

Lessons From East Europe's Voucher Privatization

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The unsavory truths about Russian privatization are slowly coming out. But the tendency of the press to focus on the juiciest scandals may obscure some of the broader historical lessons of this remarkable decade of the post-socialist transition. Some critics have taken easy potshots at the blatantly corrupt loans-for-shares privatization scheme (which only exposed the corruption of the *Russian* reformers), whereas I fear the lessons of the earlier voucher privatization are much more revealing. These are not just lessons about Russia (or Czechoslovakia); they are lessons about ourselves and about neo-classical economic theory.

Following the alleged "success" in Czechoslovakia,^[1] voucher privatization with voucher investment funds became the form of privatization favored (when sales to foreign investors were not feasible) across the whole region from Mongolia to Slovenia by the "Washington consensus" and by the most prominent and vocal western economic advisors.^[2] But the advisors did not impose it on supine transitional economies. New ascendant elites in the post-socialist countries had their own political reasons for supporting voucher privatization so the marriage with the prestige of western economic advisors was a very happy one with benefits for both parties.

The "Arguments"

The first line of defense is that the theories were fine, but that the implementation was massively bungled and/or subverted. But "good theories" that can only be implemented by angels in ideal conditions are theories "good" only for academic publication, not for practical advice under "real existing post-socialism." The likely conditions of implementation are part of what needs to be taken into account in giving mature and robust policy advice. But one should not be too harsh on academics for being out of touch with the real existing conditions. The leaders in the transitional countries and the experts in western development institutions surely had a better grip on existing conditions, and yet they too employed many of the same arguments for voucher privatization. Hence we turn to those arguments for a better understanding of the story. Blatantly poor arguments put forward by very intelligent and knowledgeable people can be quite revealing of underlying "pre-analytical judgments" (known vulgarly as "ideology" outside the science of economics).

In voucher privatization, vouchers or coupons to buy assets being privatized are distributed for free (or for a nominal processing fee) to all citizens. The distribution might be equal or take into account age or years in the workforce. The vouchers may or may not have a fixed face value or be tradable between citizens. Often intermediaries, voucher investment funds, were promoted which issued their shares to citizens in return for vouchers and which, in turn, used the vouchers to buy portfolio shares in companies being auctioned by the government.

It was often argued that voucher privatization was necessary because of the lack of cash. The no-cash argument was that the free or almost-free distribution of vouchers was necessary since the citizens had no cash to buy shares. What liquid wealth the Russians had was labeled "Ruble overhang" and was inflated away by the price

liberalization program of the first reform government. The savings of the Russians were in any case incommensurate with the assets to be privatized, and voucher privatization was promoted with the no-cash argument across the board, not just in countries where inflation wiped out initial savings.

The no-cash argument was used repeatedly by western advisors with pockets bulging with credit cards and who may well have used credit to buy their cars and homes. Why did they suddenly forget about credit and assume that one could only buy assets with cash? Once "reminded" of credit, the advisors were quick to point out that the fledging banking systems in the post-socialist countries were in no shape to finance the credit transactions on the necessary scale. But credit does not have to come from a third party. The credit for non-cash but non-giveaway privatization would be seller-supplied credit where the seller (the government in this case) "takes paper" and is paid off in future installment payments. This seller-supplied credit approach not only could be used but was used in some of the best (non-voucher) privatization programs such as the Polish leasing program (known officially as "privatization by liquidation" and considered in more detail below). When "reminded" of seller-supplied credit and installment payments, experts promoting voucher privatization ("voucheristas") moved on to other arguments such as the "speed argument."

Voucheristas were prone to setting up a false dichotomy between "rapid" voucher privatization and "gradual" case-by-case privatization (as non-voucher options were often called). The dichotomy was false on both counts: vouchers were not necessarily fast, and case-by-case was not necessarily slow. Perhaps the most notorious sloth-like mass privatization program (MPP) was the Polish one. It was originally billed by a western professor as the "rapid privatization program" complete with a monthly timetable based the academic guru's extensive experience in institutional transformation. Every year, westerners working on privatization would go to the annual conferences in Eastern Europe to get the "progress report" on the Polish MPP that was "just around the corner." After four or five or however many years (I lost count) and much external pressure, the Poles have a scheme of holding companies (National Investment Funds) whose shares are sold for vouchers and floated on the Warsaw Stock Exchange (that's why it was called "privatization") and which are managed by western portfolio managers collecting substantial fees for their efforts. After the MPP was sold as a "privatization" plan for the better part of the decade, it is now being more plausibly asserted that privatization is occurring as some of the portfolio companies are being sold to strategic investors or floated on the stock market.

