November 13, 1990

YELLOW LIGHT FOR EASTERN EUROPE: BEWARE FOUR ECONOMIC DEVELOPMENT MYTHS

INTRODUCTION

Socialism has left Eastern Europe in economic and environmental ruins. Dilapidated 40-year-old factories grind out goods whose quality is vastly inferior to Western and even many Third World products, all the while polluting the air and soil. A traveler in Poland is unlikely to see any tractors in the course of a four-hour drive through the countryside, even though agriculture is the strongest sector of the economy. In the Soviet Union there are only 50 cars for every 1,000 citizens. By comparison, eight decades ago in 1909, one out of every 34 farmers in Iowa owned an automobile, and by 1930 for all America that number had risen to one out of every 1.3 households.

The breadth of poverty and underdevelopment in Eastern Europe is greater than most in the West imagine. These countries now face the daunting and unprecedented task of transforming centrally planned economies into free-market systems. How this can be done, in what sequence, and at what pace is not easily prescribed. Such a radical transformation never before has occurred. Nations have been transformed from capitalist to socialist, but not the reverse.

Decades of Evidence. Yet some things are known about what works and what does not work in promoting economic growth. Decades of experimentation with statist development programs by governments in Africa, Eastern Europe, and Latin America amply demonstrate that extensive state controls of the economy, state planning, and massive subsidies and credit for preferred industries do not work. These policies perpetuate poverty, not eliminate it. Variations of statist intervention and central planning produce equally poor results.

As American government officials and American businessmen and economists head off to give East Europeans advice on how to restructure their collapsed economies, they must keep in mind what has worked and has not worked in the past. The lessons of history should be like a flashing yellow traffic light warning of four myths of economic development that, if translated into policies, will keep Eastern Europe impoverished. The myths are:

Myth #1: Significant government spending on roads, tunnels, airports, wastewater treatment, and communications is necessary for economic growth in Eastern Europe.

Myth #2: Privatization will not succeed in Eastern Europe because of a lack of capital and stock markets.

Myth #3: Massive Western financial assistance is needed for Eastern Europe to develop.

Myth #4: Rigid austerity measures and prolonged economic pain are necessary to set East European countries on the road to the free market.

As with all myths, these simply are wrong. Unless they are exposed as such, Western governments and development banks will dole out flawed economic advice along with their economic aid, prompting East Europeans to perpetuate the mistakes of others. Unless the myths are exposed, the International Monetary Fund (IMF) likely will urge East European governments to raise taxes to balance state budgets. This will constrain economic growth. So will the World Bank if it pursues government-to-government lending policies in Eastern Europe as it has done in the Third World. These loans will politicize East European economies further and increase their bloated government bureaucracies.

East Europeans have suffered enough. Their suffering should not be prolonged by economic policies that have been discredited by decades of experience. They should heed the warning of the blinking yellow light.

FOUR ECONOMIC DEVELOPMENT MYTHS

As teams of economists formulate economic reform plans for Eastern Europe, and as the United States Congress debates foreign aid to the region, policy decisions must be based on empirical evidence, not on myths. Otherwise economic growth in Eastern Europe could be retarded and American taxpayers' money could be squandered.

The four prominent myths that could impair economic development in Eastern Europe are:

Myth #1: Significant government spending on infrastructure like roads, tunnels, airports, communications systems, water systems, and wastewater treatment plants is necessary for East European economic growth.

Too often politicians, academics, journalists, and other observers argue that East European governments need to invest massive sums of money to build an infrastructure of airports, bridges, communications systems, energy plants, ports, roads, and water systems. They argue that with the help of Western aid, East European governments must play the leading role in Eastern Europe's economic development by spending heavily on this basic infrastructure.

This ignores historical facts. Nobel Laureate economist Peter Bauer has written:

> The suggestion that a ready-made infrastructure is necessary for development ignores the fact that infrastructure develops in the course of economic progress, not ahead of it....Much of the literature suggests that the world was somehow created in two parts; one part with a ready-made infrastructure of railways, roads, ports, pipe lines and public utilities, which has therefore been able to develop, and the other which the creator unfortunately forgot to endow with social overhead capital. This is not the way things have happened.[1]

Western nations were not blessed with benefactors who laid down roads, bridges, canals, and tunnels prior to economic development. Rather, infrastructure was developed in Europe, North America, the South Pacific, and Southeast Asia, often by the private sector, as the economic need for it arose.[2]

Turning to the Private Sector. To be sure, Eastern Europe needs water systems, wastewater treatment plants, airports, roads, telecommunications, and high-speed rail lines before the region will enjoy the economic prosperity common in the West. But to make the financing of these projects the responsibility of Eastern Europe's governments is to ensure that these projects will be inefficient, and thus a drag on development. Rather than rely on the state, reformers in Eastern Europe should engage the private sector to modernize the infrastructure of their economies.

