović, 2003). Since the beginning of the transition, China’s average annual rate of growth has been enormous. It marked China as one of the most successful transition economies (Lin, Cai & Li, 1996). But we need to outline that China was on a lower level of economic development than Russia.

If we observe Madison Project Database (2013) data which are shown in *Figure 2*, we can see GDP/pc trend from 1979 to 2010. As we can see, Russian GDP/pc is higher in the whole period of observation,

but Chinese GDP/pc increased in the same period and the gap between these two countries is getting smaller during the years. Accordingly, in terms of GDP/pc growth we can recognise that China's performance since the reforms began at the end of the 1970s was strong. On the contrary, Russian performance in terms of GDP/pc growth is disappointing during the 1990s, when reforms in Russia took place.

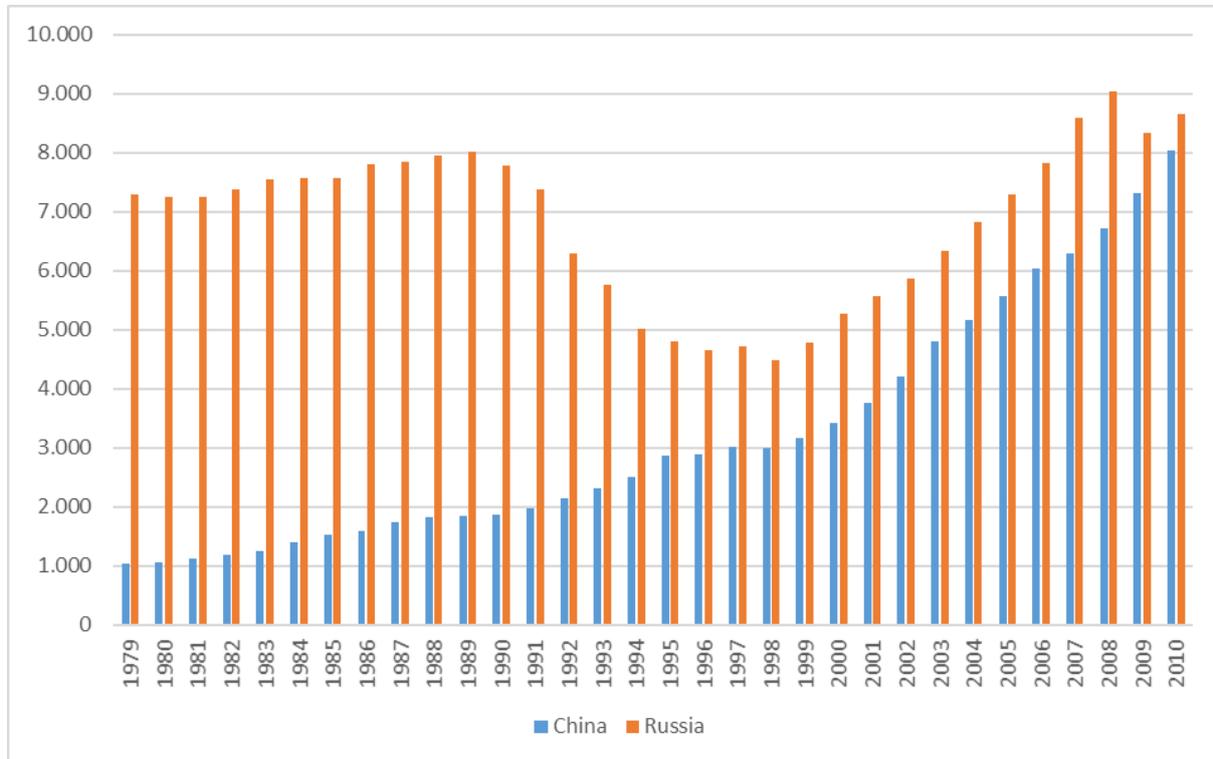


Figure 2. Gross domestic product per capita (GDP/pc) trend from 1979 to 2010

Source: Maddison Project Database <<http://www.ggd.net/maddison/maddison-project/home.htm>>, 2013 version

For our research, the observed (*Figure2*) years for China are from 1979 because the transition in China started at that time. In that way, we can notice that since that period till 2010, which is the final year of this observation, China's GDP/pc increased. To conclude, in terms of GDP/pc, since the very beginning of reforms China grew continuously. GDP/pc is one of the indicators which show us the efficacy of the transition. On the contrary, Russian period of observation is from 1992 because, as we said in the previous paragraph, this is the year when Russia carried out "Shock therapy". Consequently, we can deduce, as it is shown in *Figure 2*, that Russian transition failed because GDP/pc after 1992 had deeply dropped. After 1999 it increased, and in 2007 it reached approximately the level of GDP/pc in 1989.