It was not just in Poland that voucher privatization was not rapid. In Russia and in many other FSU countries, voucher privatization's "great leap forward" over the chasm fell far short of the "market economy" on the other side, and it will take a long time for the countries to climb back out of the chasm. It would have been far quicker to incrementally build a bridge across the chasm. Reform needs to start from people's experience, and people "need a bridge to cross from their own experience to a new way" [Saul Alinsky 1971. *Rules for Radicals*. xxi].

Meanwhile a "privatization by liquidation" program designed by Poles without the advice of western experts used seller-supplied credit and standardized "cookie-cutter" procedures to privatize thousands of small and medium-sized enterprises (SMEs) in the manufacturing sector. The firms show up statistically as "de novo" firms since the assets are dropped down into newly incorporated companies while the old state-owned companies are legally "liquidated" (hence the name). The "privatization by liquidation" scheme is also called "Polish leasing" since the installment payments can be viewed as lease-purchase payments. Instead of dreaming up voucher schemes for "privatizing" the larger firms, many could have been (and could still be) "busted up" into contractually-related medium-sized units which could then be privatized in this manner. These lease buy-out firms have been a key

part of the success story of "new firms" in Poland.

Lease we forget, there was a counterfactual

Sober, safe, and sane social scientists must ask; "What was the alternative?" Did the Russians at the time have a real alternative to their Great Leap Forward of voucher privatization? They would, for example, need something like the Polish leasing model to seed the crucial small and medium-sized enterprise sector. The Soviets indeed had such a model called the "lease buy-outs" developed during the Gorbachev *perestroika* era.^[3] In the Soviet lease buy-out model, the company made lease payments to the government over a period of years and then could exercise the final buy-out clause (much like an individual hire-purchase arrangement). The current workers were the members as in a collectively-owned worker cooperative or were "shareholders" in Soviet versions of share-cooperatives similar to those later developed in many of the Chinese township-village enterprises (TVEs).

But, it will be said, surely these lease buy-outs were just case-by-case privatizations which "everyone knows" are too slow. Actually, it was the other way around. The lease buy-outs were too fast, not too slow. In Russia and in many of the countries of the FSU, the lease buy-out programs were stopped so that there would be "something left to go into the voucher program."

But, it will be said, surely these lease buy-outs were "imperfect" and afflicted by corruption. The early leasing models had a technical problem with "collective ownership" but this could be easily fixed with a limited liability company as in the German GmbH or with a closely-held joint stock company. Indeed the problem was fixed both in indigenous cases and in the pilot lease buyouts done in Moscow in the pre-voucher time period (1991) by the European Bank for Reconstruction and Development (EBRD). And even that "flaw" may not be that important in practice since the Chinese TVEs initially suffered from that social ownership problem and yet have fueled the spectacular Chinese growth. The question is not whether or not lease buyouts were "perfect" (e.g., free of any corruption) but could they have provided a better path to the market if the same effort and resources had been applied to improving that option?^[4]

To their credit, some of the western legal advisors (who essentially drafted the current Russian corporate law codes) have now soberly reappraised the effectiveness of the Russian privatization program and their involvement. Bernard Black, Reiner Kraakman, and Anna Tarassova (a Russian lawyer who worked with Black, Kraakman, and Jonathan Hay) have even acknowledged the leasing counterfactual.

It's ironic that the Russian Communists of a decade ago, knowing that central planning was a dead end but not fully trusting markets either, likely built through enterprise leasing a better means for enterprises to manage privatization than the privatize-now approach that Western advisors later promoted and Russian reformers enthusiastically followed. The Russians who blame Western advice for destroying their economy are not entirely wrong. [Black et al. 2000]

Thus to summarize, the Russians (and other FSU republics) had a home-grown privatization method (lease buy-outs) that with some improvements and anti-corruption efforts would be more or less equivalent to one of the most successful programs in Eastern Europe (Polish leasing) in terms of speed and depth of privatization. Yet it was abolished by the reformers with the full approval and indeed insistence of the western advisors. Thus the reformers and their western counterparts not only pushed Russia along a disastrous path but deliberately blocked an alternative indigenous path that showed great promise elsewhere (e.g., Polish leasing and Chinese TVEs).