There are a variety of methods by which this can be done. One is to sell a state-owned entity, such as an airport or a wastewater treatment plant, to the private sector. Last year, for example, the British government sold its ten water utilities for $8.34 billion and the Dutch government sold the Ijmuiden Fishing Port Authority in the Netherlands. Another method is for the government to offer a long-term franchise to a private consortium to design, finance, build, own, and operate a project for the life of the franchise. These are called Build-Operate-Transfer (BOT) projects. The franchise generally runs for the

1 Peter Bauer, *Dissent on Development* (Cambridge: Harvard University Press, 1976) p. 111.

2 Economic development should not be measured by the number of power plants or bridges a country has. Forced Stalinist industrialization of primarily agricultural countries has impoverished Eastern Europe and blackened their environments. Economic development means simply economic growth, not industrialization.

number of years it takes for the private operator to realize a return on his investment. A third method is for governments to contract with private firms to operate public infrastructure, such as a management contract to run an airport or a wastewater treatment plant.

Improved Services. There are many reasons why East Europeans should rely on the private sector, rather than the state, for developing a modern infrastructure. Private provision of infrastructure can improve service, induce competition to keep costs low and quality high, improve efficiency, make infrastructure suppliers more sensitive and answerable to consumers, and decrease the costs of government.

Providing electricity, water, and even telecommunications to the public historically, of course, typically has been the province of huge, public monopolies. With these public monopolies, as with any government bureaucracies, service is often poor, new technology is slowly introduced, and business decisions tend to be based on political rather than economic considerations. This need not be the case. Privatizing electricity monopolies and dividing them into numerous generating companies can bring competition into the industry. The same can be done for telecommunications and water systems.

Useful for East European water service may be the example of the oil industry because oil, like groundwater, is a resource that, without the assignment of property rights, is subject to depletion and quality deterioration. In the oil industry, typically private suppliers extract oil though unitization agreements, which are contractual arrangements and rules that allow many different operators to pump oil from a vast underground oil pool. Each operator has an indivisible stake in the pool. Similar arrangements can be used for groundwater extraction in Eastern Europe. East European countries thus should avoid, whenever possible, replacing a public monopoly with a private monopoly. The introduction of competition decreases the need for extensive government regulation because competition checks monopolistic pricing.

Little Incentive for Quality. Governments in Eastern Europe and in the Third World have little credibility in developing infrastructure. This is obvious from the dismal quality of basic services in Eastern Europe like clean running water, telephones, and heating and electricity. Not subject to market competition, those providing these services have little incentive to deliver quality to customers.

It is for good reason then that, throughout the world, the private sector increasingly is being asked to build infrastructure. Privately financed high-speed railroads are on the drawing boards in Bangkok, Southampton, Barcelona, Houston, and Miami. Private systems supply water in Britain, Chile, Guatemala, France, Kuwait, Italy, Spain, and the U.S.[3] Three bridges in Britain – the Dartford Bridge, the Second Severn Bridge, and a bridge link-

3 Fixler, Poole, Scarlett, and Eggers, *Privatization 1990* (Santa Monica: Reason Foundation, 1990), p. 28.

ing Scotland to the Isle of Skye – are being built, financed, and operated privately.

Privatizing public works is being perceived increasingly by government officials, at a time of tight budgets, as the way to modernize decaying infrastructures. Robert Poole, Jr., president of the Reason Foundation, a free-market research institute based in Santa Monica, California, writes that: "the 1990s may well go down as the decade of privatized infrastructure. Around the globe, governments have begun a major shift of the responsibility for financing, building, operating, and, in many cases, owning major capital-intensive infrastructure projects."[4]

Tunnels and Roads. Build-Operate-Transfer projects have financed tunnels and bridges in Europe since the 1950s. The majority of roads built in America during colonial times were private toll roads and most bridges were in private hands until shortly after the 1930s Depression. The $11.9 billion Channel Tunnel project, which will connect Britain and France, is the largest private infrastructure project to date. The only government participation is granting franchises to private firms for rail operations and an auto tunnel. Private tollway projects will be built in Asia, Britain, France, Mexico, and the U.S.