Russia was deindustrialized during the transition, and during that period Russia became the exporter of raw materials, mainly oil and gas. In same period Gross Domestic Product of China was strongly increasing as result of industrialisation and restructuring of economy. Finally, in Russia, the consequence of unsuccessful transition and bad economic performances was the reduction of the expected life expectancy and migration of educated people (Stigliz, 2014).

3.2 Institutional environment and decentralised organisational structure

While Russia was passing through political and economic transition, China held communist leadership with sufficiently large political control. In that way, institutional environment in China wasn't changed while Russia experienced "Shock therapy" in institutional environment as well as in economic regime.

Large political control in China allowed successfulness of gradual economic reforms without complete privatisation (Zeiter, 2005). Some economists claim that China's success is the result of institutional incompatibility caused by partial approach to reforms (Lin, Cai & Li, 1996).

We can find the reasons for China's better performances of economic transition shown in trends of GDP/pc (*Figure 2*) in organizational structure of state administration. The decentralization can be observed in economic and political area. There are some studies which connect the degree of political centralisation with successfulness of economic transition. In China where is high rate of political centralisation, unlike in Russia, central government has been strong and disciplined (Blanchard & Shleifer, 2000). In economic area, China was a more decentralized country than Russia was at the time when the transition started. Additionally, Russian economy was centralised what was the most obvious in administration controlled by large central ministries. It allows oligarchy to accumulated power and wealth bypassing the central leadership. They had no interest to develop law and institutions that would have the purpose of regulating new market system. On the other hand, Chinese economy was controlled by regional government (Kim, 2015).

In Russia, as the repercussion of the fast liberalisation, there were no adequate institutions to support the economy, especially small entrepreneurship, like bank system. It was assumed that the abolition of the old state-owned banking system would naturally move on to a new efficient banking system, which did not happen (Rosser & Rosser, 2004). Without a doubt, decentralised organisational structure was helpful for gradual reform path in China. On the contrary, the bad corporate governance was inhibiting transition in Russia. It was the result of a lack of corporative law. Consequently, private sector was not regulated appropriately.

3.3 Impact of foreign investments

Foreign investment or foreign direct investment (FDI) has a positive effect on the modernization of countries' economies. During the period of economic transition and the shift from planned to market economy, China had a high rate of foreign investment and generated significant inflow of foreign direct investment. (Svejnar, 2007) On the contrary, Russia had a low rate of foreign direct investment. As we can see in *Figure 3*, unlike Russia, China relied on attracting Foreign Direct Investment (FDI), especially in the 2000s.

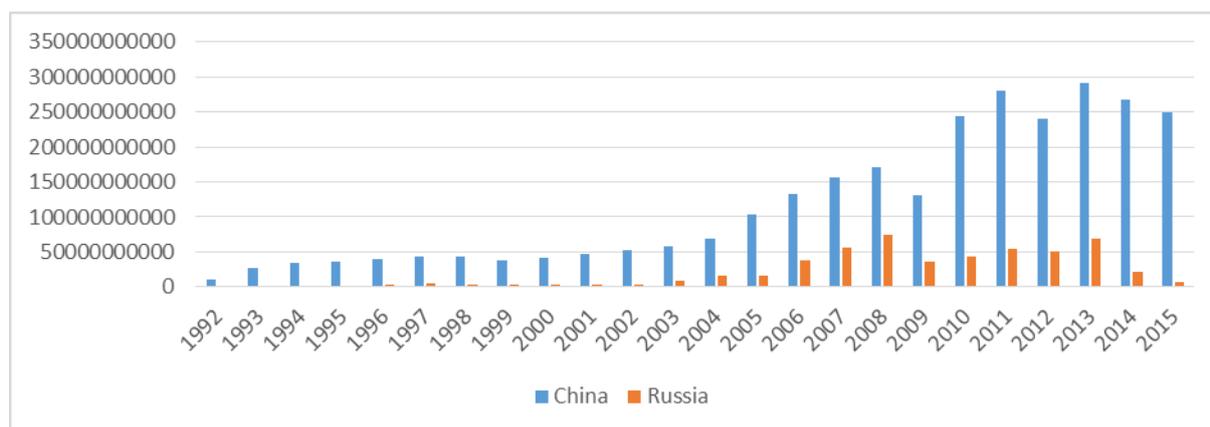


Figure 3. Foreign Direct Investment (FDI)² rates in dollars (\$) from 1992 to 2015

