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# What is Shock Therapy? What Did it Do in Poland and Russia?

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**Abstract:** A prominent theorist of Soviet and East European economics critiques the vision of political and economic processes implicit in shock therapy, defending an alternative, evolutionary approach. The critique of shock therapy rests on both theoretical reasoning and examination of evidence from recent cases. An intensive study of economic change in Poland and Russia since the late-1980s concludes that, in both countries, shock therapy failed in its goal of implementing top-down reforms that by-pass existing political and social forces. The evolutionary approach, it is argued, holds the better prospect of generating economic progress that will be sustained over the long term. *Journal of Economic Literature*, Classification Numbers: E61, L33, P21, P51.

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Apart from considerations of foreign policy, the attention of Russian society was at that time directed with special interest to the internal changes taking place in all departments of government. . . . Meanwhile life—real everyday life, with its essential concerns of health and sickness, labor and rest, and its intellectual preoccupations with thought, science, poetry, music, love, friendship, hatred, passion—went on as usual, independent of and apart from all possible reforms (Lev Tolstoy, 1978, Volume 2, p. 156).

Just four months after the abortive coup that led to the breakup of the Soviet Union, a small group of economists began to implement a program of radical reforms that aimed at irreversibly changing Russian society. These reforms were condoned, if not endorsed, by the International Monetary Fund; they were strongly encouraged, if only weakly aided, by Western governments; and they were promoted, if not designed, by the usual, peripatetic, Western economists. The present paper considers the Russian reforms in the wider context of the ongoing debate in the West concerning the advisability of these so-called shock therapy reforms.

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The first task is to clarify the nature of shock therapy. This term is now common currency for reform programs whose central element is an uncompromisingly radical stance toward existing society.<sup>2</sup> Using the Polish and Russian cases as examples, the paper lays out the essence of these programs, showing their essential coherence and highlighting their primary ingredients. I argue that shock therapy rests upon a consistent approach to promoting economic, political, and social change. It is the vision underlying this approach that one must examine to form a coherent critique.

The critique that follows contains two elements. The first examines the assumptions implicit in the vision underpinning shock therapy, the judgments about the nature of human activity implicit in these assumptions, and the goals of radical reform programs. The worldview of shock therapy is contrasted with an alternative viewpoint, which might be called an evolutionary or organic view of economic processes.

The second prong of the critique examines the reforms in Poland. The reforms of 1990 are the best-known application of shock therapy. To some observers, they were very successful: admiration of the Polish reforms was apparently an important ingredient in the calculus of the Russian reformers. Analysis of the Polish case is therefore crucial in considering the productivity of shock therapy for post-socialist reforms. I argue that Poland has advanced far in the reform process, but that there is little reason to believe that shock therapy was the primary force behind that advance.

The paper closes with an examination of economic events in Russia in 1992. I show that, as in Poland, shock therapy failed in its primary objective of producing a sequence of top-down policy changes that neutralizes and by-passes the existing political and social forces dominant in economic matters. In both cases, society vanquished the shock therapists. But in Russia, shock therapy left the country in a much more parlous state. The core group of Russian reformers was more intent than were the Poles on destruction of the existing system at whatever cost. In Poland, there was much in society that the shock therapists were willing to use as building blocks for reform during this primarily destructive phase. This was not the case in Russia. Hence, after the initial, primarily destructive, burst of shock therapy had accelerated the breakdown of the mechanisms of government that had begun in the Gorbachev years, there was much less on which to build a recovery. The economic foundation stones for sustained economic progress in Russia are far from being in place.

## WHAT IS SHOCK THERAPY?

"Ugh, those advisers, those advisers!" he said. "If we had listened to them we would still be in Turkey: we should not have made peace,

and the war would never be over. Always in haste, and the more haste the less speed . . ." (Tolstoy, 1978, Volume 3, p. 178).

To identify the essence of the radical approach, I rely primarily on an examination of the views of shock therapy's most untiring advocates, David Lipton and Jeffrey Sachs, particularly focusing upon the early, straightforward statements of their viewpoint (Lipton and Sachs, 1990a, 1990b). Written when the general enthusiasm for shock therapy was high, these papers are the most candid presentation of the major features of radical programs and of the analysis underlying them.

Lipton and Sachs (1990a, p. 75) begin with the goal of reforms—the creation of an economic system comparable to those of Western Europe. Their discussion does not examine existing institutional structures and how to change them to reach the goal, but rather focuses on the ways, the methods, and the strategies to replace these structures entirely. There is complete disdain for all that exists, exemplified by the blanket claim that "no rationality existed in Russia's international trade pattern" (Lipton and Sachs, 1992, p. 240).<sup>3</sup> History, society, and the economics of present institutions are all minor issues in choosing a reform program.<sup>4</sup>

Given that existing structures are the problem, society must be side-stepped in the reform process. The over-riding strategic objective is to take decisive steps to ensure that existing structures and interests cannot derail reform. Politics is paramount; economic calculus and immediate economic effects are secondary.<sup>5</sup> "The economic strategy must take cognizance of the political context, which in our view argues *overwhelmingly* for a very rapid, straightforward, and sharp program of economic reform" (Lipton and Sachs, 1990a, p. 87, emphasis added). By moving costs to the beginning, radical reformers are able to implement policies before existing interests become mobilized to react. The reformers are viewed as acting on behalf of the social forces that will emerge as a consequence of reforms.<sup>6</sup>

Even though the main aim of shock therapy is to brandish the invisible sword of political revolution, rather than to grasp the invisible hand of

<sup>3</sup>Compare for example, Hewett (1983, p. 269): "[W]hile it is no doubt accurate for many Western economists (including myself) to characterize the institutions that manage Soviet foreign trade transactions as cumbersome, antiquated, and prone to discourage trade, it is equally true that, while the Soviet Union relied on those institutions over the last several decades, its foreign sector turned in a quite credible performance."

<sup>4</sup>The emphasis on the foreign language capabilities of the small group of Russian reform economists (Ellman, 1992, p. 49) is therefore not at all curious but consistent.

<sup>5</sup>Confirmation that this was the theoretical view of the Russian reformers can be found in Institute (1993), a report written collectively by members of the Institute, many of whom served in influential positions in the Russian government in 1992.

<sup>6</sup>This strategic conception has been offered as a justification for Polish and Russian shock therapy programs by Sachs (1991, p. 42) and by Gaydar (1993).

efficiency, this strategy could hardly be advocated if it was thought that the immediate economic results would be disastrous. But this is not the case. With the disdain for all that exists comes the supposition that living standards will rise quickly. Hence, there is emphasis on the short-term efficiency gains flowing from macroeconomic stabilization (Lipton and Sachs, 1990a, pp. 89–99). For Russia, "enormous scope exists for increases in average living standards within a few years" (Lipton and Sachs, 1992, p. 214).

Implicit in this view is an assumption that the institutional changes necessary for short-term gains can be quickly accomplished. For example, the Gaydar program was said to contain all the essential elements necessary for rapid transition to the market.<sup>7</sup> Establishment of a market economy is seen as mostly involving destruction. Where institutional construction is needed, shock therapists assume that technocratic solutions are fairly easy to implement, even in an environment in which "All the vehicles of macroeconomic policy must be constructed more or less anew, reconstituting the Central Bank and the Ministry of Finance, as well as payment mechanisms and tax collection systems."<sup>8</sup> Thus, despite the fact that "The monetary problems in Russia are perhaps the most complex in world history" (Lipton and Sachs, 1992, p. 261), the issues of greatest importance can be solved within half a year (Sachs and Lipton, 1992, p. 1).

The optimism on institutional construction is necessary because the logic of a radical program requires the implementation of a long interdependent sequence of measures. In the case of Poland, Lipton and Sachs (1990a, pp. 99–103) cite as most significant the following: fiscal and monetary austerity; a convertible currency; deregulation of prices; demonopolization of the state sector; the removal of all barriers to international trade; full liberalization of the private sector; the creation of new rules for the regulation of state enterprises; tax reform; institution of unemployment insurance and job retraining schemes; credit allocation to individuals to start small businesses; and privatization. There are also legal changes, such as the seven thousand separate acts for Poland to coordinate legislation with that of the European Economic Community.