Before the "reformers" in Russia went on from voucher privatization to the loans-for-shares (where most of today's oligarchs were created by blatantly rigged auctions of major Russian companies), we used to hear much about the "equitable distribution of the national patrimony." Let us suppose for sake of argument that the so-called "reformers" wanted to make an equal distribution of the national patrimony to be privatized (usually a shallow play upon the sentiments of primitive communism: "Let's split it up equally and start all over again").

Anyone who can tell the difference between "sources and uses" can distinguish the sources of privatization proceeds, say, present and future cash lease payments on the one hand, and the eventual uses of those funds in equitable distributions to the citizenry on the other hand, e.g., through partial funding of the pension system. Sources and uses are two different questions. Yet voucher supporters always affected a curious style of thought where wealth could only take the form of shares and to have an "equal" distribution of wealth to the current citizenry, they pretended that vouchers tradable for shares would just *have* to be distributed across the citizenry.

The social justice argument could also be seen as a high-brow version of the political feasibility argument that voucher privatization was necessary to "buy" political support for privatization. Here again is the confusion between distributing wealth and distributing shares. Even if it were necessary to "buy" support with a wealth redistribution, that is not an argument for distributing shares as opposed to other forms of wealth.

Learned Ignorance of Managerial Capitalism

The "vision" of a private property market economy that informs voucher privatization arguments often seems to be an essentially pre-Berle-Means world where shareholders "own" and "control" large companies. Yet the people who hold power in the large firms in America do not do so based on their "clear-cut property rights" (as their shareholding is infinitesimal) but on the basis of their organizational role.

In the Anglo-American system of managerial capitalism, Berle and Means emphasized the separation of share ownership and managerial control. Shares are owned by the dispersed and atomized shareholders (including institutional holders) who exercise little *de facto* control over the companies. The separation of ownership and control means there is a difference between the "ownership of companies" and the "ownership of shares." Shares are still privately owned. The shareholder exercises full "clear-cut property rights" over the shares, i.e., to buy, hold, or sell the shares. But no organized decision-making unit "owns the company as its private property." The "ownership of the company" has been dispersed, as it were, by the four winds to the mass stock market. Thus the large US company becomes in fact a *social institution* that is nonetheless touted to the post-socialist world as the exemplar organization "based on private property." It is easy to see why this is such a touchy topic and why much of the business press, the corporate mandarins (who are servants of "the Shareholders" in about the same sense that the Party bosses were servants of "the People"), the brokerage industry, and finance professors prefer the fantasy-world of "shareholder capitalism" to the realities of managerial capitalism.

If there is any culprit in the drama of managerial capitalism, it is the key institution that transformed the shareholder from a proprietor into a speculator and that "socialized" the equity of the large companies. It is remarkably the same institution that is presented by so many experts as the key to "privatization"--the Stock Market. Voucher privatization and stock market development are often presented as necessary for each other. Voucher privatization is a good idea because it will kick-start the stock market, and a stock market is necessary for post-privatization trading of the shares. It's like a chicken-and-egg thing! But I am afraid the "chicken" is a turkey and the "egg" is rotten. Vouchers privatize shares, not companies, and the mass stock market socializes,

not privatizes, companies. Indeed, it is precisely the socializing tendency of widely dispersed shareholding that leads to the next "bright idea" by western experts and their reformer counterparts, namely voucher investment funds.

Before turning to voucher investment funds, let me comment on the phrase "capital market" which was often heard uttered in the same breath as "Russian financial sector." Applying names like "capital markets" and "banks" is much easier than actually developing such institutions. In my old-fashioned texts, I read that the "capital market" intermediates between household savings and investment by firms. Is that what the new Russian financial sector has been doing? I see outfits called "banks" that specialize in money laundering, expediting capital flight, serving as shells for oligarch power plays, and other forms of stealing. There are now reported to be around ten thousand "firms" in Moscow specializing in money laundering and capital flight. Perhaps the Russian banks have been "intermediating" between the "savings" of the oligarchs and their "investments" in foreign accounts. Not too many ordinary Russians were foolish enough to put their savings in the new Russian banks, and even they are fools no longer.

