Why Shock Therapy Is Wrong
David Ellerman

When Economic Advisers Disagree with the President
Jeffrey Frankel

Dealing with Asset Price Bubbles
Thomas Palley

Does Sex and the City Predict the Future of Marriage?
Roderick Duncan

Unemployment Insurance and the Bias Against Families
Rebecca Smith, Rick McHugh, and Andrew Stettner

Distorting Adam Smith

The Use and Abuse of Adam Smith
Gerald Houseman

Adam Smith and the Contradictions of the Free Market
Peter Nolan
On the Russian Privatization Debate

David Ellerman

Gradual, not shock, therapy is the right route to development in transition countries, argues the author. We have two natural experiments to learn from.

More than a decade has passed since the privatization debates raged in the international financial institutions (IFIs) and in academia concerning Russia and the other transition economies. It is time for reflection on and evaluation of these debates. Have the Western advisory institutions learned any significant lessons from the Russian debacle, or have they essentially adopted the Sachs-Summers-Shleifer strategy of quietly closing an embarrassing chapter in their history and moving their attention (and hopefully the public spotlight) on to the breathless pursuit of more immediate and pressing concerns? This paper addresses two questions: the overall institutional change strategy, and the arguments against and alternatives to voucher privatization.

David Ellerman, recently "retired" after a decade in the World Bank, was for two years (1998-99) an economic adviser and speechwriter for Joseph Stiglitz, then the chief economist of the World Bank. Ellerman is currently at work on a book about the World Bank and its mission.
Institutional Change Strategies

History offers few “crucial experiments,” but the contrast between the Russian and Chinese transitions is probably the best that one could ask for to contrast an institutional shock therapy or blitzkrieg approach with an incremental, step-by-step, or staged approach to institutional change. As the Yeltsin reformers such as Anatoly Chubais did use rather “Bolshevik” methods to try to storm the ramparts during the few windows of opportunity, Joseph Stiglitz (1999) and Peter Reddaway and Dmitri Glinski (2001) have called this “market bolshevism.” A wise commentator has described these Bolshevik tactics well.

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.

These words are as true today as when they were written. And they were written by John Maynard Keynes (1933, 245) about the original Bolshevik transition, not today’s market Bolshevik transition in the opposite direction.

What was the alternative strategy? In this case, the incremental non-Bolshevik/Jacobin alternative has long found its sophisticated expression in the work of Albert Hirschman about incremental reform-mongering change driven more by endogenous pressures, bottlenecks, and linkages than by exogenous “carrots and sticks” embedded in IFI loan conditions. The reform experience in China—which has never had an International Monetary Fund (IMF) program—represents something like this incremental approach in practice: crossing the river groping for the stepping-stones rather than jumping over the chasm in one last “great leap forward.” As Deng Xiaoping put it in 1986: “We are engaged in an experiment. For us, it [reform] is something
new, and we have to grope around to find our way. . . . Our method is to sum up experience from time to time and correct mistakes whenever they are discovered, so that small errors will not grow into big ones" (see Harding 1987, 87). When experiments had positive results, the idea was to then catalyze the process. As Chinese reformer Hu Qili put it at the same time: “We allow the little streams to flow. We simply watch in which direction the water flows. When the water flows in the right direction we build channels through which these streams can lead to the river of socialism.”

One of the important misformulations of the transition question was “Fast versus slow?” “Incremental” might be misleading if it is construed as “gradual” or “slow.” The Chinese reforms were neither gradual nor slow, and the Russians will not soon climb out of the chasm they failed to jump over in one leap. The point is to find and build step-by-step upon the reform efforts of the past (which requires taking into account past conditions) rather than trying to wipe the slate clean and legislate ideal institutions in one fell swoop. Murrell (1992) explored the connections between incrementalist strategies and conservative political philosophies. In Lau et al. (2000), the Chinese “two-track” system of reforms is analyzed where a second track, step, or stage is inaugurated and can then grow to eventually render the earlier stage obsolete. Black et al. (2000) use the word “staged” in much the same sense. In Joseph Stiglitz’s “Whither Reform?” (1999), the two “ideal types” were compared in a table as a “battle of metaphors.” (See Table 1.)

Another part of the incremental approach, also evident in China, is the willingness to allow experiments in different parts of the country and then foster horizontal learning and the propagation of the successful experiments. This is an important part of the alternative to the Bolshevik/Jacobin approach of legislating the brave new world from the capital city to be applied uni-
Table 1