Airports. Privatizing airports also is underway. From Denmark to New Zealand, governments are planning to sell their airports to the private sector. There is already interest in this in Eastern Europe. Poland is looking into the possibilities of privatizing airports. There are many advantages in this. Sales of airports generate revenues for the government, lead to a more efficient distribution of resources by introducing rational "peak-hour" pricing of runway use, increase investment in airport facilities because the private sector owner has an incentive to acquire new business, and reduce by half the time needed to build an airport.

Most important for the East European governments, no public funds are needed to create new airport capacity. The reason: new capacity is funded by private sector investors who earn a return on their investment by developing land adjacent to the airport. The most striking example of this has been the British Airports Authority (BAA) sale in July 1987 of 500 million shares worth $2 billion to private companies and individual investors. Since privatization, income per employee is up 10 percent, profits have risen 19 percent, capital spending has more than doubled, and income from commercial enterprises such as parking and food service has grown faster than aviation charges to airport users. Also notable is that BAA is developing a $400 million rail link between London and Heathrow airport. Though need for the rail link has been apparent for the past decade, the government did nothing to address this.

4 *Ibid.*, p. 27.

New airport terminals and even entire airports can be created through Build-Operate-Transfer arrangements. An investment team is developing a $200 million, 18-gate terminal at Ataturk International Airport in Istanbul. Once completed, the terminal will be operated for at least 15 years by Lockheed Air Terminal of Burbank, California. Lockheed also is involved in developing a $300 million, 24-gate terminal at Toronto International Airport. New airports in Hong Kong and Macao will be built and operated by public-private consortiums with majority private ownership.

Water Systems. Water used for drinking, bathing, irrigation, and other purposes is supplied by the private sector in much of the world. Private companies in France provide 72 percent of the water used by the French, while 13 percent of Americans receive water service from almost 16,000 private water systems.[5] A privately financed water supply project in Lubuan, Malaysia, is now in operation. Britain sold its ten water utilities for $8.34 billion in 1989. An improvement in Britain's water quality, which has been among Western Europe's worst, is expected from the increased competition among private water companies.

Telecommunications. There is a widespread movement toward private sector development of communications services and privatizing large state-owned telecommunications monopolies. Argentina, Britain, Canada, Chile, Jamaica, and Japan have privatized their telecommunications sectors. Israel and Korea plan to do so. These serve as examples for Eastern Europe. One thing, however, that East Europeans need not do is replace government telecommunications monopolies with private monopolies as was done in Britain and Hong Kong. While the private British Telecom is better than when it was government-owned, it is not nearly as good as a fully, competitive industry would be.

At one time, because of the so-called natural monopoly characteristics of telecommunications service, an argument could be made for a huge, regulated private monopoly. This no longer is the case. Technical innovations, like fiber-optic cable, multilateral connectivity, and electronic intelligence, give East Europeans a luxury that the West did not have in setting up modern telecommunications systems. With these revolutionary advances, competition is appropriate and valuable in most telecommunications services in Eastern Europe. There are over 200 separate suppliers of long-distance telephone service in the United States.[6] Competition between these firms has brought down long-distance telephone prices, improved customer service, and increased the clarity of telephone transmissions. Competition will do likewise for Eastern Europe.

5 *Ibid.*

6 Gabriel Roth, "The Private Provision of Public Services," paper prepared for the 1990 International Privatization Congress, Saskatoon, Saskatchewan, Canada, May 13-16, 1990, p.7.

Waste-Energy. Most privatization of "waste-energy" projects, which convert refuse into energy, has occurred in the U.S. Most American waste-energy plants are privately operated and many are privately owned. Wheelabrator Technologies Incorporated, for example, owns and operates 19 waste-energy plants in the U.S. The major clean-up effort required in Eastern Europe should provide a major market for private waste-to-energy providers if they are not hampered by government involvement.

Private Investment Underway. The private sector is already beginning to invest in Eastern Europe infrastructure development. A group of American investors, led by Richard Rahn and Lawrence Hunter from the U.S. Chamber of Commerce, and Scott Rasmussen, the founder of Entertainment Sports Programming Network (ESPN), have contacted the Hungarian government about constructing and operating a cellular telephone network in Hungary. The Swedish telecommunications firm Ericsson already has contracted to build a mobile telephone system in Budapest. Another Swedish firm, the Kemira Group, is building a water purification plant on Poland's Vistula River. Trans World Airlines Incorporated (TWA) is considering converting a military base in East Germany into a private, international airport. This already substantial private sector interest in developing Eastern Europe's infrastructure demonstrates that where market opportunities exist, if allowed, the private sector will fill the need for new roads, airports, railroads, ports, water systems, telecommunications, and other basic building blocks of a modern economy.