Or is it the "bond markets" that provide the "capital markets." At least, we no longer wonder why the western experts didn't better forewarn the Albanians about the dangers of running pyramid schemes. The experts were too busy helping the Russian reformers to "preserve the ruble corridor" by building the biggest pyramid scheme in history. The protection of the ruble exchange rate (by means of the mega-Ponzi scheme) was until mid-August 1998 described as "one of the main accomplishments of the Russian reforms" and I would imagine that those GKO (Russian government bonds) speculators, outside and inside the government, who were handsomely paid off by the last multi-billion dollar western loans would agree.

I'm still looking for that "capital market" in the Russian financial sector. If not the banking sector or bond market, perhaps it is the Stock Market? Even in developed western economies, the stock markets are rather minor players in net capital investment.

"To a large extent equity markets are an interesting and fun sideshow, but they are not at the heart of the action. Relatively little capital is raised in equity markets, even in the United States and the United Kingdom. One cannot expect equity markets to play an important role in raising funds in the newly emerging democracies."^[5]

Post-Socialist Stock Markets as Cargo Cults

Why, then, all the emphasis on the Stock Market in post-socialist countries (particularly by the aid agencies from the US and UK)? I am afraid that one of the main reasons is totemic or "religious" in an anthropological sense. The Wall Street mentality found in the post-socialist world is reminiscent of the cargo cults that sprung up in the South Pacific area after World War II. During the War, many of the glories of civilization were brought to the people in the southern Pacific by "great birds from Heaven" that landed at the new airbases and refueling stations in the region. After the War, the great birds flew back to Heaven. The people started "cargo cults" to build mock runways and wooden airplanes in an attempt to coax the great birds full of cargo to return from Heaven.

Post-communist countries, with hardly a banking system worthy of the name, have nonetheless received considerable aid resources to open up Hollywood storefront "stock exchanges" to supposedly kick-start capitalism. Government officials in East Europe, the FSU, and even Mongolia proudly show the stock

exchanges, complete with computers screens and "Big Boards," to western delegations (with enthusiastic coverage from the western business press) in the hope that finally the glories of a private enterprise economy will descend upon them from Heaven. In this context, it is not just a "fun sideshow." An earlier generation of misguided development efforts left Africa dotted with silent "white elephant" factories, and the present generation of misguided reforms in the post-socialist world left the region dotted with dysfunctional "cargo cult" institutions—the American-promoted "Stock Markets" being foremost among them.

Voucher Funds: "Final Solution" to the Corporate Governance Problem

Returning to voucher investment funds (VIFs), after much initial focus on "privatization" as a panacea, the argument changed to the assertion that VIFs were necessary to provide the "corporate governance" to restructure the voucherized firms. This argument contains several infelicities in reasoning--which have now been also revealed by the developments in the Czech Republic. My point is to focus on the problems in reasoning which were apparent all along (not on the facts which only in hindsight seemed to become clear^[6]). There is of course the formal "concentration of ownership" by the funds but the point is that the funds themselves are run by fund management companies and that hundreds of thousands of shareholders of the funds have even less influence on the fund management company than would the stakeholders of an operating company with shares dispersed among employees, local residents, suppliers, and some merely financial investors. How could it be that so many western experts thought that going from perhaps thousands of shareholders in an industrial company to hundreds of thousands of shareholders in a nation-wide investment fund would "solve" the corporate governance problem rather than considerably aggravate it?

In the promiscuous atmosphere of ancient Rome, when noblemen went off with their escorts or concubines, they might leave guards to watch over their wives. The Roman satirist, Juvenal (circa 60-130) needled them by remarking, "But who is to guard the guards themselves? Your wife arranges accordingly and begins with them." [*Satires* vi 347] The phrase "*Quis Custodiet Ipsos Custodes?*" (Who is to guard the guardians?) has come to signify the corporate governance problem.^[7] In the case of voucher privatization, the voucher funds were supposed to "guard" the corporate managers but who could guard the even more unaccountable fund management companies controlling the VIFs? In a "promiscuity" spawned by Thatcherite disdain for regulations, the Czech voucher funds were able to "tunnel" funds out of companies on a scale dwarfed only by the tsunami of capital flowing out of Russia which the apostles of capital account liberalization in the Kremlin and elsewhere are still somehow unable or unwilling to stop.

The expert design of the voucher privatization programs provided an unintended empirical test to the boast: "If economists understand anything, they understand incentives." In addition to "solving" the corporate governance problem, the voucher investment funds were designed to have the "proper incentives" to restructure the portfolio companies.