<table>
<thead>
<tr>
<th>“Battle of Metaphors”</th>
<th>Shock Therapy</th>
<th>Incrementalism</th>
</tr>
</thead>
<tbody>
<tr>
<td>Continuity vs. Break</td>
<td>Discontinuous break or shock—razing the old social structure in order to build the new.</td>
<td>Continuous change—trying to preserve social capital that cannot be easily reconstructed.</td>
</tr>
<tr>
<td>Role of Initial Conditions</td>
<td>The first-best socially engineered solution that is not “disturbed” by the initial conditions.</td>
<td>Piecemeal changes (continuous improvements) taking into account initial conditions.</td>
</tr>
<tr>
<td>Role of Knowledge</td>
<td>Emphasizes explicit or technical knowledge of end-state blueprint.</td>
<td>Emphasizes local practical knowledge that only yields local predictability and does not apply to large or global changes.</td>
</tr>
<tr>
<td>Knowledge Attitude</td>
<td>Knowing what you are doing.</td>
<td>Knowing that you do not know what you are doing.</td>
</tr>
<tr>
<td>Chasm Metaphor</td>
<td>Jump across the chasm in one leap.</td>
<td>Build a bridge across the chasm.</td>
</tr>
<tr>
<td>Repairing-the-Ship Metaphor</td>
<td>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.</td>
<td>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.</td>
</tr>
<tr>
<td>Transplanting-the-Tree Metaphor</td>
<td>All at once transplantation in a decisive manner to seize the benefits and get over the shock as quickly as possible.</td>
<td>Preparing and wrapping the major roots one at a time (nemawashi) to prevent shock to the whole system and improve chances of successful transplantation.</td>
</tr>
</tbody>
</table>


Note: See Benziger 1996 on the Chinese “not knowing what they were doing,” Elster et al. 1996 for the use of Otto Neurath’s “rebuilding the ship at sea” metaphor in this context, and Morita 1986 on nemawashi.
formally across the country. The transition from socialism to a market economy had not happened before in history, so the situation clearly called out for experimentation and pragmatism. Instead, the World Bank succumbed out of its own arrogance and la rage de vouloir conclure (the rage to conclude) to the social-engineering Bolshevik/Jacobian mentality (complete with cold-warrior moral fervor to wipe the slate clean of past evils), with help from elite academic advisors, and supported Moscow legislation to apply the dreamed-up solutions across all of Russia.

Today, any passively voiced “mistakes-were-made” admissions are invariably accompanied by TINA—“There Is/No Alternative”—pleadings. But not only was it feasible for experiments to take place, they were taking place and were stopped in the market Bolshevik frenzy to legislate the brave new world during the window of opportunity. I will focus on the alternatives or “counterfactuals” available concerning privatization.

The Privatization Debates

After some initial limp resistance, the World Bank quickly succumbed to the public relations image of the Czech voucher privatization as being “successful” and then promoted that model in other countries. In the rather standard model of voucher privatization, vouchers were distributed to all citizens, but it was expected that individuals would only invest the vouchers in mutual-fund–like voucher funds in return for shares in the funds. The funds would, in turn, use the vouchers to buy shares in the companies being privatized at state-run voucher auctions. But the voucher funds were run by fund management companies that could be completely owned by a few individuals or even by state-owned banks (e.g., in the Czech case). The voucher funds were supposed to be “controlling owners” who would supply “corporate governance” to the privatized companies. The com-
panies were called “privatized” since their shares were predominantly held by the voucher funds, which in turn were “owned” by millions of private citizens. But the funds were, in fact, controlled by the fund management firms, which had negligible ownership interests, so the net effect was the “tunneling” of assets out various “back doors” to the benefit of the fund managers and their colleagues. Such was the scheme promoted by the IFI and academic experts in institutional design for “private property market economies.”

In a World Bank working paper later published in Challenge (Ellerman 2001) (which, incidentally, circulated for several years around the Bank in samizdat form before Stiglitz arrived and allowed it to be brought out as a working paper in 1998), I argued that the economic case for voucher privatization was remarkably superficial and that the basic rationale was political. In Stiglitz (1999) and Stiglitz and Ellerman (2001) an additional argument is developed as to why the voucher privatization programs such as the Russian scheme actually contributed to the debacle. This argument can be developed in different vocabularies.

The Argument in Terms of Agency Chains

One approach is via the notion of agency chains. Long agency chains are very difficult to police and maintain. Information economics emphasizes the “asymmetric information” and monitoring failures in principal-agent relationships. The longer the agency chain, the more the asymmetry and the greater the chances for opportunistic behavior. It took most of the twentieth century to develop the array of watchdog institutions (e.g., accounting/auditing firms and the Securities and Exchange Commission [SEC]) to police long agency chains in the West, and a glance at runaway executive compensation in America, not to mention the Enron-like scandals, shows the continuing
problems in making the system work. The market Bolshevists tried to legislate and install institutions such as stock markets, watchdog agencies, and publicly traded companies as if all that could be done practically overnight. 12 Voucher privatization, which threw most medium and large-sized companies into the stock market, was an extreme “pathological” example of trying to legislate well-functioning long agency chains.

