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Bad Transitions

I was very grateful to Lajos for inviting me. I have known him for many years as a man of integrity and of action; such people are very much needed in the public life. And I know that in the world of professional economists, the plan that bears his name enjoys a very high esteem. I am not going to discuss this plan; I do not have a comparative advantage relative to other speakers. I would rather make a remark on huge differences in economic growth after socialism. You might know that Poland's GDP in 2013 was over 100 percents higher than in 1999, while in Hungary it is much less. As a guest I would not mention how much.

It is a very important question why it was so. I would argue that most important reasons are not on the supply side, as in the previous period there were no major differences in the supply-side reforms between Poland and Hungary, at least until recently. I think the main reason is on the fiscal side. To be sure, Polish fiscal policies were far from ideal. But they were not as bad as in Hungary, except for Bokros' program, as in Hungary there has been a very high spending-to-GDP ratio, more than in most West European countries. It involved various social traps and chronic imbalances, which from time to time spilled over into crisis. It shows how fundamental it is to reform the public finance. Which means that the reform of the bloated welfare state is very important for long run growth. Entrenched fiscal discipline is very important for the society, and it cannot be imported from Brussels. It has to be entrenched in the society – which requires a large number of fiscally conservative voters. It is an indispensable insurance against crisis.

However, my main topic is bad transitions. Transition means major changes in the institutional system of a country. Transitions can be good, which means a change from a bad system to a better one; or bad, which means you change a relatively good system for a worse one. Obviously, good transition would be a more attractive topic in times of crisis. But I think what is really relevant, and worth more research, are the bad transitions, in other words, the reversal of reforms. But to discuss this, we have to define what is good and bad in a country's institutional system. Let me start with concepts of democracy; rule of law, which is separate from democracy; and capitalistic economy. There are many definitions of democracy. I take a very

simple one: the level of democracy depends on the extent of open competition in the political system, as expressed through free and regular actions. We know from experience that elections without such competition are no democracy, or – in other words – a sham democracy. Therefore, if you reduce competition in politics, you reduce democracy, for example, by entrenching the party in the state apparatus or by curtailing the access of the opposition to the media. Without media access, you cannot compete in politics. Or by imposing restrictions on the opposition's organizations. POLITY IV measures the level of democracy from zero to ten, and until recent times we can say that all countries of Central Eastern Europe had a fair degree of political competition and thus democracy. In this respect, it is very interesting to have a look at the recent developments in Hungary.

Rule of law also has many definitions. It more or less corresponds to the notion of limited government, i.e. constraining what government can do, especially through various informal measures, including the actions of secret police, or tax administration with respect to political opponents. Not only democracy is a Western invention but rule of law as well. It was a great invention of the West, and it was then exported. So if for some reason there is a decrease in democracy and the rule of the law, then there is damage to the classical western values.

And finally, capitalism. It is usually defined as the dominance of the private sector in the economy. There are various types of capitalism. The one which is worth striving for after the decades of socialism is a capitalism can produce the highest long-term pace of economic growth. And we know from a lot of research that such systems display a high level of economic freedom within the constraints of the rule of law. Another feature that I have already mentioned is a lasting fiscal discipline.

So we have defined three building blocks. A good transition makes Pareto improvements in at least one of these subsystems, e.g. it moves from non-democracy to democracy without worsening the other systems. In contrast, we can speak of a bad transition if one, or two of them worsen without any improvement in the remaining component(s).

Now I would like to discuss very briefly some cases of bad transition and then I try to make a few generalizations. I am surprised how little systematic research is dedicated to bad transitions. Most research focuses on good transitions, but even there you have the problem of how to entrench the good solutions in society. You cannot rely on a good tsar, for good tsars come very

rarely.

I have selected a few cases of bad transitions. First, Latin America: Argentina and Venezuela. The starting point was in both a bad oligarchic capitalism, which created a big potential of discontent, and this potential was activated by two factors. One was the appearance in Argentina of a charismatic leader, a demagogue without many inhibitions. His name was Perón. (On top of that, he had a very popular wife, Evita.) The second factor was that he had good luck. Which in his case was that the prices of raw materials were growing at that time of his appearance in the 1940s, and he was able to finance his policies, he could distribute benefits among his clientele, and mobilize the potential of discontent, and create a large group of people, who believed that without Perón and Peronism, they would not maintain what they have already earned. And the myth was so strong that everybody, even anti-Peronists had to become Peronists. There was this longing for the Peronist order, which we have seen during the last ten years, under the Kirchners, especially Cristina Kirchner. Under their rule during the last ten years, they are destroying democracy, the rule of law and market economy. That went together. How were they destroying democracy? By limiting the access of the opposition to the media. By making it illegal publishing the estimates of inflation they extended the scope of state secrecy law. As I came here to Budapest, I heard something I could not believe. I have heard that a parliamentary bill was passed that would make a state secret for thirty years the contents of the contract with Russia regarding the construction of a nuclear plant. Do you have any Green movement in this country? I am not a proponent of aggressive Greens, but there are some situations when Greens can be useful allies.

