SOME THOUGHTS ON TRANSITION REFORMS AND THEIR REVERSAL

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ITALY UNITED STATES

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The break-up of the Soviet Union in the late 1980s created a movement and a desire, on the part of many citizens of the previously centrally planned economies of Eastern Europe, to start on a transition route towards becoming market economies. They believed that this route would raise their living standards and bring them closer to the levels enjoyed by their Western European neighbours. There was less discussion of the role that the governments of these countries would play during the transition, and later on. The view that there might have been a "third way", that might integrate central planning with free markets, was dismissed. Vaclav Klaus captured the prevailing view when he stated that "the third way was the direct way to the Third World". The Eastern European populations wanted to be part of the First World, and not of the Third.

Governments had been largely discredited as a result of unfulfilled promises during the years of socialism. There was also, of course, the problem that many of those who would make important decisions during the transition were the same individuals who had controlled the governments during socialism. Most of the general public had no clear or informed idea of how market economies operated. Would the policymakers see the role of the new state following transition in the same way as it was in advanced countries? If the answer was yes, of which advanced countries?: the high–spending welfare states of continental Europe, or the lower-spending, Anglo-Saxon countries and, especially, the US?

The East European countries entered the transition with some favourable and some unfavourable initial conditions. The favourable conditions were:

a. their physical and cultural proximity to the European Union;
b. the high educational levels of their populations;
c. income distributions that were relatively even, with Gini coefficients in the low 20s;
d. a desire to get out of economic situations that were often characterized by shortages of some important goods and services and long queues in shops;
e. a realization that they had not been living in the promised "workers' paradise", but in countries with low standards of living. Increasing information exchanges had made this latter point obvious to many of them.

The unfavourable conditions were:

a. most of the countries had entered transition with already significant macro-economic difficulties that would most likely get worse;
b. there were major distortions in the allocation of resources and in relative prices. The misallocation of resources was evident from the large Incremental Capital Output Ratios (ICORs); the very large inventories held by enterprises; the excessive use of energy to produce a given output, and so on. Too much saving was mobilised, and it was misallocated. This had led Wassily Leontief to comment that these countries had created a peculiar "input-input system", one that absorbed resources but created little, valuable output;
c. there was confusion as to the ownership of the factors of production, which had different public owners, and some of them had or would have claims from private, past owners;
d. there was little understanding of how a free and unguided market operates and on the role that relative prices, profits, and interest rates played in allocating resources;
e. essential fiscal and monetary institutions and some essential personal skills were missing, because they had not been needed in centrally planned economies;
f. poor working habits had been developed by many workers in public enterprises where, as some cynics put it, "the workers pretended to work, while the enterprises pretended to pay them".

The process of transition had to face and solve several problems. Some important ones were:

a. How to value assets to be privatized, when there had been no market for those assets, and when prices had been very distorted?
b. How to privatize productive assets in countries, which had few or no rich individuals, and no financial markets?
c. How to prevent insiders in state enterprises from taking personal advantage of their insider's knowledge and positions, to benefit from privatization?
d. How would the new governments collect the public resources they would need to finance public goods, during and after the transition?
e. What public revenue would replace those that the governments had received earlier from what had been, effectively, transfers within parts of the public sector?
f. What kind of tax system should be put in place?
g. What should be the level of taxes and of public spending during and after the transition?

It should be recalled that at the time of the transition, say during the 1990s, there were two significantly different reference models that the transition countries could have followed. The first was the model offered by several of the EU countries. These countries had chosen government roles that required high levels of public spending. This model required high taxes, to finance the expensive welfare programs, and many market regulations. The second model was the one offered by supply-side economics and by market fundamentalism, ideologies that had become very popular, especially in the 1980s and 1990s, in the UK, the USA, and in other Anglo Saxon countries and with many vocal economists. This model argued that the market could be efficient and could solve many economic and social problems if it were not constrained by governments and by high taxes. During those years, a common refrain for dealing with problems became: "the market will do it". This approach had the attraction of calling for low tax levels, for flat tax rates, and for limited regulation. The "flat tax" became particularly popular in transition countries and was adopted by several of them. It was promoted by American Advisers who believed in the Laffer Curve and was assumed to be simple and efficient.

The transition period lasted longer than had been expected by optimists and by those who had believed in the value of "shock therapy". Many macroeconomists, even some in international institutions such as the IMF, recommended it. It consisted mainly of freeing-up prices and privatizing assets. The transition was generally not a happy period for several countries. Expectations of fast growth and rapid convergence in living standards with Western European countries were not met. Several transition countries experienced large drops in output, high unemployment rates and high rates of inflation. Inflation was caused by large fiscal deficits, often financed by monetary expansion, and by "monetary overhang", combined with the fall in output.

It became clear that policies could be changed more rapidly than the new and needed institutions could be created. The creation of those institutions would require years and much technical assistance. The process of privatization would have an impact on income distributions, making them less even and would leave much unhappiness among the populations. Insiders took advantage of their privileged positions and some very rich individuals, including dollar billionaires, appeared in these countries who had previously experienced even income distributions and no rich individuals.

The transition occurred in the 1990s, at a time when the EU was creating, for many of its members, a closer union, with the creation of the European Monetary Union and the euro. At this time, it was normal for citizens of the transition countries to believe that it would be nice for their countries to also be part of this new European family and architecture. They could see the danger of being left out and of missing the European train. Being part of the EU would have many advantages, would provide a convenient anchor for the policies of the transition countries and would also provide significant economic resources, obtainable from the EU. That would accelerate the process of convergence in living standards.

At this point some potential conflicts started to appear, which would become more significant with time. The EU policies were at times in conflict with those suggested by market fundamentalism. The EU had adopted strict economic and political rules and a growing number of regulations. These reduced the degrees of freedom of national policymakers. There were also politically based requirements that conflicted with some of the views held by some of the policymakers in the transition countries. Some of these countries did not have strong democratic traditions. Furthermore, the sense of having acquired independence from what had been a supra-national structure (the Soviet Union-led CMEA), was in part lost when a different supra-national structure, the EU, acquired power over the national governments.

The EU package, that had appeared to be very appealing when the transition countries were on the outside, started to appear less appealing, at least to some of their policy-makers, from the inside. Attempts to reverse some European and domestic policies started in some countries (Poland, Hungary and some others). Some EU policies, such as those related to immigration, become a catalyst for growing conflicts with the EU. This was especially the case in countries that had rediscovered the attraction of nationalism.

This reversal process was also stimulated by other factors. One would be the growing populism in the world at large. Populism has provided a convenient cover to some policy reversals in specific countries. Another factor would be the growing opposition in several countries to globalization and to global rules. A further factor would be the growing complexity of the EU rules that made it more difficult for national governments to understand, follow and justify them to their populations, especially when they conflicted with national rules.

The next few years will reveal whether the new members will change the EU; or the EU will change the new members.