Myth #2: Privatization will not be successful in Eastern Europe because of the lack of capital or stock markets.

East European countries obviously lack developed capital markets, stock exchanges, and similar institutions. This constrains privatization because capital markets allow savings to be transferred efficiently into investment. Yet privatization can be successful without developed capital markets. In fact, privatization in Eastern Europe can prompt development of a capital market infrastructure. So long as the state owns nearly all factors of production, there is very little in which to invest and thus no reason for a capital market to develop. This is why Hungary's stock market has been so sluggish since its establishment in 1987. With 85 percent of Hungarian industry still state-owned, stock investors have little opportunities for investment.

A capital market cannot be created if there is no demand for it. This demand explodes when the huge amount of securities and stock shares are issued when state industries are sold to the public.

Chilean Example. A striking example of how privatization prompts the rapid development of capital markets is what occurred in Chile in the 1980s. Chilean capital and financial markets were in ruins after the inflation of up to 500 percent annually in the 1970s and the debt crisis of 1982-1983. In fact, the Chilean situation was similar in a number of respects to that of Eastern Europe today. Nearly all the Chilean financial institutions were owned by the state and operated on fixed credit from the state. The country also had severe foreign debt problems reaching a peak of $19.6 billion in 1986. As in Eastern Europe now, essentially the entire financial system was state-controlled.

Two-Round Privatization. Despite this, Chile has pursued one of the world's largest-scale privatizations. This came in two separate rounds. The first round of privatization consisted primarily of returning the enterprises free of charge to the previous private sector owners.[7] The second round began in 1984 and sought to spread share ownership, mainly in giant public service and infrastructure companies. A number of the state-owned enterprises (SOEs) were sold to joint foreign and private investors such as I.M. Trust and Austin Powder. Pension funds, such as the Provida and Santa Maria Corporations, were privatized via "public capitalism," by which Chilean citizens who purchased shares in the privatized companies received long-term loans from the government at zero interest. They also received very favorable investment tax credits.

Privatization and the Development of the Chilean Stock Exchange

Year	Total Transactions (1988 US$ million)	Privatized State-Owned Enterprise Transactions as % of total
1984	41.9	na
1985	59.7	20.6
1986	337.1	43.8
1987	542.8	61.0
1989	654.4	61.5

Source: Santiago Stock Exchange.

Other state enterprises were privatized by selling the shares directly to the workers, a process sometimes called "labor capitalism." Key to the success of the Chilean program was that the government varied the privatization method depending on the size, economic attractiveness, and potential market interest in the sale of each enterprise.

Spreading share ownership among workers, taxpayers, private pension funds, and small and medium-sized investors sped development of the Chilean capital market. The new investors, after all, created a flurry of stock transactions activity.[8] The Chilean stock exchange is now one of Latin America's most active. Volume increased from $41.9 million in total transactions in 1984 to $654 million in 1989.[9] At the same time, transactions of

7 During the 1970-1973 period, the Socialist government of President Salvador Allende took control of all banks, large public utilities, and numerous large and medium-sized corporations.
8 Rolf Luders, "Chile's Massive Divestiture Program: 1975-1990, Failures and Successes," unpublished paper presented to the Conference on Privatization and Ownership Changes in Eastern Europe, The World Bank, Washington, D.C., June 13 and 14.
9 Santiago Stock Exchange

stocks of privatized state-owned enterprises increased from under 21 percent to over 61 percent of the total. The sale of the state enterprises meanwhile created over 114,000 new shareholders in Chile.

Chile is not the only example of how a country with dormant capital markets can privatize state-owned enterprises. Privatization of the Kenya Commercial Bank is another example. It demonstrates, moreover, the ability to privatize even if there appears to be almost no pool of private savings.

This is the situation in much of Eastern Europe. Savings in Poland is estimated at no more than 2 percent of the book value of all property. Yet the experience of a number of developing nations, where few savings were presumed to exist, suggests that as long as the privatization stock offering is well-publicized and attractive, domestic savings will appear from outside the formal banking sector.

Savings from Nowhere. This happened in Kenya, the 26th poorest country in the world. When 7.5 million shares of Kenya Commercial Bank stock were offered to the public in 1988, there were four times as many bids to purchase shares of the stock as there were shares available. This was wholly unanticipated by economists and Kenyan government officials. The savings needed to purchase the stocks seemed to appear from nowhere. In fact, they came from the underground sector of the economy.