Given the situation of an investment fund controlling a portfolio company, the actual decision-maker is the fund management company who has an almost negligible ownership relationship to the firm. For instance, if the fund can own at most 20% of the operating company (e.g., Czech Republic), and the fund management company's fee is 2% of the value of the assets under management, the amount of the ownership value that annually filters through to the actual decision-maker is $2\% \times 20\% = 0.40\%$ or 4/10ths of 1%. Such a minuscule "0.4% solution" was the magic "desirable concentration of ownership" offered by the experts to drive restructuring in the economies with powerful investment funds.^[8]

Let us suppose that a fund management company had put in all the time and effort to figure out how to restructure a portfolio company and to figure out how to actually implement the restructuring plan. Its annual gross return from this time and effort is 0.4% of the increase in value! And 99.6% of the increase in value would go to free-riders. And that is the gross return to the actual decision-maker. You have to subtract off the explicit costs and implicit opportunity costs of the time and effort to get the actual net return to the fund management company. Thus there is negligible or negative ownership returns (a.k.a. the "incentives" that western economic advisors understand so well) from restructuring so one should not be surprised when it was finally "revealed" that the Czech fund management companies had found more "efficient" ways to extract or "tunnel" value out of their portfolio companies. Such financial piracy is now even spreading to the better-regulated voucher investment funds of Slovenia (dysfunctional funds left as a residue of a Sachs & Associates consultancy job).^[9] Since the lack of restructuring incentive was clear all along, why did the western advisors and reformer counterparts strongly promote voucherization with voucher investment funds? Here is one case where they just had to "do the math" to really understand the incentives.

It is sometimes argued that voucher privatization was necessary to irreversibly "get the State out" of the economy.^[10] Yet that is not an argument for voucher privatization as opposed to other forms of privatization. Moreover much of the thrust of the voucher-oriented schemes was to first recentralize power by reversing and undoing earlier reforms that had decentralized power away from the state—all of which revealed the underlying political motive rather than a single-minded drive to "get the State out" of the economy.

In Poland, shock therapists used state corporatization to reverse the earlier decentralizing reforms and break Solidarity's hard-won power on corporate boards. In parts of the former Yugoslavia, voucher supporters tried to bring power back to the state by reversing decades of decentralized social ownership. And as already mentioned, the reformers in Russia and some other former Soviet republics sought to reverse the decentralizing reforms of the Gorbachev's *perestroika*. In all these cases, where home-grown decentralizing reforms had *already* "taken the State out," the shortest distance to the market would have been to proceed straight ahead in the same direction all the way to full privatization, not to reverse direction and "put the State back in" by renationalizing or corporatizing under state ownership.

Voucher Privatization was a *Political* Strategy

We have seen, time and again, that the "arguments" for voucher privatization were blatantly poor--indeed quite unworthy of the most worthy elite advisors from the West and their reformer counterparts from the East. What was going on? The holes in the Swiss-cheese arguments are akin to Sherlock Holmes' "dog that didn't bark"--the absence tells the story. The advisors and reformers were following another logic that was less defensible in public.

The effort to pull power and ownership back to the state to be "properly" redistributed revealed the underlying political battle. It was not the battle between Light and Darkness presented to western on-lookers; it was the conflict between two very different strategies out of communism. The battle was between:

- (1) the new "clean" post-socialist revolutionaries--those who emerged from internal or external exile, relatively untainted by the old system, armed with free-market rhetoric, and well-connected to western aid sources--to take over after the democratic revolutions of '89-90, and

(2) the old "embedded" decentralizing reformers--those who worked against the old system from within and who generally had social democratic views but were dismissed as "nomenklatura" by the new "clean" revolutionaries.

In a nutshell, "voucher privatization" was essentially the cover-story for the power plays of the new "clean" post-socialist revolutionaries against the old "embedded" decentralizing reformers.

In the years and, in some cases, decades before '89-90, many of the socialist countries had decentralizing reforms with varying degrees of success: self-management in Yugoslavia, goulash communism with the enterprise councils in Hungary, Solidarity with the self-management councils in Poland, and *perestroika* with the decentralized management, cooperatives, and lease buy-outs in Gorbachev's Soviet Union. When the dam finally broke in '89-90 and the new "clean" post-socialist revolutionaries were elected, what was the best path to the market? The most direct and continuous route would have been to push the halfway decentralizing reforms in the same direction all the way forward to the market. That would have meant transforming the quasi-ownership of the workers embodied in the various self-management councils into management and employee buy-outs (MEBOs) as in the employee stock ownership plans (ESOPs) of the US and UK, or as in the Mondragon cooperatives of the Basque region in Spain.