The most difficult and complex measure is privatization (Lipton and Sachs, 1990a, p. 101). It is also the measure in which the colors of radical reform are seen most vividly. The whole program of reform is contingent on "massive and rapid privatization" because "the government is in a race against time" and unless privatization occurs "quickly and on a vast scale" earlier economic gains will be lost (Sachs, 1991, pp. 40–41). The radical program is then marked by the programmatic nature of the sequence of changes envisaged at the beginning, with the steps contingent upon each

other. This characteristic would surely earn for radical reforms Popper's (1971, ch. 9) label of Utopian Social Engineering.

Privatization begins by rejecting all existing ownership claims (Lipton and Sachs, 1990a, p. 128). This follows from the imperative of basing even the earliest strategic moves on immediate implementation of measures that are ultimate goals. One must reject all existing arrangements:

Shifting to a Western European ownership structure will of course require that enterprise governance be removed from the workers councils and managers and placed squarely in a supervisory board (or board of directors) controlled by the owners of the enterprise. In essence, privatization of the enterprises requires first that ownership rights, now vested in the enterprises, and particularly in the workers councils, must be eliminated . . . (Lipton and Sachs, 1990b, p. 308).

Similarly on the political level, the objective within Poland's privatization process was to by-pass both the politicians and the labor unions, precisely the agents of change that had brought the country to the point at which radical reform was possible.

Instead, privatization is ideally to be implemented *via* a team of technocrats. Bargaining and negotiation among members of society—the traditional processes of market democracy—are to be avoided (Lipton and Sachs, 1990b, pp. 298–299). Consequently, privatization will require the wholesale construction of large new institutions, such as financial intermediaries. But the institutional optimism shines through: the goal is to complete the major portion of privatization within four years (Lipton and Sachs, 1990b, p. 327).<sup>9</sup>

To summarize, shock therapy is nothing less than a revolutionary strategy for the complete reconstruction of the economic arrangements of a country. With the goal treated as unattainable unless revolutionary changes are implemented immediately, existing arrangements only require attention insofar as they present roadblocks. With existing structures defined as the problem, political considerations become dominant when formulating economic strategy. If implemented quickly, formal measures created by visionary leaders and their technocrats will fundamentally change the characteristics of society. This top-down policy is considered viable because the knowledge of how to create market institutions is viewed as readily available and easily implemented.

<sup>7</sup>According to Sachs, as quoted in the *Financial Times*, December 13, 1991.

<sup>8</sup>The quote is from an adviser to the 1992 Russian government, Åslund (1992a, p. 3), who also offered the view on the primacy of destruction.

<sup>9</sup>In response to the experience of shock therapy in Eastern Europe, some of these theorists have softened their attitude toward existing enterprise stakeholders. According to one of the advisers to the Russian reform team, stakeholders now need to be "appeased, bribed, or disenfranchised" (Shleifer and Vishny, 1992, p. 2). However, this cannot be interpreted as a rethinking of the philosophy of radical reform. Existing society is only appeased, not used as an agent of reform.

## SHOCK THERAPY AND EVOLUTION: AN EXAMPLE OF A RECURRING DICHOTOMY

For investigation of the laws of history, we must entirely change the subject of our observations, must let kings, ministers and generals alone, and study the common, infinitesimally small elements that influence the masses. No one can say how far it is possible to advance in this way toward an understanding of the laws of history; but it is obvious that only in that direction lies any possibility of discovering history's laws (Tolstoy, 1978, Vol. 3, p. 274).

Thus, shock therapy provides a coherent strategy for the promotion of economic, social, and political change. This strategy rests as much on views of society and change, as on fundamental lessons of economics. To formulate a critique, one must examine these views. What is at issue is the persuasiveness of shock therapy's implicit assumptions about the nature of society, polity, and economy, and the appropriateness of those assumptions to post-socialist reforms.

There is no precise set of assumptions that forms the vision of each and every advocate of shock therapy. Rather, there are many viewpoints, all sharing many common elements. One such viewpoint is presented below. Just as shock therapy's vision varies among proponents, no single alternative to shock therapy's assumptions provides the standard counterpoint. Many could be used, each sharing some common ground.<sup>10</sup> Using ideas that seem particularly common in the literature on reforms, this essay fashions one such alternative, which I call an evolutionary or organic view of society.<sup>11</sup>

At its core, the present paper reflects the judgment that the divide between radicals and evolutionists is not simply a matter of technical judgments about narrow economic issues. Rather, that divide reflects fundamental disagreements about the way human societies function, differences in judgments on matters of politics, psychology, and society, as well as economics. Indeed, the fact that the Polish and Russian reform programs were primarily a product of local policy-makers demonstrates that these programs derived from a philosophical stance that is nourished by more than the latest fashion in Western economics.

Viewed in this way, it is easy to see that the present dichotomy between shock therapy and evolution echoes others throughout history. There are

<sup>10</sup>For a discussion of the sense in which the contrast between two very general worldviews can be productive, see Berlin's (1970, p. 2) elucidation of a feature of Tolstoy's thought that has much relevance here.

<sup>11</sup>I make no claim to originality for the position presented. But it is unwise to associate the argument with any particular scholar; even the words "evolutionary" and "organic" are disputed by members of this collection of scholars. For examples of relevant works, see Bolton and Roland (1992), McKinnon (1992), Kornai (1990), Poznanski (1992), Leijonhufvud (1993) and Murrell (1992a, 1992b, 1992c).

the Platonic and Aristotelian views of knowledge, the revolutionary implications of Rousseau contrasted to Burke's conservatism, the teleologists and geneticists in the Soviet 1920's, and Popper's utopian versus piecemeal social engineers. Shock therapy fits more comfortably with Plato, Rousseau, and Preobrazhensky; the evolutionary view lies with Aristotle, Burke, and Kondratiev. Thus, radical and organic views are modern economic variants of wider, older traditions.<sup>12</sup> However, this is not the place to review these debates and lay bare their common core, but rather to refresh them in the light of yet another episode in history to which they seem so relevant.

## SOME POINTS OF DEBATE

"One would have thought there were enough writers about," said the old Prince. "In Petersburg they do nothing but write—and not only notes, they keep writing new laws. My Andrey up there has written a whole volume of new laws for Russia" (Tolstoy, 1978, Vol. 2, p. 310).

Let me now specify differences between the approach of shock therapists and that of evolutionists. Of necessity, my statements of the positions are brief and stylized, indicating two points within a multi-dimensional space. As with all simple dichotomies, the question is one of relative stance rather than commitment to an absolute. The views of the two sides are presented in sequence in the ensuing sub-sections. Both presentations address a common set of themes: the nature of the economic agent; the capacities of technocrats; the essence of capitalism; the direction of the causal link between the structure of society and formal law; the choice and interpretation of historical examples of reform; judgments about the progress of reform.<sup>13</sup> Following these presentations, I address the contrasting implications for reform strategies of the two viewpoints.

### The Vision of the Shock Therapist

The behavior of individuals and organizations is a product of the current incentives presented by society. It is a reasonable approximation to use the informed-rational-actor model to analyze the behavior of both economic and political actors during reforms. Therefore, the problems that should most concern reformers are ones of present incentives and interests, rather than of the historical process that has shaped existing economic agents and the institutions they use. With correct incentives in place, it is

<sup>12</sup>Consider, for example, British debates concerning the rule of colonial India. The Bengal and Madras administrations represented the two sides of the dichotomy between radical and organic prescriptions for colonial rule. It is truly startling how many parallels exist between those old debates and the present ones on post-socialist reforms (see Stokes, 1959).

<sup>13</sup>Thus, portions of each section could be read in parallel with each other.

reasonable to postulate that the behavior of economic agents will be prompt and rational, functional for the new system that is being created.