Source: World Bank (Foreign direct investment, net inflows (BoP, current US\$)
<<http://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD>>

² International Monetary Fund: „Foreign direct investment refers to direct investment equity flows in the reporting economy. It is the sum of equity capital, reinvestment of earnings, and other capital. Direct investment is a category of cross-border investment associated with a resident in one economy having control or a significant degree of influence on the management of an enterprise that is resident in another economy. Ownership of 10 percent or more of the ordinary shares of voting stock is the criterion for determining the existence of a direct investment relationship. Data are in current U.S. dollars.”

To attract Foreign Direct Investment (FDI), China created Special Economic Zones with favourable tax and regulatory conditions. FDI was the crucial distinction in Russian and Chinese transitions which ensured success and economic growth for China. This was particularly supported by the proximity of Hong Kong and Taiwan through strengthening economic connections. Also, China was importer of raw materials and exporter of final products (Kim, 2015). Conversely, foreign impact in Russia was completely different. Political insecurity, as a consequence of leadership change, reflected on foreign investments and trade collapse. Moreover, it reflected on economic transition performance. During the 1990s, there was a low inflow of foreign investments (Ilić, Prvulović, 2003).

Since we are talking about planned economies, unemployment is an unknown phenomenon. Thus, before the transition there are no data about that, but in most communist countries it emerged rapidly. If we observe *Figure 4* we can find that in 1992, the first year of transition in Russia, unemployment rate declined, and in the following years it was rising till 1998 when unemployment rate declined again.

The unemployment rate was fluctuating from 5% to 13% of total working-age population during the 1990s. The highest level of unemployment rate has been achieved in 1998, when it amounted 13,3% of working-age population. After reaching the peak in the 1998, the unemployment rate declined till the 2008 when due to global economic recession increase again but not worrisome (*Figure 4*).

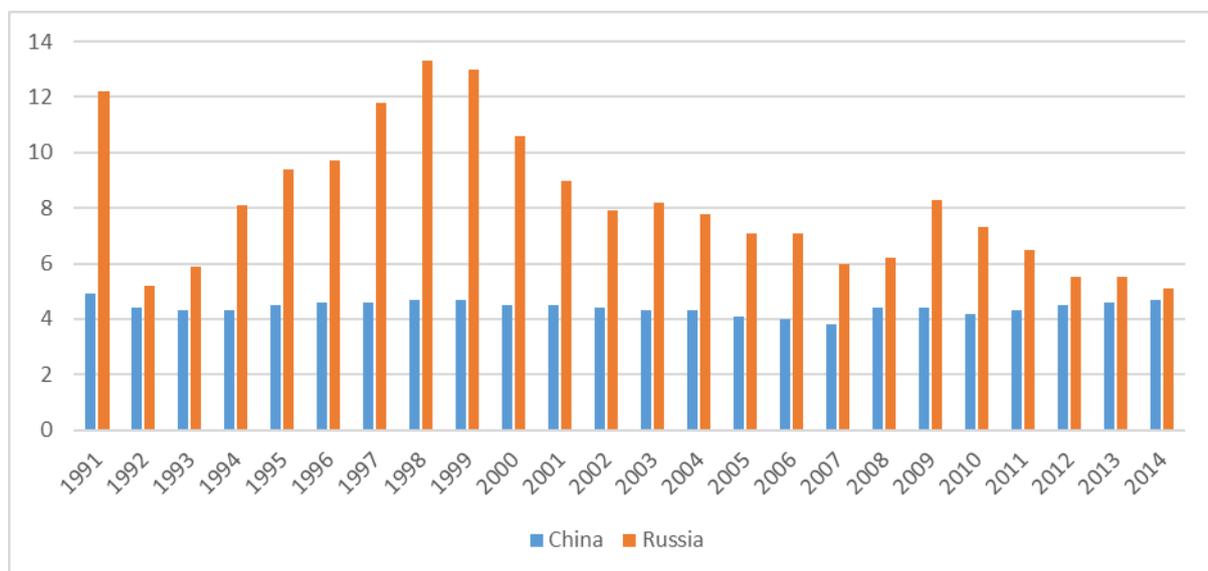


Figure 4. Unemployment rate³ (%) movement in Russia and China from 1991 to 2014

Source: World Bank Open Data; Unemployment, total (% of total labor force) (modeled ILO estimate)
<<http://data.worldbank.org/indicator/SL.UEM.TOTL.ZS>>