Savings in East European countries likely will appear from similar sources. There are more domestic savings in Poland and other East European Countries than is commonly presumed. Such savings may be in the form of stockpiles of lumber or bricks in people's backyards or as merchandise smuggled from the West. East Europeans have put their capital in art, precious stones, coins, VCRs, personal computers, appliances, and other so-called physical resources because these goods retain their value during high inflation.

These physical resources could become a source of capital when a country makes its currency convertible, as Poland has done and when there is low inflation. Poles could be tempted to transform their physical resources into capital for investment in privatized industries if they conclude that such investments will give them a greater return.

"Popular Capitalism." Another possibility for privatization in the absence of developed stock markets is known as "popular capitalism." By this, bonds or coupons are sold to citizens at very low prices or given to them free. With the coupons, shares can be bought in the privatized state-owned enterprises. Markets soon develop, of course, as people buy, sell, and trade coupons and stock shares. This approach is what the Czechs and Poles plan.

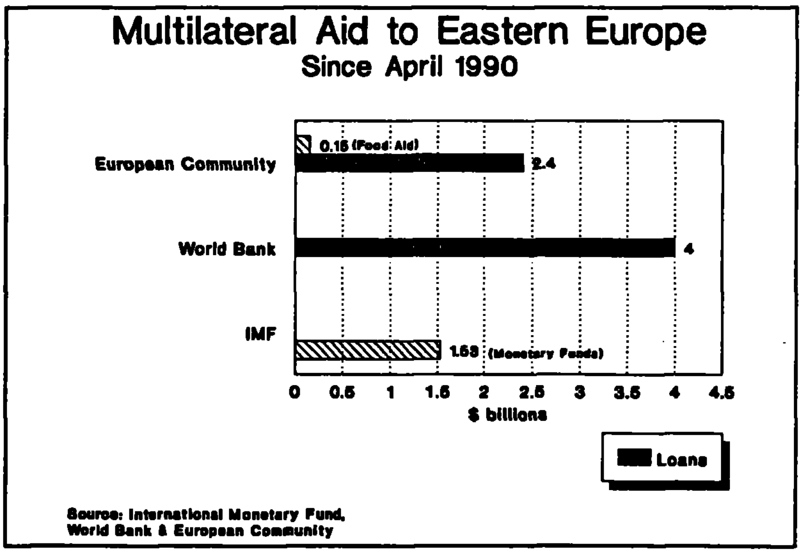
As a first step toward popular capitalism, holding companies are created. These are shells that own state enterprises. The second step is to give holding company shares to each adult citizen. This encourages saving because many people purchase more shares in the companies or, as people sell their coupons, encourages the development of a stock market. Most significant, this speeds privatization of the economy.

Management Contracts. Another option for privatizing without capital markets is contracting with a private firm to manage the state enterprise prior to full privatization. The majority of privatizations in Africa have been in the form of management contracts and leasing. Putting the enterprise under private management can improve the efficiency of the enterprise significantly, which, in turn, decreases the cost of the enterprise to taxpayers.

A state-owned bicycle factory in Zambia, for example, in 1983 was operating below capacity and in the red, and its equity for investment was depleted. As a last-gasp effort to save the enterprise, the Zambian government privatized the management of the factory. The deal negotiated with the private company made the private manager financially liable for 100 percent of the enterprises's losses under private management. However, if the factory became profitable, the management firm received 20 percent of all profits. Within a few years the bicycle factory began making a profit. The reason: The change in incentive structure gave the private company a financial stake in quickly turning the factory around. East European countries can try similar arrangements as interim measures on the way to full privatization.

Myth #3: Massive Western financial assistance is needed for Eastern Europe to develop.

Many economists and Members of Congress believe that the reconstruction of Eastern Europe requires great sums of cash from the West. Harvard economist and advisor to the Polish government Jeffrey Sachs, for instance, calls for a $30 billion Western aid package to the Soviet Union during the "transition" to a market economy.[10] House Majority Leader Richard Gephardt, the Missouri Democrat, also calls for a large-scale aid program to the Soviet Union.



Yet, experience in

10Jeffrey Sachs, "The U.S. and the Economic Future of the Soviet Union and Eastern Europe," lecture at Progressive Policy Institute forum, September 24, 1990.

dozens of developing countries demonstrates that generous foreign aid is not the answer to Eastern Europe's economic problems. In fact, in most cases, foreign aid has done more harm than good. Over 50 percent of Yugoslavia's $20 billion debt was squandered on uneconomic projects or used to subsidize consumer consumption in the 1970s and 1980s. For instance, over $300 million in loans and grants from Western governments and loans from Western financial institutions were poured into a nickel smelting factory in Feni, Yugoslavia, from 1982-1985. While the factory was a technical wonder, it proved a commercial failure and closed.