This view of the nature of economic agents applies especially to the technocrat who designs reforms. Economic laws are universal and well understood and the technocrat faces little difficulty in knowing how to design and construct new institutions. With its universality, the plan of reform resembles the Platonic absolute ideal. The main problems of implementation arise from opposed interests. Then, the exemplary reformer is the person of technical prowess standing outside society, untainted by historical prejudices and present commitments. This is the politics of rationalism, as described by Oakeshott (1962), with its disdain for the usefulness of the practical knowledge that can only be derived from experience.

The task of the technocrat is made that much easier because the nature of successful economies can be easily described. At its essence, capitalism can be viewed as a laissez-faire economy within a secure system of property rights and an environment of monetary stability. Standard results of economic theory provide important insights for understanding capitalism's effectiveness and for defining the tasks of reform. The theorems of welfare economics show the relationship between competitive markets and static efficiency. From these comes the emphasis on immediate decentralization. The Coase theorem stresses that, while secure property rights are important to economic efficiency, the allocation of property rights can nevertheless be arbitrary. Thus, for the purpose of building an efficient economic order, any perceived customary property rights can be disregarded.

With the belief that the technocrat has precise knowledge of how to construct successful economic institutions, there is also the assumption that the technocrat's creations will have a powerful and salutary influence. Formal structures—new institutions, new laws, or credible policies—are powerful and immediate agents of change, even when created by a policy-making elite removed from society. Hence, laws and institutions can be transferred from one domain to another, quickly and productively, even when their nature is essentially alien, given the history of the society to which they are being applied. The involvement of society in the creation of these formal structures is not necessary for their effectiveness. Indeed, given that the key problems of reform are the opposing political interests, such involvement is a distinct disadvantage.

Important insights into the essential elements of reform come from examining why reformers in pre-1989 Eastern Europe were unable to succeed in changing the essential characteristics of their economies. According to shock therapists, the failure of reform was a failure of piecemeal reforms. Such reforms are always thwarted because they allow existing economic forces time to organize to block changes detrimental to their interests. Moreover, the old central planning system is such an interconnected whole that attack on all fronts is necessary to ensure its demise. Speed and scope must be maximized in a strategy that aims at achieving a set of self-sustaining reforms.

In this respect, the Latin American experience of the 1980's is enormously instructive for the shock therapist advising the post-socialist countries. Vital economic reforms were blocked by narrow economic interests and populist politicians. The post-socialist countries, with their dominant state sectors, are fraught with the danger of repeating this experience. In contrast to Latin American experience, the West German monetary reform of 1948 shows just how much can be achieved by a shock process implemented by a strong government. Indeed, the post-war successes of the West German and Japanese economies speak to the possibilities of major economic reconstructions that are driven by the importation of institutions from abroad. In contrast, the economic experience of China is of little relevance because of the dominance of agriculture, because of its relative economic backwardness, and because its political situation is at such variance with that in Eastern Europe and the former Soviet Union.

The mark of progress in reform lies therefore in the implementation of measures that break the existing fusion of structures of economic and political power. Politico-economic models of democracies suggest that there is a "window of opportunity" during which forces of resistance to change can be side-stepped and reforms implemented by technocrats. The nature of these reforms is well known and the essentials would not vary widely between countries. At their center is the quick conversion of the state sector into a decentralized, market sector, through swift and comprehensive policy changes that give shock therapy its name. This is necessarily followed as soon as possible by forced privatization. The slowing of this top-down privatization process is to be regarded as evidence of the stalling of reforms, or perhaps even their failure.

### An Alternative: The Evolutionary Viewpoint

On almost all points noted above, the viewpoint of evolutionists is substantially opposed to that of the shock therapist. The behavior of economic agents, according to the evolutionist, is a product both of present incentives and of the historical and social processes that have shaped these agents. Since this is especially so for perceptions of the world and for information acquisition, problems of incomplete information and of learning are especially important in times of great change. Any vision of how change might best be accomplished must take into account the fact that economic agents accumulate knowledge in a learning-by-doing process that is shaped by their historical experience. The perceptions and the knowledge gained by economic agents through participation in an economy is a determinant of both the character of an economic system and the performance of the economy.

An economic system is a product of history and society. Although the image portrayed by the economist's welfare theorems provides important insights into the functioning of markets, the power of that image pales in comparison to the vividness of the variety of arrangements that are

present in functioning capitalist economies. That image, which is useful in understanding why capitalist markets should be the goal, provides no information about how real capitalisms are built. In fact, the institutional matrix at the heart of any successful system is produced slowly in an idiosyncratic, contingent process. That matrix is deeply intertwined with the social system in which it is embedded and is dependent on informal constraints arising from the cultural transmission of values (North, 1990, pp. 36–44, 137). The enforcement of property rights and the implementation of policy are thus to be understood in their broader social and cultural context (North, 1990; Kornai, 1990).

The historical contingency underlying the genesis of any economic system implies that the institutional needs of the economy's participants cannot be known *a priori*, but are a product of circumstance. Over the short and medium term, these needs might be very different from those of the imagined economic agents that will exist after reforms are complete. Therefore, it is important not to undervalue the existing practical knowledge possessed by economic agents, even if it has been acquired within a system now undergoing reform.<sup>14</sup> Because of the persistence implied by the dual dependence between the stock of information and system properties, this knowledge will be as important as the technocratic knowledge of the institutions of the imagined goal of reforms. Therefore, the knowledge of the technocrat is just one input into reform and the capacities of the technocrat must not be exaggerated: "It is not reasonable to assume that a complete reconstruction of our social system would lead at once to a workable system" (Popper, 1971, pp. 167–8).

This raises the question of whether an economy can be effectively reformed through top-down changes devised by an elite. On the contrary, formal policies will be most effective if they are a product of the deeper informal structures of society. Law can be a powerful tool, but only if it is created by society rather than imposed upon it. Formal structure can be constructed and enacted and laws can be transplanted, but the effect is primarily in the long run and not necessarily predictable. Thus, "[P]ublic opinion usually causes constitutional structure, and seldom, if ever, the other way round" (Riker, 1976, p. 13).

From this perspective, the primary lesson of the socialist era was that the centrally planned system was a product of a philosophy that supported a theory-driven, top-down, radical reconstruction of economy and society. The aim of the Marxist revolutionaries was to side-step society, because of the supposed corrupting influence of false-consciousness that lay within.

<sup>14</sup>The term practical knowledge is used in the sense of Oakeshott (1962) and of Polanyi's (1962) personal knowledge.

Later, the failure of piecemeal reforms was due to the limitations of policies both designed at the top and imposed by the top. Had these piecemeal reforms responded to real social interests, rather than being constructed within and constrained by a closed political system, capitalism would have been created. When shock therapists cite the failure of communist piecemeal reforms to argue that high-speed, top-down reforms are necessary, there is a fatal flaw in their logic. This argument disregards the fundamental changes in conditions, once the old political system has vanished: the energizing effects of democracy; the involvement of society in the present reforms; and the lessons being taught on every street corner by the vibrancy of the new private sector.<sup>15</sup>

With democracy as an essential element of reform, some of the most important lessons for reformers must surely come from the policy process in the most successful democratic market economies. In these countries, the policy process is always gradualist and piecemeal and always includes the deep involvement of affected members of society. This process is the science of muddling through, with technocrats offering important insights, rather than the science of system-design by technocrats.

If lessons do lie in Latin America, they hardly establish the effectiveness of shock therapy, since that continent is still struggling with reform.<sup>16</sup> Moreover, it is plausible that China's experience is relevant, given the starting point of a socialist economy. Of course, China's reforms cannot be imitated. However, there are important lessons therefrom. One of these is that a pragmatic process of institutional creation is viable, if based on elements of the old and the new, with policy-makers responding to real, immediate needs rather than imagined long-term ones.<sup>17</sup> In addition, China shows the importance of reforms initiated from below, the growth of a flourishing capitalism without privatization of the state sector, and the effect of the new capitalists on the old state sector, first in providing important inputs and then, by example and by competition, ensuring that the state sector must reform.