But the clean post-socialist revolutionaries and their western advisors each had their own reasons for opposing this direct route to the market where employee ownership would have been a major theme. The clean post-socialists had won electoral victory over the older generation of embedded reformers, but the older reformers were still represented in the management of the enterprises and on the worker councils. The new generation having obtained political power needed to secure and enrich it by also obtaining economic power. They needed a grand scheme to stop the drive towards decentralization and the market so that economic power could be pulled back to the state now controlled by the clean post-socialist revolutionaries and then redistributed to their allies. After some debate and experimentation, voucher privatization with voucher investment funds emerged as precisely that grand scheme--and western *wunderkind* economists emerged as the ideal shills with world-class credentials to testify that it was the True Path to the market.

The "gaps" in the arguments for voucher privatization can now be readily filled in; the dangling questions can now be answered.

- The cash value of the no-cash argument was to avoid the alternative of MEBO privatization which used seller-supplied credit and installment payments following a modest cash down payment. Hence the voucheristas had to pretend that the choice was only between all cash or voucher giveaways.
- Why confuse the sources and uses of privatization revenues? Separating sources and uses of privatization revenues would reveal that it was perfectly possible to have MEBOs or lease buyouts (source of funds to government) and still have an equal distribution of the "national patrimony" (use of funds by government).
- Why pretend that all corporate wealth could only be shares? An equal distribution of wealth to the citizens in the form of shares would keep controlling shares out of the hands of the workers and managers of each enterprise. "Equal shares to all" provided the moral high ground against the quasi-ownership rights established in the earlier reforms (e.g., "social ownership" and worker councils).
- Temporarily forgetting Berle and Means allowed the voucher promoters to sell the vision of "private property owners" who are "controlling" the companies. When convenient, a timely appreciation of Berle and

Means argued for the necessary of having voucher investment funds as "intermediaries" to provide "corporate governance."

- If thousands of shareholders could not provide sufficient "corporate governance" over the managers of operating companies, how could hundreds of thousands of shareholders across the whole country possibly supply "corporate governance" over the management companies of the large voucher funds? Easy question! The old managers of the operating companies were typically allied with the embedded decentralizing reformers, while the new fund management companies were the political allies of the clean post-socialist revolutionaries. Thus the old managers were "Red directors" who "needed corporate governance," not to mention vetting, but that was "not necessary" for the new fund management companies.
- Most of the "incentive" arguments pictured the funds as 20%, 33%, or 40% owners and those are controlling shares. This conveniently forgets that the "fund" was managed by a fund management company which only got about 2% of the asset value "under management" so their main role has been to extract enough capital from firms for their fees and then to "tunnel" the remaining value out to themselves and their economic and political allies.

We have now examined the main arguments for voucher privatization and we have found them wanting. In spite of all the phony economic arguments, voucher privatization with investment funds was a brilliant *political* strategy for the post-socialist revolutionaries to reverse the decentralizing reforms of the past and to pull power back the State—to their new "clean" State—so that economic power could than be redistributed to the "right people."

Western Economic Advisors and Voucher Privatization

Some of the current scandal-mongering is hinting that the prominent western economic advisors may have had "economic" motives. While there may have been some cases of strong temptation and lapsed judgment, the point is that the economic advisors were almost surely *not* "in it for the money." They tried to use "coupon" privatization as their "ticket" to fame but not to fortune.

Interestingly, in this context, "western" seems to mean "American" (or "Anglo-American"). German or Japanese economists seem to have felt uncomfortable as intellectual evangelists (or "imperialists") preaching to the post-socialist countries even though they may actually have more relevant experience to offer than their Anglo-American counterparts. Only the mixture of American triumphalism and the academic arrogance of neo-classical economics could produce such a lethal dose of gall. If the economics of Pinochet's Chile was attributed to the "Chicago Boys", then the economics of Yeltsin's Russia might be attributed to the "Harvard *Wunderkinder*."