International Bank for Reconstruction and Development (IBRD) Loans to Polish Government
February 1990 - July 1990

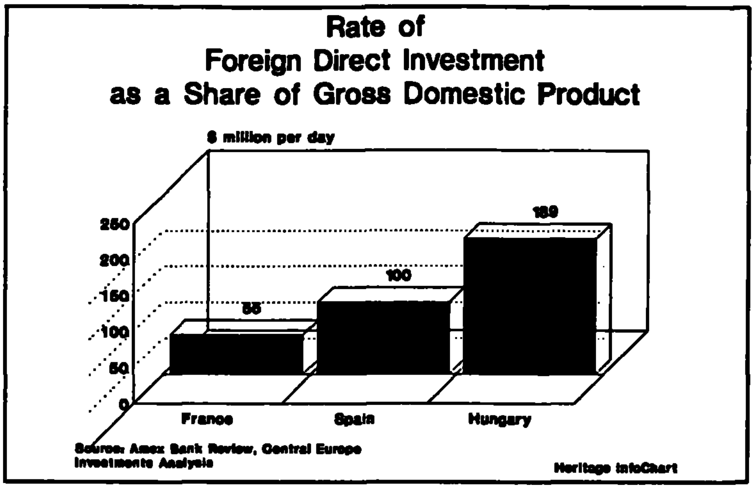
	$ millions
National Bank of Poland	260.00
National Bank of Poland	100.00
Environment Management	18.00
Republic of Poland, Transport — General	8.00
Polish State Railways	145.00
The Polish Oil and Gas Company	250.00
Republic of Poland	300.00
Totals	1,081.00

Source: IBRD

Foreign aid, moreover, allows recipient countries to delay needed economic reforms, prop up state-owned enterprises, and sustain economic policies that stunt development. The International Bank for Reconstruction and Development (IRBD) already has allocated over $1 billion in loans to Poland. The overwhelming bulk of this money is going to such state-owned enterprises as Polish State Railways and the Polish Oil and Gas Company. These government loans to government entities will add to Poland's huge debt burden and allow government bureaucrats to delay privatization.

Without foreign aid, Sub-Saharan Africa years ago would have had to abandon socialist economic policies.

Harmful Relief. Even food relief, though frequently prompted by admirable humanitarian impulses, often harms the recipient country by underpricing locally-grown foodstuffs and ultimately bankrupting local farmers. The U.S. General Accounting Office finds that food aid to India, Indonesia, and Pakistan in the 1960s "restricted agricultural growth...by allowing the governments to (1) postpone essential agricultural reforms, (2) fail to give



agricultural investment sufficient priority, and (3) maintain a pricing system which gave farmers an inadequate incentive to increase production."[11]

Emergency food aid given to Poland in 1989 and 1990 by the U.S. and other Western countries has distorted badly Poland's agricultural market. Polish farmers, unable to compete against the free food dumped from the West, have gone out of business.

Foreign aid, meanwhile, further politicizes economies because government-to-government transfer of resources allows government bureaucrats to determine who gets the aid. These are almost always political decisions. Writes James Bovard, associate policy analyst at the Cato Institute, a Washington, D.C.-based free market research organization:

> Even when it is ultimately ladled out to private businesses, foreign aid weakens the comparative position of the private sector by increasing the government's revenue and power.[12]

Foreign aid creates incentives for long-term dependence on the benefactor. Haiti, Israel, Sudan, Tanzania, and Zaire, among many others, have become almost completely economically dependent on foreign aid for survival.

Saturating the Economy. Undermining the case for foreign aid to Eastern Europe is the fact that the region already is attracting substantial private investment from the West. Over 1,400 joint ventures have registered in Poland within the past year and the number is increasing daily. Hungary is attracting more private investment per day as a proportion of its gross domestic product than France or Spain. In Hungary, such investment funds as the Austro-Hungary Fund, First Hungary Fund, and the Hungarian Investment Company, and others have more than $600 million worth of private funds to invest in private ventures. The trouble is that most of the money is not being spent. The reason: the economy cannot absorb all the available capital because the snail-like pace of privatization has not created enough private ventures. An economy that cannot use available private capital does not need foreign aid.

11General Accounting Office, *Disincentives to Agricultural Production in Developing Countries*, November 26, 1975.

12James Bovard, "The Continuing Failure of Foreign Aid," Cato *Policy Analysis* No. 65, January 31, 1986, p.5.