From the evolutionary perspective, the progress of reform is not to be judged by the simple criterion of how many formal measures are introduced and how many businesses are nominally privatized. The massive changes that are needed are inevitable given the deep internal forces for change within society (Kornai, 1993). The question then is how productive government can be in forcing changes. The economy cannot be shocked

<sup>15</sup>The inevitability of economic change, once the political changes have occurred, is an important theme in Kornai (1993).

<sup>16</sup>Turning to the other favorite example of the shock therapists, the 1948 German reforms were not of the order of the shock advocated for the post-socialist countries; previous changes in society had prepared the ground (Dahrendorf, 1969) and the reforms were much more gradualist than is acknowledged by the shock therapists. The elements of continuity in the pre- and post-war Japanese and German economies are to be stressed.

<sup>17</sup>In China, despite the absence of democracy and political freedoms, there was a real sense in which reformers were reacting to both the economic needs of society and the economic lessons generated by society. The paradox then is that the involvement of society in China's economic reforms was more than that envisaged by the shock therapists for the new democracies of the ex-Soviet bloc.

into new behavior, but rather will be changed by forces deep within society. Institutional change is an intrinsically slow process, highly dependent on circumstance, and efficient only if it responds to real economic needs. Therefore, one should be careful not to attribute too much importance to either the absence of formal changes in the beginning of reforms or to their not matching some ideal type. The deep involvement of society in the reform process is not evidence of the end of reform; indeed, it can be a criterion of success. An essential sign of progress is the rise of activity in the new private sector, the most dependable mechanism to produce the human resources that will make a productive transition to capitalism.

### Contrasting Implications for Reform

The shock therapist stresses immediate creation of a set of institutions modeled on those envisaged for the goal of reforms, lest the chance be lost forever. From the evolutionary viewpoint, the efficient profile of institutions depends critically on the historical process through which the economy has passed. Thus, the difference between the two perspectives lies not in views of what is a desirable endpoint for reforms but rather in the significance attached to the details of the imagined endpoint for the immediate tasks to be undertaken. For example, while a shock therapist emphasizes immediate economy-wide liberalization, the evolutionist might suggest a dual economy during the early years of transition (Kornai, 1990; Murrell, 1992c). The institutional arrangements and the macroeconomic instruments of control will be temporarily different for the state and private sectors, reflecting requirements determined by the historical development of these sectors (McKinnon, 1992).

With the shock therapist's view of prompt and rational conduct, decentralization and privatization of the state sector lead to immediate benefits as incentives improve. However, these benefits are less likely to be immediately significant to the degree that organizational behavior is a product of history. Thus, eighteen months after shock therapy in Poland, Pinto *et. al.* (1992, p. 1) concluded that ". . . the Polish economy is in deep crisis traceable to the state-owned enterprise sector. . . . Enterprises have reputedly failed to adjust . . ."<sup>18</sup> Thus, there is the likelihood of a costly mismatch between new, hastily created institutions of economic control based on some imported blueprint and the historically derived behavior of economic entities.<sup>19</sup>

There follows a difference in relative concern over the dislocating effects of change. To the radicals, subjecting enterprises to the largest possible

<sup>18</sup>Institute (1993, p. 29) saw Russian firms in 1992 as behaving in traditional ways. One of the major research topics in coming years will be the issue of the actual speed and size of enterprise adjustment. The argument here, seemingly verified by the quotation in the text, is that near-term adjustment is likely to be small, and that this will affect the productivity of macro policies that are based on the assumption of automatic enterprise adjustment.

<sup>19</sup>The interenterprise debt problem is one example of this phenomenon. See Ickes and Ryterman (1992) and Institute (1993).

profile of policy changes leads to a quicker realization of present incentives, with consequent salutary behavior. If such realization comes more slowly, the likelihood of economic collapse produced by institutional shock (e.g., a precipitate trade opening, an abrupt withdrawal of subsidies, etc.) is a threat (McKinnon, 1992; Murrell, 1992a).<sup>20</sup> Because society and economy are deeply intertwined, such collapse can impinge on the development of the economic mechanism in profound ways, as Hayek (1944, p. 209, fn 2) emphasized in a different context: ". . . however much one may wish a speedy return to a free economy, this cannot mean the removal at one stroke of most of the wartime restrictions. Nothing would discredit the system of free enterprise more than the acute, though probably short-lived, dislocation and instability that such an attempt would produce."<sup>21</sup>

Differing conceptions of the capacities of the technocrat are important determinants of the differing views on the productivity of implementing wholesale changes at a stroke. To the shock therapist, the technocrat has the knowledge to accomplish effective implementation of large-scale institutional changes. There is faith in the workability of rapid, large-scale schemes of privatization, which offer the crucial advantage of side-stepping existing interests and social structures. For the evolutionist, skepticism concerning the power of the technocrats' knowledge leads to emphasis of the possibility of large costs arising from unforeseen problems in the implementation of theoretical abstractions.<sup>22</sup> Such schemes weight too heavily the technocrat's knowledge and denigrate the decentralized knowledge that has been accumulated through experience. Decentralized processes of privatization are crucial in facilitating the matching and selection that are central to the operation of the market. Since such processes require the input of true market agents, rushed privatization might be a disadvantage, pending the growth of the new private sector. A synthetic market using vouchers is no substitute.<sup>23</sup>

Differences in views on the location of society's useful knowledge—concentrated in the narrow body of technocrats or decentralized—also account for differing perceptions of the costs and benefits of the involvement of society in the reform process. To some, such involvement implies the poisoning of policy by inappropriate interests and incorrect learning. Åslund (1992b, p. 41), one of the Russian government's foreign economic

<sup>20</sup>Such concerns motivated the abortive Yavlinsky plan to preserve trade between the republics. It is surely no coincidence that Yavlinsky is one of the severest critics of the Gaydar program.

<sup>21</sup>It is not only this quotation that would lead one to see an affinity between Hayek's views and those ascribed to the evolutionist school here. For example, Hayek's view of the capacities of the technocrat would surely lead him to label the radical schemes as "constructivism."

<sup>22</sup>Shock therapists often cite privatization in Czechoslovakia as an example of the success of such schemes. It is, however, a bit premature to make such a judgment. The problems in the Chilean privatization of the mid-1970's appeared six years later, but then on an immense scale and directly due to the design of the privatization scheme. In the Czech Republic, the effects of the privatization scheme are only beginning to appear.

<sup>23</sup>See Bolton and Roland (1992) for a detailed criticism of the large-scale, voucher-based privatizations and for suggestions of decentralized alternatives that are driven by ideas similar to those presented here.

advisers, suggests that ex-Soviet professionals cannot have a place among the reformers.<sup>24</sup>

In contrast, one might argue that successful institutional reform must reflect the demands of the economic agents whom the institutions serve, implying the involvement of these agents in signaling their demands. Because institutional reform is inevitably a long process and inevitably involves changing, rather than destroying, many of the old institutions, the knowledge acquired from participation in the old system is valuable in producing workable changes. Thus, Leijonhufvud (1993, p. 13) suggests that one should not downplay the knowledge possessed by the much-maligned enterprise managers of the former Soviet Union.

The advocacy of shock therapy also emanates from the assumption that effective new institutions can be created by a formal process that is relatively independent of society. However, in the evolutionary view, the economy's formal institutions must be supported by informal structures. Informal constraints change more slowly than formal rules and there can be tension between the two (North, 1990, p. 87). Since these informal constraints are essential to the functioning of any economic system, an attempt to bypass them and establish an antagonistic set of formal institutions might be highly counter-productive.

An example lies in the forced reassignment of property rights in the face of existing claims arising from inherited social perceptions. To the believer in the power of formal law, the costs of negating such claims are small. But if the effectiveness of law is dependent on informal arrangements and understandings, the security of property rights is a product of the expectations and beliefs of society. The attempt to negate customary property rights produces conflict between the formal rights decreed by the state and the understandings of society, bringing into question the legitimacy of those formal rights, and slowing the development of an efficient property rights system.

