



THE CHALLENGE OF CHANGING THE OLD MINDSET

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Transition: launching into the unknown

Let me just state briefly a couple of things that are very important to know, that anyone has to know when endeavoring on such a quest of researching and analyzing what has happened and what has worked in the process of market transition in Eastern Europe or former Soviet Union. One of the things that we have to know is that this has been a deep, unknown transition. No one, in the beginning of transition, has known how it's going to play out, what the differences are, because no one has ever encountered such a huge challenge of transforming the former state-owned, state-run enterprises and highly centralized economies into pro-choice market economies similar to what we have in Western Europe.

Transition that is both easy and hard

Now, one of the things that we have to underline here is that the challenge of changing the old mindset has proven both unexpectedly easy and unexpectedly difficult. Why easy? Because if someone told you in the 1980s that there is going to be a change in the former communist bloc, and that in 1989 you will have a change in the system, no one would ever believe that person. And similarly, if [someone] said in 1989 that 15 or 16 years later, 10 of the former communist countries in Eastern Europe will become European Union members, you would not believe them. At the same time, if you told the West Germans that they will have to put in one and a half trillion euros for the transition of Eastern Germany and still have it lagging behind in terms of unemployment, in terms of mindset, in terms of entrepreneurship, and in terms of new enterprises in 2007 – that is 20 years later – you would still be surprised. This shows how both easy and difficult this transition has proven. That is why when we talk about changing the old mindsets, we have to consider that it's really a very, very difficult issue.

The legacy of post-communist mindset

Now, let's turn to the legacy of the post-communist mindset. What is, or what was the post-communist mindset? The first and probably the most important challenge to transform the post-communist mindset was the lack of personal responsibility. In the former Eastern bloc, the state took care of everything and it had huge security apparatus. Everyone knew from cradle to grave what was out there for him. You knew that if you



start at a certain position, where you will end 35, 40 years from now, what pension you would receive, and, in the end, even what your funeral would be. Taking personal responsibility, taking responsibility for your choices, taking responsibility for what you do, for your personal happiness and wealth is one of the distinguishing features of the Western society, whereas in Eastern Europe, there was a fairly high security. But at the same time, everything was taken care of by the state.

The second feature that was there in the post-communist mindset was the right not to choose. If you entered at a retail shop somewhere in the 1980s in Eastern Europe or in the former communist bloc, chances are that you would either not get anything, because there was no choice, or you would only get bread. When you entered a pastry shop, you'd just say, "I want a piece of bread." Now, if you go, 20 years later into a pastry shop and say "I want bread," the immediate question would be: what kind of bread?

Transition to making choices

One of the really big transformations that we've seen in the past 20 years is the amount of choices that everyone has to do every day from retailing to schooling, in managing your pension accounts, in managing your insurance accounts, and so on and so forth. Now, what is the really difficult part of making this transition? Maybe someone would say, okay, what's so difficult about it, I mean you simply have all these choices and the human being is an adaptive animal, so it shouldn't be that difficult to change this. But the problem is that changing from the old communist mindset toward today's market economy means changes in values. And we have to bear in mind that the values of freedom to choose, the values of freedom of personal responsibility were not inherent in the post-communist societies. They didn't have their internal stakeholders. That is as if you were a ship without [an anchor] of values.

Differences within the region

What happened in the 1990s after transition began was that basically you had shattered values. People didn't believe in communism anymore. People thought they got everything wrong. Families fell apart. Ethical values crumbled down. And at the same time, you wanted to make a transition towards a new set of values. So you had on one hand an environment of lack of values, and on the other hand, you had a necessity to build a new value system without having inherently the internal stakeholders. And of course that has been different in different countries. If you look at Czech Republic, Poland, or Hungary where they had a tradition of market reforms or where you had tradition before the 1940s the tradition of capitalism, this was much easier. Whereas countries that were rural in the 1940s when communism came were much less developed.



Formal and informal institutions

Now, this all has to do with institutions. So what I would like to turn attention to is the different paths towards democracy and market economy. They are formal and informal institutions. In Eastern Europe you had both. You had institutions where the economy was very much centralized and there were neither formal nor informal institutions of market economy. Bulgaria and the former Soviet Union were the case. This was where communism came in, basically directly following feudalism. There was no well-established market capitalism or industrialism before that. They were simply agrarian societies. Now, these countries have to go through a long process where you had to build both formal and informal institutions of market economy and democracy.

