DESIGNED to shock

In the wake of the Soviet coup, Eastern Europe's rapid transition to the market has taken a spurt. Reformers are determined to make a clean break with the past. But Louis Haddad sounds a note of caution. The fast-track road to private ownership, he argues, could turn out to be just a fast-track to economic chaos.

Economic reformers in Eastern and Central Europe seem to know exactly what they want and where they are heading: a well-functioning market system of the kind found in developed Western countries. Further, they are in a hurry to get there, and are in no mood for any experimentation on the way lest it leads them into a costly detour or dead end. For them and their supporters in the IMF there is simply no alternative to the free market system. Marxism, socialism, communism and even planning are dead and buried in Europe. The ideology of marketism has presently triumphed over the ideology of communism.

All the same, having a clear vision of one’s goal is one thing: getting there is quite another. The transition from central planning to the market cannot be effected simply by a process of transplanting all the institutions, structures and policies of the developed market economies. This is not simply because of the legacy of the bureaucratic past; it is in the nature of the beast. Systemic changes and institution building are not a matter of mechanics, of assembling the different components together as in a building. What is involved is an organic process that requires time to allow the interdependent components mutually to adjust and interact with one another in order to get together.

Anyone who knows anything about the evolution of markets in developed countries will be aware of the fact that it took decades, if not centuries, for these markets to develop and function efficiently and effectively. This is not
to deny that the period of transition can be telescoped by copying from the developed market economies their institutions, organisations and policies, through foreign technical and financial assistance, investment and joint ventures, and through sales of state enterprises to foreign corporations. These things are helpful and are indeed encouraged by the reformers. Of course, the speed of transition will depend on the circumstances of particular countries, on the initial conditions such as the degree of decentralisation of decision-making, the size of the existing private sector and state of the economy, its internal and external balance.

Nevertheless, there is, in principle, an 'optimal' pace of reform for each country which should not be artificially speeded up or delayed. But in practice the policy-makers in Eastern Europe are confronted with the stark choice between the application of shock therapies and a sequenced, gradual transition. Both strategies have their merits and demerits, as I will explain below.

In general, though, the reformers in Eastern Europe at present are in favour of rapid transition to a market-based system. In this they are strongly supported by the IMF, the World Bank and a number of experts in the West. They all reject the gradual approach on historical, political strategic and economic grounds. According to them, the gradual approach was tried in the past and found wanting. Previous attempts to reform the planning system in Hungary, Poland and elsewhere have met only with a limited degree of success. Further, the gradual approach, they argue, provides the anti-reformers with ample time to frustrate the reform process and ultimately derail it. Furthermore, as old habits die hard, it is necessary to administer quick, sharp measures in order to force people to change their thinking and behaviour. Shock therapies, which are meant to cut the Gordian knot of the bureaucratic legacy, can shorten the most painful and insecure stage of transformation. Finally, there are economic gains to be got from dismantling the old costly system and replacing it as quickly as possible with a well-functioning market system that will allocate resources more effectively and generate a higher rate of technological innovation.

The radical reformers are fully aware of the likely danger of chaos that might follow the destruction of the old system, which did work after some fashion, while the new one is being installed, a danger that already exists in the 'Soviet Union', Romania and Bulgaria. But to them the risks involved in their strategy are less than those of the gradual approach. The reformers and their supporters are also aware of the inevitable hardships of market reforms, the economic and psychological costs which flow from the strategy of rapid transition. However, they believe such 'adjustment' costs will be temporary and will be more than offset by the permanent gains that would accrue from the establishment of the market system. With appropriate macroeconomic policies, it is maintained, a recovery from the reduced level of output and employment will be possible within a relatively short period of time—perhaps a few years. As to the human and psychological costs of adjusting to market forces, they argue, these can be cushioned by a 'social safety net' designed to help the most vulnerable segments of the population. Moreover, these costs, it is suggested, will be accepted by the population since it is widely understood that the old planning system is simply unable to deliver a modern progressive economy. The alternative gradual approach would, according to the radical reformers, postpone but not avoid the painful costs of adjusting to a market economy.

