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## The Transition Problem: The Unhampered State as an Obstacle to Democratic and Market Reforms

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### Article at a glance

- Transition governments in post-communist countries have been held back by a failure to understand and implement the essentials of democratic and market institutions.
- The sudden shift from socialist to market systems exposed the weaknesses of many policy prescriptions indiscriminately adopted from the West.
- State interventionism, which failed to generate greater social well-being, can no longer be an alternative to full-fledged democracy and free markets in the region.

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## Introduction

Major systemic transformations in the post-Soviet states are over. Yet the outcome in most cases is not a full-fledged democratic market economy but rather an unsatisfactory compromise between socialism and free markets. Transition countries by and large focused their energies on creating a “social market economy” à la Western European welfare states. Thus, socialism as a system of completely centralized decision-making has been replaced by interventionism, a system with various degrees of state involvement in economic affairs. This “third way”-ism took the place of Marxism as an ideological pillar of the new post-communist world; however, it failed to produce a viable alternative to how the goal of greater social well-being can be accomplished.

Central planning might have been substituted by econometric modeling, but the old way of thinking about achieving prosperity remained redistributive, state-focused, and government-inspired.

Post-communist governments of the former Soviet bloc had to act in dire circumstances of large deficits, hyperinflation, loss of savings and markets, suspended production, and citizenry demoralized by the state’s failure to deliver basic services. They did not have time to consider various theoretical models of transformation. Advice and recommendations from Western policymakers, analysts, and international organizations were overwhelmingly accepted at face value.

Meanwhile, the West was not prepared to address the breakup of totalitarian socialism. It had not done enough careful evaluation of its own ability to deliver prosperity, stability, and sustainability elsewhere in the world. The lessons from painful and costly economic experiments held in Africa, Asia, and Latin and South America by the World Bank and International Monetary Fund were the only ones available for post-totalitarian countries to try.

Alan Greenspan, in *e Age of Turbulence*, accurately described the unpreparedness of the world community to face the collapse of the Soviet Union as “impotent.”

The Washington Consensus was the only offering Western policymakers could generate at the time. Far from being a concrete blueprint for reforms, it was rather a set of benevolent recommendations based, in many cases, on wishful thinking. Above all, these recommendations failed to recognize the importance of creating local political and economic institutions that are prerequisites for successful democratic and market-driven development.

## Omitted Theories and Ignored Facts

There are a few important blunders and false propositions that were made by or recommended for emerging post-totalitarian countries. Major theoretical mistakes include ignoring the following:

*Conclusions of the economic calculation debate.* The calculation enabling rational allocation of resources in an economy is impossible under socialism due to the lack of a price mechanism. During the onset of transition, price liberalization of all production factors including money was limited, preventing complete clearing of the socialist structural flaws. Therefore, economic entities and decision-makers had to act in a severely distorted information environment.

*e Austrian theory of business cycles and its conclusions.* This theory addresses the nature of money and the role of central banks and governments in countercyclical policies. Its implications were not fully grasped by the transition countries and led to macroeconomic instability.

*Lessons from applying development theory recommendations worldwide.* In many cases, misguided policy recommendations resulted in malinvestment, indebtedness, corruption, and environmental damage in countries where they were applied.

*Conclusions of public choice and rational choice theories and the nature of the government in general.* Conventional economics has been excessively focused on market failures, often based on dubious facts, while failing to provide in-depth analysis of state failures, especially in the social sphere.

*e nature of decision-making processes in transition countries.* The assumptions concerning decision-making mechanisms in post-Soviet states failed to address factors such as the power of nomenclature, weakness of formal institutions, and the role of culture, traditions, and habits affecting interpersonal relations and common attitudes toward the state.

*e weakness of democratic institutions.* The lack of proper democratic governance going beyond elections led to the severe deficit of state transparency and the inability of the state to deliver its fundamental services such as protection of property rights, guarantee of the rule of law, and contract enforcement.