Venezuela is an even clearer model of the destruction of democracy, rule of law and market economy. The authorities there confiscated products from the private enterprises, and of course they control more and more prices. By the way, normally we think that capitalism is destroyed by open nationalization and by introducing the ban on the creation of new private firms. These are the classical ways. But there are some other ways, i.e. to make it practically impossible to continue private business. The government can make private business bankrupt through regulation. And if you destroy private business, you also destroy the fundamentals of democracy. So far there was no democracy without a large and healthy private business.

Let us turn to Russia. Russia under Yeltsin was moving toward a western model. One interesting measure taken by Yeltsin was to divide KGB into three services. One measure that Putin did was to

consolidate them, and adding some new competences. Yeltsin was a great man, but he had made one fateful mistake: choosing his successor. Putin had a lot of good luck. First, because when he was elected, it could not get worse, it could only get better after the crisis of 1998, and the oil prices were increasing. So he became truly popular, and in the first three years he was not seriously reversing Yeltsin policies. Then he began the destruction of democracy, instead of which we have what? "Sovereign democracy"! He began dismantling the rule of law, and initiated a gradual destruction of the economy. Russian economy under Putin has been getting weaker and weaker regarding its growth potential. There have been three processes responsible for that. First, the increasing politicization of the economy, and this was in two ways. First, through the outright nationalization of some private companies. State ownership everywhere transmits political power into the firms. The second type of politicization of the economy has taken the form of what I call a temporary private ownership: you are private owner as long as you are allowed to. But you may have a competitor, who has better connections to the ruling group and KGB, and so he has an advantage – he can finish you off (this is called in Russian the raket). Of course one cannot expect much investment under this sort of ownership. What you would expect is capital flight. And finally, under Putin, Russia's dependence on raw materials has increased, which meant it grew more and more vulnerable to the fluctuation of prices. I have a great respect for Russian democrats, who are exposed to grave danger. They are heroes.

Greece (I am coming closer to Hungary). There is a myth that the problems of Greece are due to Greek mentality. This is just cheap talk. Because in the period of 1950 to 1973, Greece was one of the fastest-growing countries in Europe with strong fiscal discipline. And then an accident happened: a sudden worsening of political culture. The hero of that story was Andreas Papandreou. He was a professor of economics; a star of welfare economics, which has very little to do with economic reality. He poisoned the political culture. Papandreou created fiscal populism. He removed Greece from discipline towards an extreme spending spree, which was partly financed partly by the European Union, and by borrowing. But what is worse, the main opposition party switched to this position too. So there were two bad parties, and their competition was about who promised more. And they were fulfilling their promises. You might have a structurally good party system with two consolidated blocks. But when both blocks are bad on policies, especially the fiscal one, you cannot have a good economy. And this reminds me of something what happened after 2001 in Hungary.

Let me mention that we can see bad transitions in other places, e.g. in Turkey under Erdogan. Again, a strong, ruthless leader and an untapped potential for his increasing power.

Some final remarks without offering a recipe how to avoid bad transitions, and if it happens, how to get out of it. Let's have a look at the cases I mentioned. Putin's Russia is much worse than some other cases, as in Russia people who oppose the regime are in grave danger. But there are some common features in the starting conditions that give rise to bad transitions. First, there must be a large untapped potential of discontent. People who are left aside by an oligarchic capitalism; or strong nationalism bordering on xenophobia, or religious conservatives like in Anatolia in Turkey indifferent or hostile to Western political values. This is necessary, but not sufficient condition to start bad transition. Second, a ruthless, capable, demagogic leader must appear on the scene. This is a chance factor. It happens or does not. This is one of the reason why one cannot predict history. If such a person appears, and there is a potential of discontent to tap, and the person in question does not have many inhibitions, then the bad transition is more likely. However, the third condition must be present: the bad guy has to have is good luck, which is another chance factor. (The opposite situation appears when a good guy has a bad luck). What is this good luck for a bad guy? It can take the form of a surge of easy money to be distributed, like in Argentina under Peron, or Venezuela under Chavez. Or it may be a political shock on the opposition side, for example a leader of the opposing party may say something carelessly and thus detonate before elections a political bomb. Am I clear enough? A political shock is also a chance factor, which could be amplified and help to gain mighty power.

I wish I had an answer how to prevent a bad transition. I can only say here that one should worry about any party gaining constitutional majority. Fortunately it is not very likely in Poland. There is an optimal degree of political consolidation. It is not too good if you have too many parties, but excessive consolidation, which gives any party a constitutional majority, is dangerous too. For you can never know what's inside a politician. There can be unpleasant surprises. It is very important to build civil society and to build coalitions to oppose dangerous tendencies in politics. If the system allows independent organizations, then organize, organize, organize yourselves. One can never know when a bad system, i.e. that with a heavy concentration of political power, collapses. Because in such a system insiders act in a black box, which is difficult to penetrate from the outside. If external pressures grow, the tensions in the black box are likely to grow too, and sometimes they erupt. When bad guys in politics get in conflict, it is good for a

country.