The evolutionist therefore recognizes the constraints of public opinion and the powers and limitations of society's knowledge. Given that informal structures support formal policies, society's knowledge and perceptions of its own structures cannot be dismissed. In this case, there is a trade-off between the best formal rules and those that society is able to use and to support. There is a real problem of matching reforms to existing conditions.<sup>25</sup> This is exactly why reforms aiming at the immediate imposition of the imagined endpoint will fail, since their object is to sidestep society, the very structure that must ultimately support policy.

Given that the productivity of top-down, constructed change is in doubt, change might proceed faster by encouraging the development of

<sup>24</sup>To wonder where this leaves Yeltsin and Gaydar in the whole process is presumably to confront a coherent theory with a trifling quibble.

<sup>25</sup>This has important implications for the degree of specificity that should be embodied in reform proposals advocated by outsiders. See the comments below that close this section.

capitalism from the bottom up. Murrell and Wang (1993) embody this idea in a formal model of the sequencing of reforms. At the beginning, society concentrates its resources on the new capitalist sector, eschewing attempts to change the old state sector. This initial phase facilitates the speediest generation of the human and social resources that are needed to create the institutional environment for a productive market economy in the long run. When this new capitalist sector is large enough, it will be the engine of revolution. The human and financial resources that it produces can be used to reform, and privatize, the old state sector. The social changes that this sector brings about will enable privatization of the state sector to be more productive than if it were the first element of transition.

There lies herein a positive message on how change can be most effectively promoted. The development of open political systems and the rise of the private sector are revivifying forces. With secure and efficient change requiring the involvement of society, policy-makers can at least influence the productivity of this involvement. Then, reform of the state sector proceeds not through costly experimentation, but by increasing contestation within the system and by increasing the volume of private sector resources that are available to change the state sector.<sup>26</sup>

For a simple reason, the above remarks on contrasting implications for reform have been deliberately general. An evolutionary philosophy argues that the details of reforms must be highly dependent on the specific nature of the country in question. To argue that the plan of reform is essentially the same in every country is to ignore the element of historical contingency that must be present in every large-scale process of social change.

This is not to deny that crucial economic lessons of a more universal character are available. Economics has much to offer in understanding the nature of economic processes and the effectiveness of different policy options. Moreover, a shock therapist and an evolutionist are unlikely to differ in any predictable ways on many of these lessons, such as, for example, the benefits of more open trade and the problems arising from budget imbalances. But as powerful as these insights might be, they are broad lessons, rather than instructions on the strategy of political, social, and economic change that can be passed to a reforming elite.<sup>27</sup>

## WHAT DID HAPPEN IN POLAND?

The words, the form of the order, were by no means the same when they reached the farthest links in the chain. The accounts passing

<sup>26</sup>Murrell (1992a) examines at length the reasons why there is trade-off in reform policy between immediate shock reforms of the state sector and the development of the new private sector. The possibility of this trade-off seems to be denied within the shock therapy approach.

<sup>27</sup>Thus, Burke eschewed the offering of advice in another revolutionary context (see Hoffman and Levack, 1949, p. 382): "Sir, the proposition of plans without an attention to circumstances is the very cause of all your misfortunes; and never shall you find me aggravating, by the infusion of any speculation of mine, the evils that have arisen from the speculation of others."

from person to person in the various units did not resemble what Kutuzov had said, but the sense of his words spread everywhere, because what he said was not the result of shrewd calculation but of a feeling that lay deep in the soul of the Commander in Chief, as it did in the soul of every Russian (Tolstoy, 1978, Volume 3, p. 255).

There is now increasing optimism in the West concerning the Polish economy. Moreover, Polish shock therapy had a significant influence on the Russian reformers. Thus, it is important to understand the development of reforms in Poland. It is the Polish reforms that are likely to give us the best evidence to date of what happens when shock therapy is applied.

I argue that Poland's "big-bang" of January 1990 was a departure from a progression of reforms and that gradually policy returned to its natural path in the ensuing months. Society took back the reforms from the shock therapists. Thus, Polish developments do not speak to the success of the shock therapy model, but rather show that this model is not implementable over the long haul. To make this case, I distinguish four separate phases of Poland's economic reforms.<sup>28</sup>

## The End of Communism

After the debacle of the early 1980's and the half-hearted reforms that followed, Poland began to experiment with significant reforms in the last years of the decade.<sup>29</sup> The proportion of inputs allocated by the state distribution system was down to 45 percent in 1986 and then 22 percent in 1988. By 1987, "liberalization" was beginning to replace "decentralization" as a way of describing policy. The private share of employment was rising and had reached 33 percent by 1989.

Contacts with the outside world had also multiplied. From 1986 to 1989, exports to the developed West increased by 50 percent. In the 1980s, Poland had an active involvement with the multilateral financial institutions. There were many opportunities for international contacts for the professionals who would eventually participate in economic reforms. By 1988, a new law on joint ventures was passed, a liberal one by the standards of the region. Eventually, the black market in currency was effectively legalized and hard currency auctions were held, in which state enterprises could participate.

<sup>28</sup>See Poznanski (1992) for an interpretation of Polish reforms that is similar in spirit.

<sup>29</sup>It would be too cumbersome to reference separately each fact stated in the following sections. Among the sources are Coricelli and Rocha (1990), Gomulka (1991a, 1991b), Johnson and Kowalska (1993), Olsewski et. al. (1991), and Slay (1993a, 1993b), as well as publications of multilateral agencies, the standard current informational sources, and personal interviews conducted by the author.

With the further weakening of the Communist regime, reforms accelerated in 1988 and 1989. A series of measures was undertaken, which became vital stepping stones to deeper reforms when Solidarity came to power. Perhaps the most significant measure was enacted at the end of 1988, when legislation established the right of all ownership forms to compete equally in all activities. This set the stage for the burgeoning development of small business that has been the most important element of Poland's economic development to date. Privatization became legal, unfortunately coming into disrepute due to misuse by the *nomenklatura*. The most basic change in banking, the creation of a two-tier banking system, occurred in early 1989. By mid-1989, 60 percent of prices were freed and wage fund regulation was scrapped in favor of a tax based scheme.

The point to be made here is certainly not that the communists were reforming eagerly. They presented a huge obstacle to effective reform. However, with the communists gradually losing control, they faced an increasing need to react to demands from below. Once government policy began to reflect views other than those of the Party, reforms were proceeding apace. Thus, a strong commitment to economic reforms became cemented in the Round Table agreements of early 1989, which laid out a gradualist program reflecting the deep divisions within society, not only between opposition and government, but also within the opposition.

## The First Days of Solidarity

During the major part of the 1980's, the budget deficit was kept at moderate levels. However, 1989 was an exception. The last communist government's lack of will, the effects of liberalization of prices without removing subsidies, and the impact of inflation on tax collections resulted in a deficit running at 7 percent of GDP when Solidarity took power. Given the deficit's monetization and the recent price decontrols, inflation was a dominant concern.

The new Solidarity government, apparently contrary to the Round Table agreement, accepted a quite radical plan of attack. But implementation required preparation. Therefore, the last quarter of 1989 was spent pursuing what can be viewed in retrospect as a successful, brief, and truncated phase of evolutionary reforms.

The budget was brought into near balance, monetary policy was tightened, and the tax on wage increases was raised. Liberalization of the economy proceeded, with the private share of non-agricultural employment nearly doubling in 1989. Exchange controls were loosened and auction markets for foreign currency expanded. Successive devaluations reduced the black market premium on the dollar to 40 percent from an average of 400 percent earlier in the year. More prices were decontrolled and a needed correction in energy prices occurred.