*Lack of appreciation for the entrepreneur's role in job creation and market dynamics.* The emphasis of reformers was on the balance, optimal distribution, and effectiveness of state investment rather than on institutions that allow the private sector to generate more efficient production structures, labor markets, and investment patterns.

Decision-makers and theorists ignored at the time and still routinely ignore significant features of the transitional period:

*Legal nihilism of nomenclature and the population.* Pervasive disregard for the law at all levels of post-Soviet societies manifested itself in the lack of understanding of the importance of private property rights for functioning democracies and markets.

*Legacy of the socialist period.* Weak electoral support for free market solutions has, on the one hand, been the result of poor quality of educational elites, and on the other hand, the prevalence of freeloading culture rooted in socialist egalitarianism. Envy toward the rich and the successful has been cultivating the anti-achievement culture, since wealth was and is still associated with robbery, theft, and corruption.

*Lack of market-driven production and employment structure.* Fixed prices and overregulation of production and trade led to deep distortions in the functioning of post-socialist economies.

*Political corruption.* The lack of independent judiciary and proper oversight fueled the high propensity for embezzlement and state capture by different power groups, including criminal gangs and mafia.

*Weak civil society and independent media.* Post-Soviet states lacked the tradition of civic and media participation in exercising control over the state and in forming the values of open society, the rule of law, and democratic procedures.

*Reliance on legislative base passed in the totalitarian times.* The inertia of existing deeply flawed legal frameworks, which contained scores of contradictory and incomprehensible laws, made it impossible to have a fresh legislative start.

*Severe deficit of experts, analysts, policymakers.* The shortage of well-trained professionals prepared to carry out market reforms on the central and local levels inhibited the transition process

*Weak and inefficient political coordination mechanisms.* Different governmental ministries and other centers of political power in many post-Soviet states do not work as one team. Instead, they fight one another for control over resource distribution and a bigger share of the budget expenditures.

*No appropriate checks on the influence of the old elites.* Communist elites retained considerable administrative, political, and human capital. When the old system began to fall apart, they were the first to take advantage of new opportunities both in politics and in the economy. They rapidly monetized available capital and transformed old political power into economic power and vice versa.

*Deterioration of the social climate.* Given the decline of the basic functions of the government that accompanied the political and economic collapse of communism, many transition countries experienced spreading criminalization of society, state capture, widespread corruption, nepotism, and rising power of oligarchs.

## The Trap of a “Good Law”

Development strategies for many emerging economies often uncritically incorporated Western laws into domestic legislation regardless of the fact that these laws were crafted in different cultural and historical environments. As a result, transition governments faced many unintended consequences that increased the economic and social costs of transition. A good law is not a law copied from abroad, but is instead a law that takes into account the following:

- Informal norms of behavior
- The existing incentive structure in the government, business, and civil society
- Strength of formal and informal institutions and their interaction
- The quality of the judiciary
- The quality of the enforcement system
- Risks of rent seeking and sectoral lobbying
- Unintended consequences of new laws (e.g., the need to formulate additional legal acts to clarify the new law, new incentives that may distort production, investment, and employment structures)

In most transition countries, compliance costs of many new legal acts were not taken into account. Hence, the costs of government intervention were underestimated in policymaking. Post-Soviet leaders wanted to build a kind of Scandinavian welfare state model, but they ignored some key elements missing in their countries. Welfare state or interventionist models cannot generate the same results in post-communist countries as they do in Germany, Sweden, or even the United States, without these features and institutions:

- Open political competition
- An independent media
- Rigid transparency standards
- Strong corporate culture
- Open domestic and foreign economic competition
- An independent judiciary
- Civil society’s role in checking state power and establishing the basic institutional foundation for a free market economy

- Internalized values of achievement, fairness, freedom, and responsibility

## How an Unhampered State Threatens Economic Prosperity in Society

Post-totalitarian countries kept big governments, with different, often conflicting interests and functions between politicians and nomenclature. The state kept a monopoly over money, with considerable presence in financial markets and in land ownership. It still strictly regulates economic activities and interferes in production, investment, and trade. At the same time, it performs poorly in delivering its basic functions, passes low-quality, ineffectively enforced legislation, and has not built strong anti-corruption institutions.