4. IMF AND WB

Policy advice can also play an important role in transition experience. Above all, we need to examine the impact of the two most important organisations – the International Monetary Fund (IMF) and the World Bank (WB) which were included in the Russian transition, while China refused their policy and propositions. The International Monetary Fund, as well as the World Bank and World Trade Organization, propagate the propositions of the Washington Consensus – fiscal discipline, free market liberalization, tax reduction and privatisation national companies.

Some economists accept that the role of the IMF and the WB was crucial for bad economic performance of the Russian transition, while representatives of the Washington Consensus identify higher rate of

³ International Labour Organization, ILOSTAT database: “Unemployment refers to the share of the labor force that is without work but available for and seeking employment.”

industrialisation in Russia than China as the main cause of Russian failure (Zeitler, 2005). Some economists claim that Russia did not embrace the propositions and the main idea of the Washington Consensus that globalisation promotes democratization. The propositions of the Washington Consensus include free trade, freely floating currencies, the lifting of government regulation, and the privatisation of state-owned industries (Rutlan, 2009). A uniform and single model of transitional reforms for all countries was the main problem of the IMF and the WB proposals. Furthermore, it was essential to take care about interests and specificity of every single country. Radical changes, liberalisation of prices and privatisation in a short period were fatal to Russia (Ilić & Prvulović, 2003). The chief advisor to all countries that entered the transition process was the IMF. However, what was later identified as a problem with the measures offered by the IMF is the fact that the same advice was used for all countries and did not respect the specifics of each country. This was most pronounced in those countries that did not have a clear vision and strategy. In this case, the countries followed the IMF's recommendations blindly, which caused major problems with the implementation of these insufficiently well-designed measures. An example of bad leadership through the transition process was Russia. The main criticism of the IMF propositions was that propositions didn't considered the specificities of Russian society. Although the IMF's advice had already failed in the very beginning, they did not give up. The IMF and the WB did not consider the fact that socialism for a period of 75 years deeply rooted in the Russian society and that it is not possible to change the situation by implementing radical measures within a few months (Lekpek, 2012)

As a cause of failure, the advocates of the Washington Consensus policy, which Russia applied, state that Russia did not fully follow that policy. In addition, the various circumstances underlying the transition to these two countries are mentioned. Stiglitz (2014) denies that China did not fully follow their recommendations and had a strong economic growth. China gave accent on competitiveness than on privatization, especially in first phase. Next, unlike Russia, liberalisation in China was gradual and not completely. What China has taken from the Washington Consensus recommendations is industrial policy followed by interest rate policy during strong industrialization.

5. CONCLUSION

China appeared on the world market before Russia what is a significant advantage. Furthermore, China had gradual reforms and transition to market economy, while Russian market liberalization took place in a very short time. The transition paths in Russia and China are almost completely different. The Russian transition is manifested in the total rejection of the communist past and all the institutions associated with it.

There are two main explanations for different results of transitions – different circumstances under which the transitions took place and different political decisions of countries leadership. Of course, they are related one to each other. Consequently, Russia applied policy proposed by the Washington Consensus while China made her own way of transition.

To sum up all contrasts between the reform paths, we can see that in Russia during the whole period of reforms leadership held politics in the first place and the initiative for reforms was top-down, while in China economy played a crucial role in reforms and the initiative for reforms was middle-up. The pace of reforms in Russia was rapid while in China the pace was gradual. Because of this, Russian transition is also known as “Shock therapy” and Chinese as “Controlled transition”. Next, we can find the reasons for the opposite pace of reforms in the previous decades. China was devastated during the communist regime through radical reforms with failed outcomes. On the contrary, Russia had grown tired of decades of incremental reforms before 1992 when economic crises emerged. It stimulated Russian political leadership to embrace radical reforms. Equally important was the impact of western organisations like the International Monetary Fund (IMF) and the World Bank (WB) which had a strong impact on political decisions in Russia, and no influence in China.

The propositions of Washington Consensus showed up as unsuccessful in case of Russia. On the other hand, China has followed its own way. China, unlike Russia, had not privatised all national companies, especially in agricultural sector.

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