This phase of policy was soon concluded, and only a cautious interpretation is possible. There were signs that inflation was slowing. Measured real

wages in the last quarter of 1989 were below those of the equivalent period of 1988. Industrial production was higher in the fourth quarter than in the third, and the downturn in economic activity had apparently been arrested. However, given lags in data collection and given that the fuse of shock therapy had already been lit in September, there was no chance that reflective consideration of the economic events could have stopped the "big bang."

## The Shock

The program implemented in January 1990 comprised a number of related measures, each of which would have individually contributed a significant shock. Fiscal policy was tightened considerably, the first quarter of 1990 producing a sizeable budget surplus. The real value of the money supply was halved; tight limits were placed on credit, accompanied by a rise in the monthly discount rate from 7 percent to 36 percent. Trade liberalization swept away almost all restrictions, giving Poland an extremely liberal trade regime compared both to its past and to world standards. The anti-inflation wage tax was set at draconian levels. The government made a commitment to privatization on a massive scale.<sup>30</sup>

The real effects of these measures have been much debated. Some critics note a nearly 30 percent drop in industrial production. In contrast, shock therapy's most enthusiastic proponents claim that per capita well-being did not fall, citing gains in allocative efficiency and unrecorded developments in the new private sector.

In fact the private sector did not fare well in the period of the shock. Using survey evidence, Webster (1992, p. 56) concluded that: "... in the short run, full trade liberalization—designed to integrate Poland into world markets in one giant step and specifically to force efficiency gains in the state sector—may have been more effective in undercutting the fledgling private manufacturing sector than in prompting the state sector to restructure." By ignoring the trade-off between reforming the old and encouraging the new, which is at the center of the evolutionary model, the shock therapists' pursuit of speed might have paradoxically slowed the pace of change. The new private sector, the engine of growth after reforms, was temporarily slowed by the abortive attempt to produce quick change in the state sector.

It is certainly the case that the shock therapy program was perceived in Poland as extremely costly. In the first half of the year, the program held,

but did not advance. Solidarity and the Catholic Church did much to still dissent at the grass-roots level, blunting the force of political opposition to the program. The vital point to note here is the direction of causality between policy and society. Two of the strongest existing social institutions in Eastern Europe helped to maintain the shock therapy program. In contrast, the shock therapy view of the causal forces at work in reform is that economic policy should by-pass existing society to create a new world.

The shock was produced by formal policy levers that were directly manipulable at the apex of government—those measures accessible to a narrow group of technocrats. Outside these policy areas, changes proceeded more slowly. The shock-therapist Minister of Finance produced few changes in the structure of his own Ministry. Changes in the tax system, including implementing a value-added tax, were postponed. The banking structure that implemented the tight monetary policy was essentially the one inherited from the communists. No state enterprises went bankrupt during this time period. The much vaunted export boom of 1990 was, in fact, due largely to the efforts of the old foreign trade corporations.

Of course, compared to earlier years, change was rapid. This was inevitable given the collapse of the communist dam and the flowing of democracy. But change in the early part of 1990 did not conform to the shock therapy model. The strategic concept at the heart of the shock therapy approach is that a radical policy, designed and implemented by technocrats, could be an autonomous agent of social change. In fact, the radical policy was being implemented by existing economic institutions. It was being held in place by the social and political structures that had emerged from the communist era with most credibility, the Church and Solidarity. Existing society was shoring up policy, rather than policy creating a new society.

## The Return of Society

When the realization hit that the shock was not going to produce some magical effects, the program came under severe attack. Gradually, many of the elements of the initial program were withdrawn or weakened. In the summer of 1990, credits were channelled to farmers and spending on housing was raised. Credit to state enterprises began to grow and to approach its old levels, as monetary policy eased. By October 1990, policy had changed enough for a leading architect of the big-bang to resign from the government in protest.

Further movement away from the shock program occurred throughout 1991 in the face of massive and open opposition to the government's policy. Fiscal and monetary policy were considerably loosened. The budget deficit began to rise to the levels of 1989 and the government endorsed the policy of giving selective credit to enterprises. There was reversal of trade policy in August 1991, when average tariff rates were increased from 5 percent to 18 percent, and when selective protection was endorsed.

Within the state enterprise sector, which had borne the brunt of the shock, a similar story can be told. A sentimental attachment to workers'

<sup>30</sup>The reader will notice that there is no mention of price decontrol in this list. In fact, price decontrol was not a significant component of the shock program, since progress on this front had proceeded so far before January 1990.

management was a fundamental part of Solidarity's ethos, self-management being viewed as the major gain from the struggles of the early 1980's (Mujzel, 1991). This attachment had been reflected in the Round Table agreements. The plan of the radical reformers repudiated this stance. Privatization was to be massive, quick, and removed from the workers' control.

The development of the state enterprise sector belied the intentions of the radical reformers. Judged by their behavior, the enterprises soon came to resemble the worker-managed firms that had been desired by Solidarity. Gradually, the ultra-liberal policy vis-à-vis the state sector weakened, with increased involvement of Ministries and existing stakeholders in deciding on that sector's future (Slay, 1993b). The large-scale schemes of privatization were continually halted by one politician, or one coalition, after another. When privatization of the larger enterprises did occur, the route was a negotiated bargain between the state, the managers, and the workers (Levitas, 1993). The greatest fear of the radical reformers had come to pass: the deep involvement of existing stakeholders and politicians in a privatization process comprising much bargaining.

The reversals of the original shock therapy program were enacted in direct response to pressures for changes in the course of reforms, pressures emanating from interests within the society at large. Policy was taken back from the radical technocrats. It began to gain the appearance of that jumble of measures advocated by assorted coalitions and interests that is so typical of any working democracy, and so anathema to advocates of shock therapy.

The outside community gave its judgment. The International Monetary Fund suspended its endorsement of Polish policy in the late summer of 1991. The Western press and Western politicians, noting the abandonment of shock therapy, began to fear that reform itself was being abandoned. But this interpretation was a misreading of the progression of developments, a product of attaching too much importance to particular policies and too little to the commitment of the large part of society to a continuation of the processes of change.

In summary, the policies introduced in January 1990 were a radical departure from a natural progression—one that was accelerating before the big bang and proceeded after society recovered from its shock. The aim of the shock therapy program was to change irrevocably the course of policy and to wrest policy from the influence of the dominant elements of existing society. In fact, Polish society took back the reforms; the continuous progression of policy before and after the big bang is much more remarkable than any discontinuity. This is the sense in which the shock therapy approach failed in Poland.

Continuity does not imply stasis, and rejection of the radical program does not mean the halting of reforms. Although policy was modified during the two years following the big bang, the commitment of the large part of society to change was never in doubt. Change was inexorable, given

the collapse of the communist regime that had blocked reforms that had been demanded for so long. Moreover, these changes will be self-reinforcing, driven as they are by the new economic and political forces. Chief among these forces is the new private sector, which was treated with, at best, benign neglect during the early stages of reforms. This sector will provide the economic pressure that will force the state sector to become more efficient, the financial and human resources that can make the privatization process more effective, the political forces that will demand further reforms, and the type of society from which capitalism has been built in other European democracies.

Judged on its own terms, as an instrument to side-step society and create a new configuration of political and economic forces, shock therapy was a failure in Poland. But the Polish economy is now showing its first signs of success, after policy was rescued from the shock therapists. In fact, the Polish reforms, excepting the period of the shock itself, are beginning to acquire the hue of an evolutionary model. To the extent that these reforms have been successful, it has been due to the resources of Polish society in muddling through with its own model of reforms, rather than due to some magical dose of top-down policy.

## WHAT DID HAPPEN IN RUSSIA?

He was one of those theorists who so love their theory that they lose sight of the object of the theory—its practical application. . . . Failure, being due to some departure in practice from the theory, only proved to him the accuracy of his theory (Tolstoy, 1978, Volume 3, p. 53).

