Lessons from Eastern Europe’s Voucher Privatization

Several years have passed since the failure of shock therapy to create a vibrant market economy in Russia. Some of the architects of the original plans have admitted that their strategies were naive, incomplete, or excessively ambitious. Others still insist there were no viable alternatives. In this thorough piece, a World Bank economist assesses why voucher privatization in particular was such a popular reformist tool and why it was doomed from the beginning.

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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 postsocialist transition. Some critics have taken easy potshots at the blatantly corrupt loans-for-shares privatization scheme (which only exposed the corruption

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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 neoclassical 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 advisers.² But the advisers did not impose voucher privatization on supine transitional economies. New ascendant elites in the postsocialist countries had their own political reasons for supporting voucher privatization, so the marriage with the prestige of Western economic advisers 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 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 postsocialism. 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, 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 un-
derlying preanalytical judgments (known vulgarly as "ideology" outside the science of economics).

In voucher privatization, vouchers or coupons to buy assets being privatized are distributed 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, and they issued their shares to citizens in return for vouchers. The funds then 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 advisers 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 buy assets only with cash? Once reminded of credit, the advisers were quick to point out that the fledging banking systems in the postsocialist 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 noncash but nongiveaway 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 (nonvoucher) 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 nonvoucher 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 slothlike 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 on 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 now have a scheme of holding companies (National Investment Funds) whose shares are sold for vouchers and floated on the Warsaw Stock Exchange (that is 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 former Soviet Union (FSU) members, 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” (Alinsky 1971, 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-size 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) broken up into contractually related medium-size units, which could then be privatized in this manner. These lease buyout 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 buyouts” developed during the Gorbachev perestroika era. In the Soviet lease buyout model, the company made lease payments to the government over a period of years and then could exercise the final buyout clause (much like an individual hire-pur-
chase 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 buyouts were just case-by-case privatizations, which "everyone knows" are too slow. Actually, it was the other way around. The lease buyouts were too fast, not too slow. In Russia and in many of the countries of the FSU, the lease buyout programs were stopped so that there would be something left to go into the voucher program.

But, it will be said, surely these lease buyouts 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 prevoucher 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 whether they could have provided a better path to the market if the same effort and resources had been applied to improving that option.  

To their credit, some of the Western legal advisers (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 is 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 enter-
prises to manage privatization than the privatize-now approach that Western advisers later promoted and Russian reformers enthu-
siastically followed. The Russians who blame Western advice for destroy-
ing 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 buyouts) that, with some improvements and anticorruption 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 advisers. Thus the reformers and their Western counterparts not only pushed Russia along a disastrous path but deliberately blocked an alter-
native 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 oli-
garchs were created by blatantly rigged auctions of major Rus-
sian companies), we used to hear much about the “equitable
distribution of the national patrimony.” Let us suppose for the 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 com-
munism: “Let us 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, for example, through partial fund-
ing 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 (Berle and Means 1932). 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, that is, 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 U.S. company becomes in fact a social institution that is nonetheless touted to the postsocialist 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 postprivatization trading of the shares. It is like the chicken and the egg! 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 shell corporations 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. Few 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 did not 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 multibillion-dollar Western loans would agree.

I am 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.

As Joseph Stiglitz has pointed out, “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” (1994, 228).
Postsocialist Stock Markets
as Cargo Cults

Why, then, all the emphasis on the stock market in postsocialist countries (particularly by the aid agencies from the United States and United Kingdom)? I am afraid that one of the main reasons is totemic or "religious" in an anthropological sense. The Wall Street mentality found in the postsocialist world is reminiscent of the cargo cults that sprang 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 air bases and refueling stations in the region. After the war, the great birds flew back to heaven. The people started "cargo cults," building mock runways and wooden airplanes in an attempt to coax the great birds full of cargo to return from heaven.

Postcommunist 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 computer 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 side show. An earlier generation of misguided development efforts left Africa dotted with silent white elephant factories, and the present generation of misguided reforms in the postsocialist world left the region dotted with dysfunctional cargo cult institutions—the American-promoted stock markets being foremost among them.
Voucher Funds: "Ultimate 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 that were apparent all along (not on the facts that only in hindsight seemed to become clear). 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 nationwide 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 A.D. 60–130) needled them by remarking, "But who is to guard the guardians 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. 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, which has an almost negligible ownership relationship to the firm. For instance, if the fund can own at most 20 percent of the operating company (e.g., the Czech Republic), and the fund management company’s fee is 2 percent 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 $\frac{4}{10}$ths of 1 percent. Such a minuscule “0.4 percent solution” was the magic “desirable concentration of ownership” offered by the experts to drive restructuring in the economies with powerful investment funds.7

