



# Knowledge and Ignorance in the Post-socialist Transition Debate: A Retrospective View from Twenty Years Later.

In the lecture series: *The Specter of Ignorance:  
On the Limits of Knowledge in Scholarship and Practice.*  
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# Historic Debate of Early 1990's

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- One of the major events of the late 20<sup>th</sup> century was the collapse of Communism.
  - It prompted a remarkable and revealing public debate about the best transition strategies to some form of a market economy.
  - Two opposite strategies emerged:
    - Shock therapy: "Jump over chasm in one leap."
    - Incrementalism: "Build a bridge over chasm."
  - This lecture is about the lessons of that debate.

# The two sides in the debate



<b>Shock Therapy</b>	<b>Incrementalism</b>
<u>Strategy</u> : Utopian social engineering	<u>Strategy</u> : Incremental piecemeal change (Popper)
<u>Advocates</u> : Neoclassical economists, e.g., Sachs, Summers, and Shleifer.	<u>Advocates</u> : Softer social scientists, e.g., sociologists, and pragmatists.
<u>Principal example</u> : Russia.	<u>Principal example</u> : China.

# The older debate



<b>Shock Therapy</b>	<b>Incrementalism</b>
<p><u>Historical predecessors:</u> French (Jacobins) and Russian (Bolsheviks) revolutions.</p>	<p><u>Historical predecessors:</u> English revolution from monarchy to parliamentary democracy.</p>
<p><u>Classic statements:</u> Lenin, <i>What is to be Done?</i></p>	<p><u>Classic statements:</u> Edmund Burke, <i>On the Revolution in France: In a Letter intended to be sent to a gentleman in Paris</i></p>

# Updating the old debate



<b>Shock Therapy</b>	<b>Incrementalism</b>
<p><u>Modern statement:</u> Jeffrey Sachs, <i>Poland's Jump to the Market Economy</i>, 1993.</p>	<p><u>Modern statement:</u> Ralf Dahrendorf, <i>Reflections on the Revolution in Europe: In a letter intended to have been sent to a gentleman in Warsaw</i>, 1990.</p>
<p><u>Quote:</u> "I consider Professor Dahrendorf to be mistaken in his view that Eastern Europe did not shed the communist system to adopt capitalism. In my view, that is precisely what they have done, and all of their actions are directed toward this purpose. ... If instead the philosophy were one of open experimentation, I doubt that the transformation would be possible at all, at least without costly and dangerous wrong turns." [Sachs 1993, 4-5]</p>	<p><u>Quote:</u> "If any creed has won in the events of last year, it is the idea that we are all embarked on a journey into an uncertain future and have to work by trial and error within institutions which make it possible to bring about change without bloodshed. What had died ... is not just communism, but the belief in a closed world which is governed by a monopoly of 'truth.'" [Dahrendorf 1990, 41]</p>

# The Battle of Metaphors: I



<b>Shock Therapy</b>	<b>Incrementalism</b>
<p><u>Break</u>: Discontinuous break or shock—razing the old social structure in order to build the new.</p>	<p><u>Continuity</u>: Continuous change—trying to preserve social capital that cannot be easily reconstructed.</p>
<p><u>Role of initial conditions</u>: The first-best socially engineered solution that is not "distorted" by the initial conditions.</p>	<p><u>Role of initial conditions</u>: Piecemeal changes (continuous improvements) taking into account initial conditions.</p>

# The Battle of Metaphors: II



<b>Shock Therapy</b>	<b>Incrementalism</b>
<p><u>Knowledge</u>: Emphasizes explicit or technical expert knowledge of end-state blueprint.</p>	<p><u>Knowledge</u>: Emphasizes local practical knowledge that only yields local applicability.</p>
<p><u>Attitude</u>: A scientific expert who knows what he is doing.</p>	<p><u>Attitude</u>: A pragmatist who knows he doesn't "know" what he is doing.</p>
<p><u>Chasm imagery</u>: Can only jump over chasm in one leap.</p>	<p><u>Chasm imagery</u>: Must build a bridge across the chasm.</p>