The stages of the reform chronology in Russia are similar to those of Poland, but the endnote of optimism is missing. Russian society was less prepared for effecting the constructive measures necessary for the functioning of a rudimentary market economy. There was less preparatory reform during the communist period in Russia. The core group of Russian reformers was more radical and ambitious, and more removed from its own society, than were the Polish reformers. Hence, the breakdown of the essential mechanisms of central government, proceeding apace as a result of the political changes, was accelerated by the new government and its policies.<sup>31</sup> Moreover, the radical policies had hardly advanced beyond their explicitly destructive first phases before they were rejected by society and

<sup>31</sup>This breakdown might be the most important consequence of the economic events of 1992. One example will suffice. The mechanism of trade between *oblasti* now more resembles that between the pre-Zollverein German principalities than that between the regions of a modern nation-state.

vanguard by the old power centers. Thus, much work still needs to be done on building the institutional foundations for sustained growth in Russia.

## The Last Days of Communism

By 1991, economic reform in the Soviet Union had hardly progressed beyond the stage of decentralization within the old system, and that decentralization was still very equivocal. Price controls and state orders each applied to about 75 percent of economic activity. The small private sector was in a symbiotic relationship with the state sector, rather than thriving on its own terms. A law on contract, the first designed for a modern market economy, had not been implemented when the USSR met its demise.<sup>32</sup>

Most importantly, the country's economic and political leaders had still not grappled with the difficult conceptual and institutional issues that were central in using market-type instruments to establish macroeconomic control. There was ". . . little technical understanding and no tradition of an active monetary policy to limit credit growth. . . . The idea that bank credit should be limited to restrict the overall growth of the money supply simply did not exist until 1992" (Lipton and Sachs, 1992, p. 227). There was simply nothing to match Poland's years of contact with the West, the involvement of its scholars-cum-policy-makers in the worldwide academic community, and the years of learning in interactions with the world financial community.

Finally, Jaruzelski's regime seems, in retrospect, to have been a paragon of financial rectitude compared to Gorbachev's. The Soviet budget wandered out of balance in 1985 and the deficit rose inexorably thereafter. By 1991, the lack of constructive reform, combined with a decline in the disciplinary force of the old administrative system, meant that the economy was beginning to enter a free fall. Even before the chaos created by the failed coup, GDP was predicted as heading for an 18 percent fall in 1991.

## The First Days of the Reborn Russia

In 1990 and 1991, the Russian government had been gradually gathering power at the expense of the USSR government, a process that the failed coup dramatically accelerated. One unfortunate feature of the extended sovereignty war between the Union and Russian governments was the use of financial largesse as a weapon. Each level of government

sought to buy support with lower tax rates, greater subsidies, and easier credit. Thus, in contrast to the last months of 1989 in Poland, the fall of 1991 in Russia was not marked by serious attempts to grapple with economic problems. One result was a massive budget deficit, of which the imputed Russian component has been estimated at 20 percent of GDP.

In late October 1991, Russian President Boris Yel'tsin announced his intention to launch a radical attack on the country's economic problems. In light of subsequent developments, it is important to remember the policy-making environment facing the Russian government. The Congress of People's Deputies had given Yel'tsin a free hand in administrative and policy choices for one year.<sup>33</sup> He used this freedom to thrust economic policy-making into the hands of a group of theorists, who had a strong preference for rapid change and who were armed with some vague ideas about how to bring this about.

In the view of these reformers, there was a power vacuum, which freed them from many of the usual constraints on policy: "The situation was characterized by the absence of any influential social forces that would be organized enough to be capable of explicitly formulating their interests and upholding them, let alone foisting them on society. . . . [T]he possibilities for the first steps along the reform path were practically limitless and depended almost solely on the chief executive's political will" (Institute, 1993, p. 6). Thus, to the extent that any policy-making environment is appropriate for implementing shock therapy, Russia in January 1992 was ideal. The power vacuum gave the technocrats the much-desired window of opportunity, which would allow them to ply their trade unfettered by the society and polity that are viewed as central obstacles to the realization of change.

These points are crucial to understand, because it has become fashionable to argue that shock therapy was not applied in Russia (Åslund and Layard, 1993). But the field was open for the application of shock therapy and Yel'tsin had chosen a government committed to this approach. If, under such circumstances, ideal policies were not implemented, and if these are necessary for success, which is presumably what is actually meant by saying that shock therapy was not applied, then this is surely evidence of a failure in theoretical conception, not of non-application of the theory.

Thus the philosophy of shock therapy was the guiding force of policy as Russia began real economic reform in January 1992. That philosophy is perhaps best summarized using a simple example. Deputy Prime Minister Yegor Gaydar explained the strategy that led to the implementation of a value-added tax in the following manner: "So it was a dilemma for us: to reconstruct the old tax system, or to combine price liberalization with a value-added tax of 28 percent. This second answer was very dangerous,

<sup>32</sup>As for the case of Poland, reference to individual sources for each fact would be too cumbersome. Among the sources consulted are Bush (1992), Commander *et. al.* (1993), Ellman (1992), Ickes and Ryterman (1992), Institute (1993), Koen and Phillips (1992), Lipton and Sachs (1992), Litwack (1992), as well as publications of multilateral agencies, the standard current informational sources, and personal interviews conducted by the author.

<sup>33</sup>One crucial position that Yel'tsin did not control, the head of the Russian Central Bank, was staffed by a person who had been previously recognized as an advocate of hard money policies. In the sovereignty war of 1991, the Russian government had encouraged him to eschew these policies.

but that was probably the only possible moment when we could adopt it. We decided to put all our eggs in one basket . . ." (*The Economist*, April 25, 1992, p. 18).

The echoes from our previous analysis of the vision of the shock therapist are transparent: the strong preference for the immediate imposition of the desired endpoint; the assumption that institutional changes are easy to effect;<sup>34</sup> the willingness to undertake dangerous measures early on, allegedly to avoid their being blocked later; and the rejection of a pragmatic compromise with old institutions that might help to address vital problems of the day.<sup>35</sup>

## The Shock

In January 1992, Gaydar's team intended to move rapidly on all fronts. Among the announced measures were the freeing of most prices, the removal of the old supply system, the complete liberalization of imports, a thoroughgoing change in the tax system, a rapid closing of the budget deficit, a stringent tightening of monetary policy, a privatization program with very ambitious goals, preparation for early convertibility of the ruble together with an immediate relaxation of rules on foreign exchange trading, and the renegotiation of the existing trading relationships with the other ex-republics. This was an impressive menu of policy changes; given the starting point, it was certainly more radical than the Polish big-bang.

There was a further, and more fundamental, sense in which the Russian shock was greater than the Polish one. There was a greater determination in Russia to undermine the existing institutions of government. The incoming government viewed its mission as an attack on the old Soviet system. The group of technocrats aimed to change fundamentally, or even to destroy, that which they were supposed to command. But they were almost completely unfamiliar with the existing levers of power. These elements of the policy environment further increased the entropy in governmental structure and administration that had marked the last years of Gorbachev. Indeed, this entropy is likely to prove the most profound and lasting impact of the shock therapy episode, as indeed it had an important effect on the implementation of policy in the short run.

Turning to the specifics of policy, initially the intended fiscal adjustment was 19 percent of GDP, the goal being an almost balanced budget. Balance was to be produced by operating essentially on a cash flow basis. This implied draconian cuts in spending, which were made even deeper by self-inflicted shocks on the revenue side. The new value-added tax yielded only 50 percent of dues in the first quarter. Changes in foreign trade arrangements had also drastically eroded a significant source of revenue.

The evaluation of monetary policy during this period has been clouded by early criticisms of the monetary authorities by the more extreme shock therapists and by the disastrous profligacy of the central bank in the second half of 1992. In fact, there was an extreme monetary and credit squeeze in the beginning of the year. The real value of the money supply fell by approximately 70 percent in the first quarter. Central Bank credit to enterprises and commercial banks fell by the same order of magnitude.