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 how to actually implement the restructuring plan. Its annual gross return from this time and effort is 0.4 percent of the increase in value! And 99.6 percent of the increase in value would go to free-riders. That is the gross return to the actual decision-maker. You have to subtract 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 are
negligible or negative ownership returns (a.k.a. the “incentives” that Western economic advisers understand so well) from restructuring, so it should not have been a surprise 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). Since the lack of restructuring incentive was clear all along, why did the Western advisers 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 (Shleifer and Vishny 1998). 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 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 advisers 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’s “dog that did not bark”—the absence tells the story. The advisers 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 onlookers. It was the conflict between two very different strategies out of communism. The battle was between:

1. the new, “clean” postsocialist 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 1989–1990, 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 postsocialist revolutionaries against the old, embedded decentralizing reformers.

In the years and, in some cases, decades before 1989–1990, 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 buyouts in Gorbachev’s Soviet Union. When the dam finally broke in 1989–1990 and the new, clean postsocialist 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 buyouts (MEBOs) as in the employee stock ownership plans (ESOPs) of the United States and United Kingdom or as in the Mondragon cooperatives of the Basque region in Spain.

But the clean postsocialist revolutionaries and their Western advisers each had their own reasons for opposing this direct route to the market where employee ownership would have been a major theme. The clean postsocialists 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 toward decentralization and the market so that economic power could be pulled back to the state now controlled by the clean postsocialist 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.

1. 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.

2. 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).

3. 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).

4. 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 necessity of having voucher investment funds as intermediaries to provide corporate governance.

5. 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 postsocialist 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.

6. Most of the incentive arguments pictured the funds as 20 percent, 33 percent, or 40 percent owners and those are controlling shares. This computation conveniently forgets that the fund was managed by a fund management company that received only about 2 percent 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 postsocialist revolutionaries to reverse the decentralizing reforms of the past and to pull power back to the state—to their new, clean state—so that economic power could then be redistributed to the "right people."

**Western Economic Advisers and Voucher Privatization**

Some of the current scandal-mongering is hinting that the prominent Western economic advisers may have had economic motives. While there may have been some cases of strong temptation and lapsed judgment, the point is that the economic advisers were almost surely not in it for the money. They tried to use cou-
pon 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 postsocialist 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 neoclassical 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 advisers 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 advisers served as a credible shill for the policies of the clean postsocialist revolutionaries. There had been a collapse of intellectual self-confidence in the many postcommunist 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 postsocialist governments was a marketing marriage made in heaven. The clean postsocialists needed to market their scheme to finesse the earlier decentralized reforms (so the changes could be "done right" the second time), and the Western advisers were marketing themselves as the intellectual saviors of the benighted East by putting the scientific prestige of neoclassical economics behind one of the most cockamamie social engineering schemes of the twentieth century.
Aggressive self-promotion is not a sin—at least not for Americans. The problem lies elsewhere. When the spell broke in 1989–1990, 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 neoclassical economic theory seems to qualify one as an expert in something that has never before happened.9

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,” 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 goal would take many years of determined but incremental transformation. As the clean postsocialist revolutionaries had little or no practical experience or track record, the Western advisers had a key role in establishing credibility and offering 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 advisers was that their thirst for self-promotion led them to undermine more pragmatic local advice, to undercut the in-
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. Reform-mongers, 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 neoclassical Washington consensus understood the critique of Bolshevism-Jacobinism by the conservative or "Austrian" tradition of Friedrich von Hayek, Karl Popper, and Edmund 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 in 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 of evolving reforms out of existing institutions (e.g., pushing decentralization all the way to the market with lease buyouts) would be an admission that “history matters.” But history does not exist in neoclassical 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 of Václav 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 to know they did not know what they were doing, so they did not 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, "It's not so much what you don't know that can hurt you—but what you know that ain't so."

Notes

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. If the wave of voucher privatization in the early 1990s is now seen as tragedy, then the current efforts of diehard 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.

6. See, for example, Stiglitz (1999b).

7. One should triple or quadruple the 0.4 percent to account for heavily discounted future income, but the result is still minuscule (thanks to Bernard Black for this point).

8. See, for example, the story on financial piracy in the Ljubljana, Slovenia, newspaper Delo on October 25, 1999.

9. 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 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.

10. "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 do not know is best. Not to know you do not know is a flaw" (Lao-Tzu, *Tao te ching*, Chapter 71).

**For Further Reading**


Logue, John; Sergey Plekhanov; and John Simmons, eds. 1995. *Transforming Russian Enterprises: From State Control to Employee Ownership*. Westport, CT: Greenwood Press.


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