# The Battle of Metaphors: III



<b>Shock Therapy</b>	<b>Incrementalism</b>
<p><u>Repairing the ship:</u> Rebuilding the ship in dry dock. The dry dock provides the Archimedean point outside the water so the ship can be engineered to blueprint without being disturbed by the conditions at sea.</p>	<p><u>Repairing the ship:</u> Repairing the ship at sea. There is no "dry dock" or Archimedean fulcrum for changing social institutions from outside of society. Change always starts with the given historical institutions.</p>

# The Battle of Metaphors: IV



<b>Shock Therapy</b>	<b>Incrementalism</b>
<p><u>Transplanting a tree</u>: All at once transplantation in a decisive manner to seize the benefits and get over the shock as quickly as possible.</p>	<p><u>Transplanting a tree</u>: Preparing and wrapping the major roots one at a time (<i>nemawashi</i>) to prevent shock to the whole system and improve chances of successful transplantation.</p>

# Main Example: Privatization Debate



- Not Thatcher-style firm-by-firm selloffs
- System transformation to private property market economy usually on “U.S. model”
- Main Debate:
  - Mass Privatization typically by vouchers with voucher investment funds as intermediaries, or
  - Continued decentralization with insider buyouts (lease buyouts, management-employee buyouts).

# Shock Therapy: Voucher Privatization



- Main strategy supported by Western advisors
- Citizens get vouchers usually traded to voucher investment funds in return to shares in funds.
- Voucher funds bid for corporate shares in huge auctions
- Voucher privatization kick-starts "Cargo Cult" of post-socialist stock markets
- Voucher funds to supply “corporate governance” instead of mass shareholders.

# Incrementalism: Continued decentralization



- Decentralizing movements in advanced socialist countries:
  - Yugoslavia oldest and most advanced decentralization and marketization under self-management.
  - Hungarian goulash communism with enterprise councils
  - Polish Solidarity Movement with self-management councils during 90s.
  - Soviet Perestroika: decentralized enterprises and start of leasing.
- Strategy choice in 1990:
  - continue decentralization all the way to market (Soviet and Polish leasing and "tamed" spontaneous privatizations), or
  - renationalize to “do it right” with voucher privatization according to Western advisors.

# Shock Therapy vs. Incrementalism



- Issue not “fast versus slow”
  - Failed jump over chasm takes long time to climb out of chasm.
  - Incremental change can go quickly (e.g., Polish leasing or Chinese reforms).
- Alternative is Incrementalism: organic change from existing institutions.
- Shock-therapists see incrementalism as building on “evil”—need to wipe slate clean.
- People’s accomplishments under communism seen as points scored during timeout after a foul.

# Political side of shock therapy



- *New "clean" post-socialist revolutionaries*--uninvolved in earlier reforms (Gaidar and Chubais) and thus "untainted" by previous system, and well-connected to Western aid, versus
- *Old "embedded" decentralizing reformers*--who worked within old system to change it by decentralizing power away from State to firms and local authorities (Gorbachev & Co.).
- Voucher privatization as a way for new clean post-socialist to reverse decentralization under socialism and renationalize to then "do it right."
- Jeff Sachs, 1991: "Even if they are all Lee Iaococcas, does it make sense to simply give the country's industry to them [the managers]?"

# Market Bolsheviks



- “Market Bolsheviks” in Russia supported by Western advisors, e.g., Harvard *wunderkinder* (Sachs, Summers, & Shleifer)+ *WB+ IMF+AID*):
  - Old Bolsheviks just had wrong textbooks.
  - Need to wipe slate clean of old evils.
  - Institutional blitzkrieg during window of opportunity
  - “Market economy” will arise from ashes once restrictions are abolished.