Other countries, most notably Central European countries, the Czech Republic, Poland, and Hungary, had a tradition of freedom. If we look back and remember in 1956 the Hungarian uprising, in 1968 the Czech uprising, the Solidarity movement in Poland in the 1980s, we'll know that these countries were less centralized in many aspects. They had, to a much higher extent, private property in terms of agricultural land. But at the same time, still they lacked the formal institutions of market economy, the rule of law, the ability to raise capital and to invest this capital in new ventures. So basically they were constrained in their capital growth, which is a key feature of today's market economies.

Difficult transition due to weak institutions

Let's turn to the different levels of success and how this success has grown. How has the change in the old communist mindset proceeded? And this is usually done through looking at the economic growth of the different countries and different regions. Eastern Europe has gone through a considerable period of reshuffling, changing the economy in the beginning of the 1990s, or the so-called transition recession. It was markedly more visible in case of the Commonwealth of Independent States and Mongolia, which went through a much more prolonged period of change. This has to do with the fact that these countries have to change not only the formal institutions and introduce not only formal courts, rules, commercial registries, commercial acts, but also they had to go through a change in their mindset; whereas Eastern Europe went through a much briefer recession.

There is a difference in the countries of Eastern Europe, and this is clearly visible. Countries like Romania and Bulgaria had much less informal as well as formal institutions of market economy. They went through much longer soul-searching, much more protracted reforms, which in the end of the day resulted in lower growth and a prolonged recession. There were so-called two-bottom recessions, where you had steep recessions twice: one in the beginning of the 1990s and the other one in the mid-1990s, such as Bulgaria had in 1996-97. It had a 10 percent drop in GDP in 1996, while all the other Eastern European countries were already growing and the reforms were paying off.



Struggle to measure progress

There is no simple rule of measuring how formal and informal institutions are changing in Eastern Europe. And of course, it's much more difficult to measure the change in the mindset of the people. That is why different economic institutions, most notably the European Bank for Reconstruction and Development (EBRD) and the World Bank, devised different complex sets of indicators to trace the level of reform effort in post-communist countries. And these were usually divided in the different reform steps that were thought to be important to bring about market reform.

Now, of course, these are usually connected to the formal institutions, but at the same time, the level of reform and the timing of reform show also that the intensity of reform is usually connected to these so-called invisible or mindset-related variables. In some countries, there were a lot of reforms early on and they changed the mindset quickly, and they were able to quickly realize some gains. Other countries started late and they were trapped in the so-called reform weariness trap where you introduce market reforms late in the transition to market economy and you fail to realize the full potential of market reforms. Then losers seize the moment through the democratic institutions and block any further reform, thinking that these reforms are actually to blame for their unhappiness.

And fairly enough, if we compare the level of reforms as measured by EBRD, and this is an index of reforms that we're looking at, with the economic growth, you will see that countries that have realized the highest economic growth and those that earliest in transition have realized economic growth, are exactly the countries that have gone through the deepest and boldest of reforms.

Reform progress depends on the mindset

If we look at the sequence of reforms, of changing the formal institutions, again we have to say that the speed and the depth of reforms of the formal institution depend very much on the mindsets of the people. There are several steps that we have to look at: price liberalization, privatization, trade and capital liberalization, institution building, macroeconomic and microeconomic reforms, and of course the rule of law. Economic liberalization was the first step that was rolled out in the very beginning of the market reforms in the 1990s, in 1991 to 1994. Some countries did it, as Poland did, very early on. Other countries, such as Bulgaria, waited on until 1994. And of course, this was the first very important step to introduce the incentives for a new market entrance to produce and trade. That is why prices had to go up because in the former communist states, the prices did not produce any incentives. They were simply a result of central planning. They were not meant to be beacons of change or to be beacons of what society wanted.



Economic liberalization

That is why price liberalization led to quickly adjusting [price and supply of goods] levels. Goods returned to the market, goods returned to the shop, and this was the first shock of market reform. This was the first time that the old communist mindset had to realize something was changing. When price liberalization was introduced, of course, many people lost huge values of their bank accounts, but you have to weigh in whether your prefer choice of more goods or the security of having money but not having goods, not knowing where to spend the money that you already have in the bank account. And of course, in the way this proceeded, it resulted in the first backlash to reforms. In Central Europe, economic liberalization was quickly added to privatization and to institution building, and this led to the forming of a core of constituencies of reformers. But in Eastern Europe, and especially in Russia, the case was that price liberalization just brought about discontentment in the public without bringing the benefits of market reform, the benefits of choice, which were left only for the richest. That is why we have to weigh in at this moment only that the first seeds of reversal of economic reforms were planted as early as the early 1990s.