Ironically, the advocates of rapid transition and shock therapies are recommending strategies of rapid industrialisation which seem oddly similar to the kinds of 'cultural revolutions' and 'great leaps forward' adopted with disastrous consequences by the former communist regimes. Historical arguments apply both ways. But what is even more astonishing is the dismissal of the gradual approach by the managing director of the IMF as having no merit other than its 'semblance of wisdom'. But is it a semblance of wisdom to insist on preparing the ground before rushing forward, or is it not in fact a cardinal blunder to ignore the preconditions for a successful and speedy transition? And what of the likely hidden costs of hastily devising faulty social arrangements, incentives and institutions? Initial errors committed in a hurry can lead to lasting handicaps and deformities. To prevent such deformities it may be necessary to spend more time and take special care when laying the very foundations of new institutions and organisations. However, this should not be used to justify unnecessary delays and indifference to the pace of reforms.

Additionally, shock therapies if applied simultaneously in Eastern Europe, as is recommended by the IMF, can aggravate the costs of transition. They will lead to a dramatic decline in production, employment, and foreign trade. Hundreds of factories which used to produce for one another, have closed down as a result of the recent changes and shock therapies. Thus, in 1990, Hungary's trade with another, have closed down as a result of the recent changes and shock therapies. Thus, in 1990, Hungary's trade with Poland declined by 60%. Was all of this decline an inevitable cost of transition?

There is yet another danger. Despite the wholesale and universal condemnation of the old system of central planning, there are certain sectors, chiefly the urban transport system and agriculture in Czechoslovakia and Hungary, which are quite successful by Western European standards. Given the indecent haste with which changes are occurring, there is real danger that the efficient sectors and enterprises will be thrown out along with the inefficient.

Finally, the advocates of rapid transition, despite their awareness of the social and human costs of transition, do not really face the question of how the needs of those who will be adversely affected can be satisfied at a time when budgetary deficits and inflation resulting from the liberalisation of prices threaten the already meagre resources devoted to social security. Nor do they face the psychological problems of coping with the market, unemployment and security. The economic reformers have not yet set up adequate administrative and advisory machineries to help people make the transition. Already, new economic crimes have appeared in Eastern Europe which are of serious concern to sociologists but not apparently to the market economists.
It would be reassuring, especially for the victims of shock therapies, to know if the transitional phase will be as short-lived as their advocates believe and whether the expected long-term benefits will outweigh the immediate costs. But there can be no certainty about such matters. So far, the Polish experience is proving very painful—notwithstanding the substantial assistance it is receiving from abroad.

It must be noted that the list of institutions, organisations and pre-conditions for a workable market system, which we take for granted, seems endless. It includes, among other things, a legal system to protect private property and enforce market contracts, a regulatory framework that includes trade practices, the creation of financial institutions, an accounting and auditing system, bankruptcy laws, extensive privatisation of enterprises, government statistics that meet the needs of market and macro-economic policies and a corresponding infrastructure to formulate and administer stabilising policies, and last and (perhaps the most difficult for the Eastern European countries) a new army of accountants, lawyers, bankers, managers and entrepreneurs to enable the market economy to work well.

A few of these requirements can be implemented simultaneously in a relatively short period of time. The great bulk of them will take a good deal longer. The process of privatisation, for example, will not be short and easy, even if all the legal rules of ownership and property rights have been formulated and passed to speed up the transition.

In Eastern Europe it is now widely accepted that privatisation is needed for the orderly functioning of a market, and that marketisation will not be completed without a substantial degree of privatisation involving most of the economy. This belief is buttressed by the observation that no well-developed Western economy has more than one-third of its labour force employed in the public sector and that recently there has been a general trend towards privatisation in Western countries. The debate over privatisation now centres on the optimal speed and timing (ie, whether it should proceed or follow other reforms), not on the necessity of private ownership in itself. There are other subsidiary questions relating to the criteria to be used for deciding which firms will be offered for sale, to whom and at what price.