Just what was the role of the western advisors and to what extent were they responsible for the debacle? Western economists seem to have had little or no important role in the Czech voucher privatization (although not for lack of trying). In other countries, the prominent western advisors served as a credible shill for the policies of the clean post-socialist revolutionaries. There had been a collapse of intellectual self-confidence in the many post-communist countries which was often coupled with a "self-hatred" of their past. Redemption had to come from the outside. In particular, the new governments needed some prestigious western spokesmen to "sell" such a bizarre idea as voucher privatization to their own populations. Thus the union of the self-important western economists and the intellectually-dependent post-socialist governments was a marketing marriage made in heaven. The clean post-socialists needed to market their scheme to finesse the earlier decentralized reforms (so the changes could be "done right" the second time), and the western advisors were marketing themselves as the intellectual saviors of the benighted East by putting the scientific prestige of neo-classical economics behind one

of the most cockamamie social engineering schemes of the 20th century.

Aggressive self-promotion is not a sin—at least not for Americans. The problem lies elsewhere. When the spell broke in '89-90, the populations in the socialist countries turned in earnest to the West for guidance and assistance. Western scholars with knowledge of the Soviet Union understood the enormity of the task and did not leap forward to offer nostrums (e.g., Harvard's Martin Weitzman or Marshall Goldman). Economic *wunderkinder* had no such "hindrance" of knowledge about socialist economies so they felt little compunction in offering themselves as experts in the transition from socialism to capitalism. Being an expert in neo-classical economic theory seems to qualify one as an "expert" in something that has never before happened. [\[11\]](#)

Having been constrained from enjoying the western "good life" for so long, the people of the socialist countries really wanted to escape their history and make a sudden great leap forward to a western consumer economy and lifestyle. Giving up the socialist economic security and pace of work was a "different question" and hence the jokes about wanting to be a "consumer in the West and worker in the East." The embedded reformers had a fair sense that this would take many years of determined but incremental transformation. As the clean post-socialist revolutionaries had little or no practical experience or track record, the western advisors had a key role to establish credibility and to offer hope. Any local embedded reformers who cautioned incrementalism were undercut by the shock therapy advice of the western professors on how to jump over the chasm from socialism to capitalism in one great leap. How could "socialist ignoramuses" be wiser than western professors from top universities and with world-class credentials in the science of economics? Thus, in the transitional countries, the charge against the western advisors was that their thirst for self-promotion lead them to undermine more pragmatic local advice, to undercut the intellectual self-reliance of the countries, and to plant false hopes of jumping over the chasm in one great leap.

Institutional Shock Therapy versus Incrementalism

The institutional debate is not "fast versus slow" or "rapid versus gradual" methods. It never was; that was another phony argument. The argument was institutional shock therapy (or blitzkrieg) versus incrementalism. One of the best treatments of this debate about institutional change is in Albert Hirschman's 1963 *Journeys Toward Progress* which far antedated the transition debate. Reformmongers in their strategies and even more so in their rhetoric could be divided into those who take an ideological, fundamental, and root-and-branch approach versus those who take an incremental, piecemeal, home-grown, and adaptive approach.

Intellectual historians, from the perspective of history, will see how little the neo-classical Washington consensus understood the critique of Bolshevism-Jacobinism by the conservative or "Austrian" tradition of Hayek, Popper, and Burke. So many of our best and brightest economists seem to have just thought the Bolsheviks had the wrong textbooks. With the right textbooks in their briefcases, the "market Bolsheviks" thought they could fly into the socialist countries and use a peaceful version of Leninist methods to make the opposite transition.

But the task was not resetting inflationary expectations with a dose of "shock therapy." The task was deep-lying transformation of many complex interconnected institutions. These institutions had evolved through decades of communism so the deeply rooted interconnections were not apparent, particularly not to the market Bolsheviks parachuting in from the West. The origin of what became known as the "shock therapy" approach to the transition was not only a bad analogy with inflation-stopping therapies. I fear the origin also lay the moral fervor of cold-warriors who sought to "wipe the slate clean" of the institutions of communism and to socially engineer in

their place (using the right textbooks this time) the new, clean, and pure "textbook institutions" of a private property market economy.

An incremental approach evolving reforms out of existing institutions (e.g., pushing decentralization all the way to the market with lease buy-outs) would be an admission that "History matters." But history does not exist in neo-classical economic models and the people in the transitional countries wanted to escape their history anyway, all in one leap. Hence the embedded incremental route was rejected by the utopian social engineers from the East and West; it would lead to or through some halfway-house "third way" ("Third way is Third World" was a favorite market-Bolshevik slogan due to Vaslav Klaus). Western experts argued that only a slate-cleaning blitzkrieg approach during the "window of opportunity" provided by the "fog of transition" would get all the necessary changes made. That was the market-Bolshevik road to the "democracy" and "market economy" we saw in Russia. This mentality was not new. It was a reincarnation of the spirit and mindset of Bolshevism and Jacobinism.