Private investment spurs economic growth much more than foreign aid because it is attracted to market opportunities, rather than to a government bureaucrat's pet projects. If East European reforms – such as a convertible currency, low taxes, secure private property rights, and little or no inflation – create an economic climate favorable to private enterprise then private foreign investment will come and foreign aid will not be needed. If the climate is inhospitable to private enterprise, then foreign aid will not help.

Large Corporations Investing in Hungary

- General Electric Company
- Schlumberger Limited
- British Petroleum Company
- Black & Decker Corporation
- Young & Rubicam Incorporated
- Levi Strauss Associates Incorporated
- Siemens Corporation
- McDonald's Corporation
- Estee Lauder Incorporated
- General Motors Corporation
- Suzuki Motor Company Limited
- Samsung Electronics Company Limited
- Philips Industries, N.V.
- Société Générale Group
- Digital Equipment Corporation
- Shell Petroleum Incorporated
- International Business Machines Corporation

It is even possible, moreover, for Eastern Europe to develop economically without Western private investment. Even if capital, land, minerals, and infrastructure are in short supply, development can be driven by human capital. This, after all, is the lesson of the dramatic development of rural China in the decade following 1978. Writes Kidder, Peabody & Co. analyst Scott Powell: "economic growth is largely a function of human creation, drive, and willingness to sacrifice...."[13] An economic environment of low taxes, noninflationary fiscal and monetary policies, and few regulations becomes a hot house in which entrepreneurs will begin generating capital internally. This is what happened in Hong Kong, an island and some nearby territories barren of all resources but human capital.

Myth #4: Rigid austerity measures such as tax increases to balance state budgets, currency devaluation, trade surpluses, wage controls, and high interest rates are needed in Eastern Europe.

Most discussions about the transition from socialism to the free market invariably include a sermon that the medicine needed for the transition is bitter and that the citizens will suffer severe economic pain for a prolonged period of time. Many East Europeans today cannot be blamed if they look at the hardships brought about by the Polish economic reform program and then

13Scott Powell, "The Entrepreneur as the Mainspring of Economic Growth," Hoover Institution, Stanford University, 1990, p. 4.

resist the movement to capitalism. They associate capitalism with plummeting living standards, massive unemployment, and harsh austerity.

The mistake is to assume that the Polish program is the only way to move swiftly to a market economy. It is not.

The Polish "shock therapy" program primarily has emphasized controlling consumer demand to halt runaway inflation. In some ways this shock therapy or "big-bang" approach has succeeded. The currency is now convertible. Inflation has been cut sharply from 79 percent monthly this January 1990 to 3 percent this September. The state budget has been trimmed and state industries can no longer obtain easy credit. Interest rates were raised to 40 percent in January by the government to discourage heavy borrowing by inefficient state industries.

Unnecessary Pain. These reforms were all necessary. What is not necessary is the tremendous accompanying pain. Poland has been in a severe recession since the beginning of this year, and thousands of small businesses closed within the first months of the program.

Much of the reason for this painful economic contraction is that, though prices have been deregulated, communist bureaucrats and state-owned industries have remained firmly in place. Thus, large government monopolies have simply made fewer goods, charged higher prices for them, and bypassed the market by trading among themselves for supplies. This squeezes the private sector, which still must rely on state-owned industries for materials.

Without extensive privatization and deregulation there can be little competition. Without competition, price deregulation will not work. To make matters worse, prices were freed in Poland ahead of such essential structural changes as laws ensuring unambiguous property rights, enforcing contracts, and cutting taxes to encourage the growth of private business.

There are other problems with the Polish program. For one thing, inflation was halted not by increased productivity and economic output but by a deep recession and a drop in real earnings. For another, taxes, which were increased to balance the state budget, are too high. Private firms must pay a 20 percent tax on all business (up from 8 percent under the communist government), a 40 percent tax on profits, and a social security tax of 40 percent of wages. These prohibitively high taxes on business raise employer costs, causing decreased employment, investment, and output. It is no wonder then that there was only a small net increase in the number of private businesses registered from this January to July, according to Polish government reports.[14] Businesses remain unregistered because entrepreneurs wish to evade these prohibitively high taxes, and business licenses are still difficult to obtain.