# A warning about Bolshevik strategies



- "We have a fearful example in Russia today of the evils of insane and unnecessary haste. The sacrifices and losses of transition will be vastly greater if the pace is forced....For it is of the nature of economic processes to be rooted in time. A rapid transition will involve so much pure destruction of wealth that the new state of affairs will be, at first, far worse than the old, and the grand experiment will be discredited."
- Who had this great insight into Bolshevik strategies?

# A warning about Bolshevik strategies



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- Who had this great insight into Bolshevik strategies?
- John Maynard Keynes, 1933, referring to the original Bolsheviks.

# Why Vouchers Failed: Agency Chains



- Multiple-linked agency chains still difficult after over a century in West, e.g., Enron-type fiascos, and recent banking debacles.
- Voucher privatization expected five agency layers to be installed overnight:
  - Citizen-shareholders
  - Boards of voucher funds
  - Fund management companies
  - Boards of portfolio companies
  - Managers of portfolio companies
  - Middle managers and workers.
- Alternative approach: ‘shrink-wrap’ ownership around primary stakeholders who have to cooperate in order for business to work = Stiglitz’s stakeholder privatization.

# Voucher Investment Funds: “The 0.6% Solution”

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- Voucher funds supposed to "solve" the "corporate governance" problem but the funds had a much worse CG problems than voucherized firms.
  - Fund holds max 30% of company and fund-management company (FMC) gets 2% of value under management, then FMC gets  $2\% \times 30\% = 0.6\%$  of annual income.
  - Therefore tunneling money out backdoor by FMCs which was “big surprise” to Harvard, WB, IMF, and USAID institutional design experts: "It didn't work as planned."
  - The fault lies not with the architects of the absurdly designed chicken coops, but in the rapacious nature of the foxes!

# Why Shock Therapy Failed: De facto Property Rights

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- Over the years, managers and workers build up *de facto* property rights (analogous to an ‘easement’).
  - De Soto in *Mystery of Capital* gives an argument to recognize squatters’ *de facto* property rights.
  - Most Western-advised privatization (e.g., vouchers) only recognized tangible property and deliberately treated people's *de facto* rights as part of the old slate to be wiped clean;
  - Hence people "met the market" not as something to legitimate what little local control and *de facto* property they had, but as something that wiped their slate clean.

# Chinese Incrementalism

## ■ Chinese Pragmatism:

- Crossing the river feeling for the stones.
- Not important whether cat is black or white, as long as it catches the mice.
- See where water flows and when flowing in right direction, channelize so stream swells to river.
- Paving the paths metaphor.
- Institutional innovations: household responsibility system and township-village enterprises.

# Russia versus China transition



- In the first year of shock therapy (1992), Russia's production fell by 19 percent with a further 12 percent and 15 percent in the ensuing two years. It bottomed out at about 50% drop in GDP. (McMillan 2002, *Reinventing the Bazaar*)
- Russia suffered first population decline in modern industrialized country (outside of war).
- From the start of incremental reforms in early 1980s, China averaged 8% per capita growth (McMillan) which has continued (at various rates).
- Rise of China is largest growth episode in human history.

# Bottom Line in Transition Debates



- Communism grew out of 19<sup>th</sup> century attempts to extend engineering successes in natural world to the social world, i.e., social engineering.
- Transition debates show that much of the West's objections to communism was not against social engineering *per se*, but only against using wrong blueprints & wrong textbooks.
- Neoclassical economics used its social scientific prestige (along with economists from elite universities) to socially engineer the transition with the shock therapy strategies.
- "It's not what you don't know that hurts you; it's what you know that ain't so."

"...one of the greatest blunders in world history."



“If McMillan is right that shock therapy was the problem [in his 2002 book *Reinventing the Bazaar*], then the economics profession must accept some of the blame. Our profession lent some of its best and brightest to the transition effort, such as my former colleague Jeffrey Sachs. Most of these advisors pushed Russia to embrace a rapid transition to capitalism. If this was a mistake, as McMillan suggests, its enormity makes it one of the greatest blunders in world history.”  
[Gregory Mankiw, *JEL*, March 2003, 257]



'Nuff said.

The End

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