In all transitional economies, education, healthcare, and social security reforms were postponed, so even after many years of transition, the state still holds dominant influence in these areas, hampering market solutions and free and fair competition. Given that the reforms that did take place happened under the banners of democratic change, liberalism, and market transformation, the people who faced considerable costs of transition not surprisingly became disillusioned with what was presented to them as ‘democracy’ and ‘economic freedom.’

The *raison d’être* of state interventionism is poverty reduction, labor market liberalization, providing social safety net to the disenfranchised and the poor, and making the economy more competitive, sustainable, and innovative. The social outcome of economic policy can be evaluated according to the following criteria:

- Life expectancy
- Income level during working years
- Income level upon retirement
- Flexibility of labor market
- Access to food and consumer goods
- Access to clean water, stable energy supply, sewage systems, and transport infrastructure
- Availability of durable goods
- Home ownership
- Ability to buy educational and healthcare services

- Clean environment (water, air, forests, land)

The evidence, facts, and statistics provided by numerous international organizations prove that the countries that chose full-fledged democracy, more economic freedom, and limited government delivered better social outcomes.

### **Macroeconomic foundations for solid social policies:**

- Low inflation
- Balanced budget
- Low debt
- Stable exchange rate, liberalized current and capital accounts
- Dominant role of private sector in finance, investment, production, and trade
- Good governance

Central and Eastern European countries that succeeded in building strong democratic institutions and ensured economic freedom achieved better social results, though it is difficult to name a transition country that has been consistent throughout all the years of reforms. While the governments managed to reduce the interference of the state in the private lives of citizens (by passing democratic constitutions, for example) they have failed to set limits on the state's intervention into the economy (inflation ceiling, debt limit, budget deficit limit, mandated ratio of government expenditures to GDP, etc.). As a result, transition governments failed to keep financial discipline and could not deliver stable prices. They increased the size of the state, deepened indebtedness of their countries, and crowded out private capital.

Transition governments still encounter conflicts of interest in the legislative framework between managing assets and regulating market entry. Private property rights are stifled by regulations, price controls, currency and merchandise controls, and by inefficient bureaucracies. The conclusions of the Austrian school of economics and analyses of economic freedom and its impact on sustainable development have been mostly

ignored. Active industrial policies, the naming of 'strategic' sectors and 'national corporate champions,' and protectionism aimed at saving old industries resulted in malinvestment, structural unemployment, brain and skill drain, as well as nepotism, the rise of oligarchs, corruption, and a low work ethic.

## **Conclusion**

After 17 years of reforms, the recipe for economic success sounds as simple and consistent as it was in the early 1990s. At different times in their history this recipe was tried by Germany, Ireland, Sweden, Japan, Great Britain, Chile, and New Zealand. Economic freedom matters! It is economic freedom that delivers job creation, income growth, access to basic social infrastructure, education, and healthcare. It ensures modernization of institutions that obstruct sustainable development and ethical behavior. Coupled with strong democratic institutions, values of hard work, and achievement, economic freedom is the best known vehicle for achieving robust economic growth and improved social well-being.

Still, both better democratic governance and greater economic freedom are yet to be realized by most post-totalitarian countries in Europe, although interventionism has clearly proved to be ineffective and socially harmful. It even brought about the resurgent authoritarian states in Belarus, Russia, Azerbaijan, Turkmenistan, and Uzbekistan. State interventionism can no longer be seen as an alternative to full-fledged democracy and free markets in the region, but neither can one-size-fits all solutions be imported wholesale from abroad.

Scholars worldwide face a huge challenge of working out a new set of theories and practical recommendations for new development economics. These theories should be based on a solid understanding of the institutions that underpin functioning democracies and markets. They should emphasize the importance of incorporating local conditions and constraints into reform programs. Finally, they should be fact-based, value-oriented, and utopia-free.

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