14Krzysztof Ostaszewski, "The Boldest Social Experiment of the Twentieth Century," unpublished paper, p.16

Two Programs for Economic Development

	Polish Economic Reform Plan	Supply-Side Development
Currency	Currency made convertible by devaluation	Eliminating restrictions on free exchange of currencies and currency convertibility by letting currency float to market rate
Prices	Free prices	Free prices
Taxes	Tax increases	Tax cuts
Wages	Wage controls on public and private sector	No wage controls on the private sector
Privatization	Little progress	Rapid massive privatization through "popular capitalism"
Tariffs	High customs duties on consumer goods	Tariffs cut radically
Business Licenses	Still difficult to obtain – process is lengthy and cumbersome	Near automatic license approval
Money Supply	Tight credit to public and private enterprises	Tight credit to state enterprises
Main Emphasis	Macro-economic measures	Structural reforms, tax cuts, and de-regulation

Supply-Side Development. There is a free-market alternative to the Polish shock therapy program. This could be called "supply-side development." It has many of the same goals as shock therapy, like low inflation, tight monetary policy, and currency convertibility, but it emphasizes first creating the foundations of a market economy and balancing supply and demand through economic growth, rather than cutting consumer demand.

The basic tenet of the supply-side approach is removing the government from the marketplace and creating incentives for individuals to engage in economic activity by cutting government taxes, regulation, and spending. Poland, for example, would be developing faster and with less hardship if cutting taxes and eliminating controls on foreign trade were recognized as being more important than trade and budget surpluses. Entrepreneurs should be freed from excessive government regulation and taxation so they can begin generating wealth. Rather than controlling demand, economic reforms should be structured mainly to unleash the supply mechanism by cutting government intrusion – in the form of controls, high spending, regulations, restrictions, and taxes – into the economy.

Structural Reforms. It should be recognized, moreover, that immediate structural reforms are as important as macroeconomic reforms. Legislation on securing property rights, contractual rights, privatization, taxes, investment, and business licenses should be the first priority of economic reforms. Once these are in place, a private economy parallel to the state-dominated economy rapidly develops. This, in turn, introduces competition to the state enterprises. With the supply-side approach, entrepreneurial Poles could see swift improvements in their living standards because the deregulated, low-tax environment would provide opportunities and rewards for risk-taking, wealth-generating behavior.

In the supply-side plan, economic reforms should favor private entrepreneurs rather than the state-run sector of the economy. This can be done by freeing wages and prices on private enterprises and offering favorable credit terms for private firms while maintaining tight credit for state industries. Taxes on private business during the transition period to a market economy should be eliminated and business licenses should be approved within days of an application.

Supply-side economic reform plans should emphasize economic empowerment and new opportunities, not controlling consumer demand. Eastern Europeans, like people worldwide, will work hard if they are rewarded for their work by increased and improved consumer items such as automobiles, televisions, appliances, telephones, and radios, or in the form of a thriving business.

CONCLUSION

East European economic reformers can avoid the mistakes made in Africa and Latin America if the reformers reject the development myths that have kept much of the Third World impoverished. Myths that economic growth requires substantial government spending on basic infrastructure and massive foreign aid are a prescription too for a continued impoverishment of Eastern Europe. These myths and others are mobilized by liberal Congressmen who argue for vast Western aid to Eastern Europe and by old guard communists in Eastern Europe who want to scare their fellow citizens away from the free market by arguing that the transition to a free market economy must be painful.

Experience from developed and developing nations around the world teaches realities very different from these myths. These realities are:

1) **An economy can grow without substantial government spending** on airports, bridges, electricity, ports, roads, telecommunications, water systems, and other infrastructures.

2) **Privatization of state industries is possible** without developed capital markets.

3) **Western investment capital will flow** to countries that protect private property, establish the rule of law, have attractive joint venture laws, low taxes, and a stable political climate. For those countries to which private investment is not attracted, foreign aid can not help them.

4) **Economic hardship and rigid austerity measures,** like high taxes, high interest rates, and wage controls on private business **are not needed** to make a transition to a market economy.

Advice about economic development provided by many Western economists, politicians, and even businessmen could derail Eastern Europe's economic liberalization. Multilateral institutions such as the International Monetary Fund and the World Bank unintentionally have contributed to Third World poverty and underdevelopment. They do this by propping up state-owned industries and advocating state economic planning, currency devaluation, and increasing taxes to balance budgets. These same institutions and a new development bank, the European Bank for Reconstruction and Development (ERBD), now seem determined to force these failed policies on the East Europeans.

Setting the Record Straight. Before Eastern Europe suffers the fate of Africa and Latin America, the record should be set straight. Westerners should stop giving East Europeans bad advice about economic development. If the proper advice is given and heeded, East Europeans can speed their economic development, while American policy makers can avoid throwing away taxpayer dollars on misguided foreign aid programs.

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