Harvard University’s Professor Jeffery Sachs has recently argued that “accelerating privatisation is the number one priority in Eastern Europe” and that “if there is no breakthrough in the privatisation of large enterprises in the
near future the entire process of reform would be stalled for years to come with dire consequences". In Sachs' view, failure to privatise quickly means that governments will continue to be deeply involved in the affairs of state enterprises and their attention will be deflected from the bigger problems of building the infrastructure and transforming the economic institutions. Further, corporatisation or commercialisation of state enterprises, he argues, will not work in the highly political climate of Eastern Europe. Thus, he rejects the idea of commercialising enterprises before privatising them: "one must forget about putting enterprises in shape before privatising them; the idea is to privatisate them and solve the problems of enterprises, not the other way round".

The strategy of privatising first and quickly overlooks a number of fundamental problems, of which the most important is to decide on the value of the assets to be sold. It is easy to argue that privatisation is needed to create proper markets (in particular a capital market) but, in the absence of such markets, privatisation cannot proceed on a rational basis. A capital market is needed to generate meaningful valuations of assets without which product prices would not reflect the real costs of all resources used in their production. Thus the strategy of privatisation first without developing other market-related institutions can lead to waste and distortion.

Moreover, rapid privatisation of state enterprises provides opportunity for corruption and abuse. Some people will get very rich as a result, while others will become unemployed. The difficulty of evaluating the assets of an enterprise before the establishment of a capital market gives enterprise managers considerable room for manoeuvre in drawing up sale contracts. In Hungary, during the early phase of 'spontaneous privatisation', a number of state firms were bought by their (formerly communist) managers at very low prices. More seriously, there have been buy-outs by former elites with no prior experience in production or marketing. It is unlikely that such privatisation will bring much economic benefit to society, even if the problem of equity is ignored.

An argument that is sometimes encountered in Eastern Europe is that rapid privatisation should proceed at once even though state assets might be sold below their market valuations: "put it down on the bill as one more but final cost of 40 years of communist misrule". The cost of dismantling the old system, according to this view, is beside the point. It does not even matter if former party officials, 'the nomenklatura' now become owners. What matters is not the owner but the function of ownership. Any real profit maximiser is better than no owner at all.

Such attitudes explain why there has been little fuss about who owns what. It does not seem to bother these advocates of the rapid path that 20% of public property in Poland has already been converted into private ownership of former elites. Elsewhere in Eastern Europe, enterprise elites of the old order are using the new measures of privatisation to retain managerial positions in the restructured firms and in joint ventures with foreign companies. While this provides an element of continuity and stability, it also carries the danger of perpetuating old habits of doing business. It is possible, of course, that the 'new' elites will behave differently as they will be working under different rules of the game. However, one would not want to count on it.

Another argument against rapid privatisation is that it might lead to a disproportionate share of state assets in foreign ownership. Given the very low ratio of domestic savings to public assets, rapid sales of state enterprises would tend to favour foreign buyers. Curiously, however, there is in Eastern Europe at present, little concern about the dangers of foreign ownership. On the contrary, there is a good deal of enthusiasm for it. In Hungary, for example, it is recommended that sales of state enterprises to foreigners be encouraged as a means of reducing the foreign debt which, in per capita terms, is one of the highest in the world. Equally, foreign ownership is welcomed because it would bring in much needed managerial and organisational talents, new technologies, and provide international markets for domestic products. Moreover, the presence of foreign firms will provide direct competition and will have favourable demonstration effects. Given these perceived advantages of foreign ownership, it is not surprising that new foreign investment laws in Eastern Europe give preferential treatment to foreign producers. The new laws offer lower tax rates on profits and larger tax holidays to foreign and joint ventures than to local producers.
Another dimension of the problem of privatisation that the reformers must face is the issue of concentrated versus dispersed ownership. Proposals have been made in Eastern Europe to give the workers shares in their own enterprises and/or to give the citizens shares in state enterprises which they can keep or sell to one another or to institutions. Critics of these proposals argue that worker-ownership delays the much needed restructuring of old and obsolete industries. Moreover, the dilution of ownership would reduce both the interest of shareholders in enterprises and management's accountability to share owners. In any case, it seems in Hungary, at least, the problem has been resolved in favour of concentrated ownership. The Hungarian Law on Business Association which was passed at the beginning of 1989 has the effect of promoting concentrated rather than dispersed ownership. The law sets the minimum price of a share in joint-stock companies at one million forints (A$1=55 forints). In addition, the law exempts from taxation part of the income of those who participate in such companies. Clearly, under these arrangements, the rich will get richer. Quite apart from the question of equity, though, the effective exclusion of workers from the opportunity to purchase the property that they might see as in some sense their creation, could lead to instability if the legitimacy of the new ownership has not been demonstrated ethnically.

