The Absurdity of East Bloc Austerity

By RICHARD RAHN

I do not know which spectacle is more absurd – Western experts telling Eastern Europe to plan for more austerity, or East Europeans trying to plan capitalism. Our friends in the East do not need to plan for austerity; after 40 years of socialism they have it down pat. But their efforts to plan and implement capitalism suggest they are still trapped in an ideological mindset of the past.

The calls for austerity stem primarily from the old, discredited zero-sum mentality, the static view of economics traditionally associated with socialism. In effect, this view holds that in order for one person to become richer, another must become poorer. The failure to understand that free market incentives can enable everyone to become richer threatens to abort the economic rebirth of Eastern Europe at the outset.

It is ironic to note how deeply this fallacious mindset permeates the political left in the West, despite the quite apparent collapse of socialist mythology around the world. Even Winston Churchill failed to grasp the enormous potential of free markets: "The great tragedy of socialism is that all share in its poverty, and the great tragedy of capitalism is that not all share its beneficence." He was right about socialism, but wrong about capitalism.

Daring Measures

The poverty of Eastern Europe is attributable primarily to an economic and social system that discourages productive use of labor and capital, and which wastes and misallocates resources. The people lack adequate property rights and commercial legal protections, and are beset by excessive taxation, regulation and trade restrictions. Yet another critical element is the lack of a stable and convertible currency. Until these problems are dealt with in a daring and forthright manner, economic growth in Eastern Europe will remain anemic and prophecies of continued austerity will become self-fulfilling.

During recent trips to Eastern Europe, I was frequently asked by government officials for advice on how to plan for capitalism. Obviously, the most formidable challenge before them is to get away from the attitude that the government can and should plan economic development. The process is made more difficult by officials of Western governments and multinational institutions who, against all logic, are actually reinforcing that way of thinking.

The gross inefficiency of most of the state-owned and operated enterprises in Eastern Europe is now well known and understood. But due to the static or zero-sum perceptions of the nature of the economy, there is widespread belief that the state structures must be totally dismantled or privatized before capitalism and a functioning market system can be established. There is also the belief that the salvation of these economies is almost solely dependent on foreign investment. As a result, many people both inside and outside Eastern Europe accept the premise that if East Europeans agree to shrink down the size of their inefficient state enterprises, Western nations, in return, must agree to provide massive investment. The problem with this line of reasoning is that private Westerners cannot be expected to – and in fact should not – invest in these economies until full property rights have been instituted, viable legal accounting systems have been installed and, most importantly, a functioning convertible currency has been established.

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Some officials of the International Monetary Fund and Western economic advisers argue that these countries will not be able to establish non-inflationary convertible monetary systems until they get their budget deficits under control. The IMF prescription is one of insisting on substantial reductions in the subsidies to various state enterprises coupled with a high-tax regime. The problem with this solution is that the reduction in subsidies to the state enterprises means that there are going to be substantial layoffs resulting in a high rate of unemployment. At the same time, the high-tax regime discourages the creation of new private enterprises which could employ those formerly working for the shrinking state-run operations. The outcome is predictable. There will be economic stagnation with increasing amounts of unemployment which in turn will cause increased political instability. Democracy will be imperiled if it becomes associated with mass unemployment and the ensuing economic stagnation.

Let's take Hungary as an illustration, since Hungary is the country in the best position to make a successful and peaceful transition from a statist totalitarian system to one that is a free-market democracy. The Hungarians have already reinstituted private property rights and they are in the process of making the necessary legal and accounting system changes for a viable free-market economy. Their dilemma is that they run a substantial budget deficit and have about $20 billion in foreign debt and a destructive tax system – which was in part suggested by the IMF. The tax system includes a 53% payroll tax (43% paid by the employer and 10% paid by the employee); a 56% marginal tax rate on a worker's earnings at a relatively low level of income, a 54% corporate profits tax, a 25% value added tax plus many additional specific excise taxes.

Hungarian Tax Revolt

The IMF has told the Hungarians to reduce their subsidies to state enterprises which is clearly constructive. However, at the same time, the IMF has resisted what is obviously necessary tax reform under the mistaken belief that this will reduce tax revenues to the government. The problem with the existing Hungarian tax system is that it punishes entrepreneurs and workers. It greatly discourages them from starting new enterprises or paying their taxes. It results in substantial tax avoidance and evasion, particularly given the inefficient tax administration structure.

Clearly, what Hungary needs is tax reform that would greatly reduce tax rates, particularly on labor and capital. Tax reform, in itself, will be insufficient to get the economy growing rapidly without a more viable convertible currency than Hungary now has. It is more difficult for the Hungarians to implement a government currency reform than it was for the Germans in the late 1940s – the Germans were not hobbled with a socialist deficit economy. The Hungarians are essentially left with the two options: Legalizing the use of foreign currency, such as the dollar, the Deutsche mark and the Austrian schilling, which to some extent is already happening; or secondly, allowing the establishment of non-governmental private currencies. The use of private alternative currencies backed by real commodities is the solution that I have been recommending to these governments.

Austerity will not solve the economic problems of Eastern Europe. The solution is to install the proper set of policies (i.e. strong property rights, a predictable legal system, free markets, low tax rates, reductions in government spending, minimal economic regulations, free trade) and to allow the development of private money, so that free enterprise can grow rapidly enough to absorb the resources liberated from the shrinking state sector. Only by allowing the immediate growth of a legal and parallel free market economy can the peoples of Eastern Europe achieve an increased level of prosperity without dreadful economic pain.

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