In several areas, the degree of the shock, the amount of policy implementation, and even actual policy were unclear. This was inevitable, given the extent to which lower levels of government had escaped the control of central political leaders. Even though a complete import liberalization was announced in January 1992, much import licensing continued. Exports were subject to even more restrictions. Although the government's program called for the privatization in 1992 of 70 percent of enterprises in light industry, and of 60 percent in food, agriculture, and retail trade, these targets were obviously over-ambitious, at no time more so than in January 1992, when Yel'tsin declared that there would be no quick privatization of large enterprises. Thus, uncertainty about the nature of policy was present even among those at the apex of government. Misunderstandings about the policies being adopted, and hesitations on timing were in fact embodied, as are so many aspects of present-day Russia, in the remarkably equivocal Boris Yel'tsin.

The decision to adopt the shock therapy approach therefore probably arose as much from the old Soviet political culture, with its belief that society can be reshaped from the top, as from an understanding of the actual economic effects of the policies themselves. This is hardly an original conclusion, but it does indicate why shock therapy was so congenial to decision-makers in the immediate post-socialist setting. It also shows why there would be a quick retreat from the policies implicit in shock therapy when the measures began to bite and political leaders had to make daily judgments on the specifics of economic policy.

## The Return of Society

There are at least two senses in which a government imposing shock therapy tries to avoid existing society. First, society's prevailing dispositions on policy matters must not interfere with the work of the technocrats. Second, the representatives of present economic interests, who are trying to prolong a decaying old order, must be deprived of influence.

The influence of the prevailing dispositions within society could be detected already in the measures of January 1992. For example, the opening up of trade was fragmentary and price decontrol was far from complete. Given the free hand of the technocrats at the very beginning of the reforms, these choices could not have resulted simply from the

<sup>34</sup>The International Monetary Fund, for example, recommends several years of preparation for the value-added tax.

<sup>35</sup>For example, the use of old taxing mechanisms to ease budgetary problems.

pressures of political opponents.<sup>36</sup> One interpretation then is that even the reforming elite was not so immune to the general dispositions within society that shock therapy was supposed to circumvent. Conceivably, the elite's view of the trade-offs that they faced, and of the possibilities of the market, had been tinged with the influence of their formative years. This could explain why even members of Yeltsin's own entourage were critical of economic policy as early as February 1992. Perhaps the technocrats were simply too removed from a society that had little experience with market mechanisms and little faith in them.

Thus, as 1992 proceeded and the economic crisis became more threatening, some old mechanisms of control began to return. In the anti-monopoly measures of February 1992, the government gave itself broad powers to control prices and to use central directives on production. The distinction between cash and non-cash money, which had been weakened in November 1991, was hardened in March 1992. By April, the government was ready to use subsidies in order to mitigate the effects of earlier measures. In the face of the threat of large scale bankruptcy, the government began to make credit available to enterprises in significant amounts.<sup>37</sup>

By the second quarter of 1992, it was clear that policy could not be formulated independently of economic interests.<sup>38</sup> A central assumption of the shock therapy approach, that these interests could be avoided in the policy process, was proving unworkable in practice. In fact, in what might be regarded as a direct example of a failure in the strategic conception that lies at the heart of shock therapy, there was a congealing of the political opposition as a direct consequence of the policies that were being implemented.

In the spring of 1992, the perception arose that the interenterprise debt crisis was threatening the entire industrial system. Although the causes of that crisis were legion, the common feature was an inconsistency between the financial and macroeconomic policies pursued at the center and the lack of structural reform and change in enterprise behavior at the micro-economic level.<sup>39</sup> As in Poland, and as predicted by the evolutionary perspective, the absence of quick adjustment in enterprise behavior had proved to be the achilles heel of shock therapy stabilization.

An important consequence of the amassing of interenterprise debt was that the better enterprises were being brought down with the bad ones. This threat united enterprise directors in opposition to the government's policies, whereas they had previously been competitors for government

<sup>36</sup>For example, the decisions to restrict oil exports and to keep energy prices under control were strategic moves taken by the government.

<sup>37</sup>This was not solely a policy of the much-maligned Georgiy Matyukhin, Chairman of the Russian Central Bank. It was endorsed, to some degree, by the Gaydar team.

<sup>38</sup>Here, the interpretation of the sequence of events, but not the implications of this sequence, largely relies upon Institute (1993).

<sup>39</sup>This was the interpretation placed on events by Institute (1993).

largesse. The increasing cohesion of the interest groups representing old state industry, the formation of an alliance of enterprise directors and independent labor unions, and the establishment of the Civic Union in June 1992 were all a result of these economic developments. The reformers were forced into compromise with these interest groups, whose members entered the government.

Policy for the rest of the year reflected this compromise. The core principle of the economic program, that financial and monetary discipline were paramount, was now abandoned. Preventing industrial failure would now be dominant for the rest of the year as the government began to pay attention to the fortunes of individual enterprises. The backbone of Soviet society, heavy industry, which the shock therapists had hoped to break, was now at the center of influence. The imperative of production, the core principle of central planning, had quickly replaced the hard budget constraint, the essence of the market, at the heart of policy.

In summary, the progress of policy in Russia in 1992 was determined by the attempt to implement the shock therapy approach. Judging this approach on its own terms, as a politico-economic gambit aimed at producing a particular sequence of related policy and political changes, the result was failure. A direct consequence of the policies introduced in January 1992 was that the political forces representing the dominant economic interests of the old Soviet system were much stronger than they had been before those policies were introduced. Far from being able to use economic policy to avoid society, the strategic moves of the technocrats had led directly to the increasing influence on policy of the old interests.

The legacy of this brief attempt to implement shock therapy will be with Russia for many years to come. The kamikaze attack on the command-administrative system, as it has been called, probably did hasten the demise of the old administrative institutions of control. In this respect, the short burst of shock therapy in Russia had considerable success, if destruction is counted as a goal. But the destruction of the old was hardly matched by the creation of market-oriented institutions of economic control.<sup>40</sup> Politically, the forces of heavy industry are now in a stronger position than they were in the Fall of 1991. As a direct result of the shock therapy gambit, the state industrial system in Russia now resembles that of Gierek's Poland.

Fortunately, there is a fundamental difference between present-day Russia and Poland of the 1970's. Russia is now an open society in which fundamental pressures for change will have an effect on the decisions of the leadership. As the results of the April 1993 referendum showed, the Russian population has a deep desire for change. Thus, paradoxically, after the failed experiment with shock therapy, the major hope for change in the years ahead lies with Russian society itself—the very force that the shock therapy approach had hoped to avoid.

<sup>40</sup>Additionally, in events analogous to those in Eastern Europe, the existing private sector suffered more from the six months of shock therapy than did the state sector. See Belyanova and Aukutsenek (1993, p. 43) and Commander et. al. (1993, p. 7).

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## The Dynamics of "Democratic Russia," 1990-1993

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### INTRODUCTION

In Eastern Europe, social movements played a crucial role in bringing down communist regimes in Poland, Czechoslovakia, and East Germany. In each of these cases, however, social movements lost their mobilizational power in the post-communist period and virtually disappeared from the political scene. In the former Soviet Union, social movements in the three Baltic states followed an analogous path. They played decisive roles in destroying communist rule and achieving independence, only to find their influence decline sharply after the collapse of the communist regime. In Lithuania, the reformist wing of the local Communist Party even came back to power after the Spring 1993 elections, decisively defeating Sajudis, the social movement which had successfully led the struggle for independence.

In Russia, *Demokraticeskaya Rossiya* (Democratic Russia, or DR) attempted to play the same role as Solidarity, the Civic Forum, the New Forum, and Sajudis had played in Poland, Czechoslovakia, East Germany, and Lithuania, respectively. Like these social movements, DR, by means of mass rallies and elections, successfully mobilized the populace against the *nomenklatura* and thus contributed to the collapse of Communist Party rule. Also as in those countries, in the period after the August 1991 coup the movement was plagued by secessions, leadership infighting, lack of funding, and a shortage of opportunities for political mobilization. All this convinced many observers inside and outside Russia that DR had lost its popularity and mobilizational power and was, like other social movements in Eastern Europe, doomed to political oblivion in the post-communist era.

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