Privatization

The privatization process is the essence of transformation, and we have to make clear the two different types of privatization. One type, which is really much more important, is the liberalization of the market, the freedom of people to come together to start new ventures and to produce needed goods for the market. And the other privatization, which is much more difficult, is, of course, changing the state-owned properties into private-owned enterprises. Both types of privatizations are inherently difficult. On the one side, privatization through the formation of new enterprises is difficult because there were no laws in the beginning of the 1990s; no laws, no commercial codes, no commercial practices whatsoever. So it was the informal economy that initially fed into the formal economy, or entrepreneurs starting the new formal economy. The privatization of state-owned enterprises – if you imagine what this implies – is a huge transfer of money, power, and assets from the state-owned sector into the private sector, which, of course, meant a lot of state capture, a lot of assets being squandered by insiders.

So when we look at privatization we have to consider the missing local stakeholder problem. The privatizations that Western Europe has seen in the 1980s were mostly of big monopoly state-owned enterprises, but, at the same time, the bulk of the economy was private. Here you have the bulk of the economy being public and you have to privatize a much higher percentage of the assets – 100 percent in the case of Bulgaria.



The political economy of privatization

And sometimes when we're talking about privatization, we can't ignore its political implications. We have to realize that one of the lessons of transition is that you don't have a choice between a quick and a very well thought-over and very well developed privatization. You have a choice between quick or ugly privatization. Whoever in transition stopped or delayed privatization later on saw the asset values of the state-owned enterprises dwindle or be siphoned away by insider trading. And of course, the political economy of privatization in a lot of countries has turned into a quagmire of delayed privatization. A lot of problems have turned from the public hands into private hands; a lot of state-run capitalism, especially in Russia, created the oligarchs. [As a result,] the people that had built those enterprises didn't see the benefits after these enterprises were privatized.

Macroeconomic and microeconomic reforms

We have to say that, as transition progresses, the early transition was much easier. First of all, you had a so-called the rosy stages of reform, where people still remembered the horrors of communism and they were much more eager to see change. As transition went on, new measures of liberalization and privatization brought the first losers of transition. Macroeconomic reforms were much easier than microeconomic ones. Microeconomic reforms later on required a much deeper, much better understanding of the way the economy functions, which means that the further down the reform road an economy goes, the more a new mindset is needed. And countries that missed those first seven years to build this new mindset, such as Bulgaria or Russia, later on have further problems with building the microeconomic reforms, such as the rule of law, which by far is probably the essence of modern market institutions.

Institution building

While it is fairly easy to create the private sector through privatization, it's much more difficult to grow entrepreneurs, to create the environment that stimulates entrepreneurship, that stimulates innovation. And of course having the private sector does not mean having a competitive market economy, just like in the case of Russia or in countries in Southeast Europe, where you have a private economy but it's much more controlled by the state, by the public sector, or controlled by a few oligarchs that are very well connected to the state-owned sector. This means that the freedom of the different countries remains different.

Economic freedom and institutional performance

Economic freedom, of course, is one of the inherent features of today's market economy and is different across different states of Central and Eastern Europe, with the ones that



grow the most actually being the freest of all and the ones showing the briskest of growth. And of course, a lot of the institutions failed to be built in the 1990s or in the early 21st century. We could see that countries that failed or started later on the reforms have much more corruption or are much less free from corruption than countries that have better institutional performance. This is much more difficult in Eastern Europe.

The values of democracy and market economy

To recap, we have to say that both democracy and market economy are about values. You can, of course, use different indicators to measure the extent to which a society is democratic or the extent to which an economy functions according to the rules of the market. But in the end of the day it is the freedom of choice, it is the freedom of speech, it is the freedom of entrepreneurship that, if you have these values, you can show they are really important. Then, you have market economy democracy deeply rooted in a country. And of course, what countries in Eastern Europe have learned, it's much easier to build the formal traits of democracy and market economy. It's much easier to hold free elections. It's much more difficult to make people vote, to make people understand what the different political parties are proposing, what proposals are needed to build the institutions, how to de-compose all the different aspects of the economic platforms of different parties. So it is much more difficult to make the institutions that allow you not only the freedom but the wisdom of choosing.

Lessons learned

In a way, what has been difficult in Eastern Europe is that the public sector had to create the private sector and then the private sector had to influence the public sector, which in certain countries led to state capture and having just formal traits of democracy and market economy. Underneath the big monopolies and the big public and private authorities, nothing has changed.

But in the end of the day, what has been taught in Eastern Europe is that countries that have introduced both formal and informal institutions and have made the deepest change of formal and informal institutions have really succeeded in bringing about the highest growth and in bringing about the highest prosperity their society. It means that whatever way we choose or whatever way is chosen, there are different paths towards welfare and towards better lives. But again, countries that reform early and reform deepest make the highest impact on their societies.



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