Go Big or Go Home

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In January 1977, Egypt's then-President Anwar Sadat announced a modest reform of the country's consumer subsidy programs. The government planned to reduce subsidies on items like rice, tea, cigarettes, gasoline and others, while preserving the artificially low prices on staples like bread, lentils, beans or cooking oil. The attempted reform led to riots, mostly in Cairo and Alexandria, causing around 70 deaths and injuring hundreds more. In response, the government canceled the reform plans and increased its spending on subsidies.

Since then, Egypt has attempted to reform subsidy programs in the early 1980s, 1990s, and in the second half of the 2000s. However, as of 2013, one third of government spending is still directed toward subsidy spending, pulling the country into a fiscal abyss. Perhaps because of the inflow of aid from the Gulf, the new finance minister, Ahmed Galal, affirmed that he is not planning to go beyond the announced gradual tweaks to the subsidy system, such as the introduction of smart cards for certain types of fuels.

Failed subsidy reforms in Egypt, Morocco, or Jordan are symptomatic of deeper problems plaguing essentially any area of economic policymaking in turbulent political environments. The pattern is always the same. Because of economic pressures, a modest reform is announced, and sometimes implemented, but it is later reversed. When the situation becomes unsustainable again, another attempt is made, alleviating the immediate pressure, yet leading to another reform reversal down the road.

This pattern damages the credibility of further reforms. If people realize that all policy changes are temporary, then even a sincere reformer who tries to implement a permanent change is not going to be taken seriously.

This trend is in direct contrast to the experience of Eastern European countries following the fall of communism. In early 1991, 95 percent of all consumer prices in Czechoslovakia were liberalized, never to be re-regulated again. A dominant part of the economy was transferred to private hands within a year or two, and although the fairness of the privatization was sometimes contested, no one has ever seriously considered a renationalization of any part of the economy.

Or, to take a more recent example, when the global financial crisis of 2009 hit the Baltic states, governments reacted by deploying a combination of severe spending cuts and far-reaching structural reforms. The size of the fiscal adjustment was staggering. In Latvia alone -- which fired one third of its civil servants -- the fiscal contraction was equal to over 11 per cent of GDP in just one year. Yet the policies showed results quickly as the Baltic economies rebounded and started growing at a remarkable pace -- in sharp contrast to countries on Eurozone's Mediterranean periphery, which were similarly affected by the crisis but have ended up being caught in a vicious circle of bailouts and half-hearted, fragile reforms.

To economists and political scientists, these contrasting patterns are not particularly surprising. Pro-market economic reforms survive and are effective if they are seen as credible by the population. A problem arises when the public does not trust the promises policymakers make when it comes to reform. This is particularly true during transitions or in difficult political environments in which voters lack effective means to punish politicians who renege on their promises. But how can serious reformers in such environments overcome the problem of a lack of credibility?

In a classic paper, Harvard University economist Dani Rodrik showed that one such method was "overshooting" -- i.e., making the reform more radical, farther-reaching, and quicker than necessary. By being willing to go the extra mile, the reformers can send a signal to the population that they are truly serious about systemic change. In contrast, politicians who opt for the easy way out and do the bare minimum required by a crisis situation are signaling to the public that they do not really care.

The idea that overshooting can overcome the problem of a lack of credibility has become influential in academic circles. Its rise to prominence was facilitated by the experience of Eastern Europe, where radical reform strategies led to better outcomes than partial or gradual reforms, contrary to the initial predictions of many economists who believed that gradual and carefully planned piecemeal change would outperform the necessarily messy 'big-bang' solutions.

Peter Boettke, an economist at George Mason University, writes that "the former Soviet economy has been in a state of perpetual economic crisis since 1917. One reform measure after another was introduced only to be reversed within a few years." After the short-lived economic reforms of in the 1920s, 1950s, 1960s, and 1980s, the liberalization program announced by Russian government in 1991 was received with incredulity. Russians had no way of telling whether it represented a genuine attempt at dismantling the planned economy or whether it was yet another in the series of reform gimmicks routinely seen in Soviet Russia.

The substance of reforms was not particularly reassuring either. Price regulations on consumer staples were maintained, but were only delegated to local governments. That undermined the effects of the intended price liberalization. And instead of prudent macroeconomic policies, in an attempt to address the debt problems of state-owned enterprises, the Russian central bank orchestrated a hyperinflation, effectively stalling enterprise reform in the country.

In the early 1990s, to overcome the general distrust that ordinary Russians had in their government, reformers would have had to pursue economic reforms in a way that left no doubt about their intentions, like Vaclav Klaus and Leszek Balcerowicz in Czechoslovakia and Poland respectively. Russian reformers of the early 1990s -- much like the policymakers in the Middle East -- failed to do that.

Besides sending a signal of credibility, all encompassing reforms lead to more stable outcomes than partial reforms which are easier to reverse. The transitional economies of Central Europe proceeded with reform of their pension systems, starting with Hungary in 1998, Poland in 1999, and Slovakia in 2005. All three opted for a combination of the existing pay-as-you-go scheme and private savings accounts.

When the crisis hit later in the 2000s, governments were under pressure to consolidate public finances, and the temptation to seize the assets of private pension funds grew. In 2010, the Hungarian government effectively raided private pension funds. In Poland, a renationalization of private pensions is currently under discussion. Last year in Slovakia, the government reduced the ratio of contributions to private pension funds, thereby increasing the revenue of the government-run pay-as-you-go scheme.

However, such a scenario was avoided in the country that pioneered private pensions in 1980: Chile. Though Chile has experienced a series of center-left governments over the past twenty years, the private pension system put in place by José Piñera is still running, largely unchanged. The key difference between the Chile and Central Europe cases lies in the fact that Chilean reformers privatized pensions fully, leaving no role for government other than a backstop for people who have not been able to save for themselves for whatever reason.

This insight is directly relevant to the reform challenges facing Arab countries. The current Egyptian government, for example, favors a gradual elimination of subsidies. However, such gradual moves were tried -- and failed -- many times before. Therefore, if a reform of Egypt's unsustainable system of price subsidies of fuels and food is to occur at all, it will need to be rapid and all-encompassing -- as I argue in a forthcoming Cato paper, *Solving Egypt's Subsidy Problem*.

At the present time, one does not see a lot of reform momentum in the Arab Spring countries in spite of their mounting economic problems. These range from an unsustainable state of public finances to byzantine regulation and omnipresent corruption, which all cripple market competition and keep large segments of their populations in poverty. But when the time to undertake economic reforms comes, reform design will be as important as the political willingness to undertake them. Unless potential Arab reformers can convince their electorates that they are serious about putting in place institutions and policies conducive to economic prosperity by introducing far-reaching systemic changes, Arab countries will continue to muddle through, from one crisis to another.