Yet another important argument against rapid privatisation is that it might leave inadequate time for the creation of durable incentive structures for efficiency. Without market liberalisation many of the state-owned enterprises would simply be transformed into private monopolies as happened with some privatisation in Hungary. It might be possible to subject the newly privatised enterprises to foreign competition. But it seems more logical to promote competition first to establish more realistic price signals that can be used by the state to restructure the enterprises, and to privatise them afterwards.

Finally, rapid privatisation is likely to reduce the revenue from the sale of state assets if the supply exceeds the demand. In any case, given the shortage of managers and entrepreneurs in Eastern Europe, it is pointless to rush into privatisation. It is unlikely that the newly privatised enterprises would be managed by people with the required skills. There would be little to gain in efficiency from the whole process. On the other hand, slower, more deliberate and controlled privatisation will improve the chances that enterprises will be managed by those who can prove their ability in the newly emerging market economies. In short, before rapid privatisation can proceed on a large scale, it is necessary to train the various types of manager required for a well-functioning market system.

It is quite clear that reformers in Eastern Europe are faced with some difficult dilemmas in their choice of the pace and sequence of reforms. On the one hand, they want to see their economies market-driven as soon as possible—partly for political reasons (to stop the anti-reformers from interfering with the process of transition) and partly for strategic reasons (to shake the populations out of their old habits). There are also the economic benefits of dismantling the old costly system and installing the more efficient market system in the shortest possible period. On the other hand, rapid transition carries the danger of increasing costs, both economic and human. It is also likely to lead to faulty institutions and second best solutions. There are definite disadvantages in moving very rapidly in some areas if the preconditions have not been established. Haste for the radical reformers has a logic but it has also enormous costs.

Alternatively, a gradual strategy on the one hand could minimise the costs of transition and, more importantly, would be likely to lead to the establishment of sound institutions and social arrangements, simply because more care and thought could be taken in building the foundations. Of course, a gradual approach might be used as an excuse for procrastination and unnecessary delays, and vested interest groups may succeed in frustrating the reform process. Unnecessary delays can also lead to missed opportunities. Time is required to formulate sound policies and make crucial decisions, but the timeliness of decisions is also important.

Accordingly, while it might be desirable to dismantle the old system as quickly as possible in order to make way for the new market system, it is in the nature of systemic changes that they require sufficient time to be established and function well. Not all the required changes can be implemented simultaneously. The dilemma of logical sequencing has been illustrated with the problem of privatisation. The problem of sequencing can be solved more satisfactorily if sufficient time is taken to introduce the other related market institutions.

In short, it seems to me, on the whole, that a gradual approach is preferable. Rapid transition may not be the road to a well-functioning market, but a costly detour. The headlong speed with which Eastern European countries, notably Poland, are heading towards the market—a strategy urged on them by the IMF and other economists in the West—does not guarantee that the new system will function well.

The success of the economy depends not just on how markets work but also on how well economic organisations work, and on the wisdom of the policymakers, their creative and refined skill of managing the economy. The failure of the planning system in Eastern Europe, after all, was due in large measure to the failure of planners.

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Marketism has triumphed over Communism