There has been some recent criticism of the Washington consensus for "ignoring institutions." But the shock-therapists (or Bolsheviks and Jacobins for that matter) did not ignore institutions. Institutions were just "built" Jacobin-style with bright young people (some from elite western universities and financed by aid dollars) drafting "new institutions" which were then "implemented" by the "democratic powers" of presidential decrees ("democratic powers" established by blasting an elected Parliament to rubble). Robespierre would have understood perfectly.

The Chinese were not historically immune to this mentality but they "got it out of their system" in the Great Leap Forward and the Cultural Revolution. They learned the hard way where that Bolshevik mentality would lead. When they came to choose a path to a market economy, they chose the path of incrementalism (crossing the river by feeling for the stones one at a time) and pragmatism (the question is not whether the cat is black or white or Red but whether or not it catches the mice). They had the ancient wisdom^[12] to "know they didn't know what they were doing" so they didn't jump off a cliff after being assured by experts that they would be jumping over a chasm in just one more great leap forward.

Meanwhile under the Jacobinic reform regime guided by prophets armed with clean textbook models, the Russians learned the hard way to appreciate the old saying that "it's not so much what you don't know that can hurt you--but what you know that ain't so."

Notes

* The findings, interpretations, and conclusions expressed in this paper are entirely those of the author and should not be attributed in any manner to the World Bank, to its affiliated organizations, or to the members of its Board of Directors or the countries they represent. David Ellerman for the last two years (98-99) was an economic advisor and occasional speechwriter for Joseph Stiglitz, then Chief Economist of the World Bank. During the 1990-2 period, he ran a small consulting company in Slovenia working on privatization and corporate restructuring.

[1] Every three years, the World Bank and IMF Annual Meetings are held outside of Washington. In 1997, they were held in Hong Kong following the Chinese takeover of that city. The apparent success of the Czech transition led to the early decision to hold the 2000 meetings in Prague, a decision that could not be reversed even after the illusion became clear and the Klaus Government that promoted voucher privatization fell.

[2] Even Jeffrey Sachs [1999] almost a decade after his strong advocacy of voucher privatization has to his credit realized that

it was "flawed." See Kornai 1990 and Murrell 1995 for perceptive early critiques of voucher privatization.

[3] See the cases in Ellerman 1993 and in Logue et al. 1995.

[4] See the discussion of stakeholder privatization in Stiglitz 1999a. Also see the notion of staged privatization developed in Black et al. 2000.

[5] See Stiglitz 1994, 228.

[6] If the wave of voucher privatization in the early 90s is now seen as tragedy, then the current efforts of die-hard voucheristas to install voucher programs in war-torn Bosnia should be seen as farce--if it were not for the adverse consequences for the citizens.

[7] See, for example, Stiglitz 1999b.

[8] One should triple or quadruple the 0.4% to account for heavily discounted future income, but the result is still miniscule (thanks to Bernard Black for this point).

[9] See, for example, story on financial piracy in Ljubljana newspaper *Delo* on October 25, 1999.

[10] See Shleifer and Vishny 1998.

[11] There is a side-theme that might be explored. Prodigies are typically in activities based on abstract symbol manipulation (e.g., mathematics, computer programming, music, or chess) where subtle and often tacit background knowledge obtained from years of human experience is not so relevant (see Scott's 1998 wonderfully relevant discussion of "metis"). As economic theory has become more mathematical, there is now the phenomenon of *wunderkind* professors in economics (e.g., Jeffrey Sachs, Larry Summers, and Andrei Shleifer were all prodigy-profs at Harvard) who are then unleashed (with the compounded arrogance of youth, academic credentials, and elite associations) into the real world as ersatz policy "experts." Paul Starobin [1999] contrasts the *wunderkinder* of "Big Bangery" with the mature pragmatists behind the Marshall Plan, and notes the striking difference in results.

[12] "When you know a thing, to recognize that you know it, and when you do not know a thing, to recognize that you do not know it. That is knowledge." [Confucius, *Analects*, Book II, 17] "To know you don't know is best. Not to know you don't know is a flaw." [Lao-Tzu, *Te-Tao Ching*, Chapter 71]

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