Market economies start with short, not long, agency chains—indeed, they start with the identity of principal and agent in owner-operated firms and farms. The decentralization that is part of building a market economy in transitional countries needs to similarly start with agency chains as short as possible, not as long as possible. In the Czech-style “model” of voucher privatization with investment funds generally preferred by the Western advisers, the principal-agent “layers” in the long agency chain were

1. the millions of citizen-shareholders of voucher investment funds, who were to control:
2. the boards of the funds, which were supposed to control:
3. the fund management companies, which were supposed to control:
4. the boards of their hundreds of portfolio companies, which were supposed to control:
5. the managers of the portfolio companies, who were supposed to control:
6. the middle managers and workers, who were supposed to actually produce something that people were willing to buy.

Historians may find it hard to believe that the “experts” in the IFIs and in elite academia actually thought that such agency chains could be legislated and “installed,” and would then work reasonably well in economies after seventy years of communism. 13 And today, the comic-book version of the Russian de-
bacle that is promulgated for public consumption is not the farcical nature of trying to legislate five-linked agency chains overnight. Instead the story is that “It didn’t work as planned” because of the rapacious managers and state officials who did not respect property rights. Thus the fault lies not in the architects of the absurdly designed chicken coop but in the rapacious nature of the foxes.

The Argument in Terms of De Facto Property Rights

Our analysis can also be approached using the notion of de facto property rights. Neoclassical economics tends to follow Ronald Coase and to emphasize the importance of establishing clear formal property rights (and then perhaps the market will do the rest). And the cartoon picture of the transition used by the IFIs and allied experts is one that hammers away at the importance of respecting “private property rights.” Never mind if the “clear-cut private property rights” are the ownership of junk shares in voucher investment funds on the tail end of many-layered agency chains. And never mind that in the U.S. economy (i.e., the experts’ implicit mental model), there has been a “separation of ownership and control” for most of the twentieth century, so that the top managers who command the heights in this paradigm “private property market economy” do so on the basis of their organizational role (not unlike party officials) and de facto control of the board—not on the basis of their private property rights. Neoclassical cartoons tend to ignore such troublesome aspects of reality.14

Progress has been made on this question recently in Hernando de Soto’s book The Mystery of Capital (2000). Although this was little noticed by the cheerleaders who wrote blurbs for his book jacket, including Ronald Coase, de Soto did not argue just for formal property rights but for the formalization of de facto prop-
tery rights. That’s a horse of another color. After all, all the land occupied and farmed by peasants or occupied and used by slum dwellers already has formal owners; it was not part of some “commons.” The idea is that by using and improving these assets (formally but absentee owned by others), people have established certain de facto property rights that give them the capability to sow and reap. Any “reform” that would take away

One way or another, in often bizarre ways, people learned to do things in a twilight half-centralized and half-decentralized system.

those de facto property rights (and the capabilities they represent) to assert absentee formal property rights would in fact be disempowering and antidevelopment. To promote market-driven development, the reforms should find out ways to formalize some socially acceptable approximation to those de facto rights so that the people then encounter the market and the private property system as something that empowers them, rather than the opposite.

Now transpose this argument over to the transition economies. In the decentralizing socialist reforms over the years and decades before 1990, the workers, managers, and local communities had developed a range of de facto property rights (or “use rights”) over their enterprises. Central planning never worked well, and, as it got worse, forms of decentralization took hold in varying degrees across much of the socialist world. These reforms included the Yugoslav self-management system, the enterprise self-management councils of Hungarian “goulash” or reform communism, the Polish Solidarity-dominated self-management committees, and the Gorbachev perestroika reforms to increase enterprise self-accountability. One way or another, in

often beneficial way between the centralized and de facto property. They gradually got formalized.

Where the reforms are lagging, it is to impose centralized property and counter the growing approximation to perceived de facto rights. In going back to the discussion on the previous page, people would develop an ownership and would develop formal property rights.

Instead of running away with the de facto property rights and wipe the slate clean, China and to a lesser extent these “socialist oriented” passed their decentralization, de confusing the various degrees of decentralization. Russian privatization, for instance, rendered the State property something that was left to the people, whereas it was supposed to be accountable for.

These are all things to dwell upon as the Bolshevik revolution takes place.
often bizarre ways, people learned to do things in a twilight half-centralized and half-decentralized system. They developed de facto property rights that represented their capabilities to actually get a few things done and to squeak by.

When the spell was finally broken in 1989–90, the alternative to institutional shock therapy and market bolshevism—the counterfactual—would have been to formalize the nearest approximation to the de facto property rights that would be accepted as socially fair and thus continue the decentralizing thrust going "straight to the market" (e.g., through the lease buy-outs discussed later). If that alternative approach had been taken, then people would have encountered the market as something that would recognize and formalize the capabilities they had already developed and would allow them to do even better.

Instead, the market Bolsheviks designed the "market reforms" with the exact opposite purpose to deny the de facto property rights accumulated during the "communist past," to righteously wipe the slate clean by renationalizing all companies of any size, and to start afresh with formal property rights deliberately unrelated to the previous "vestiges of communism." Sometimes these "ideal reforms" were compromised in getting legislation passed but, by and large, the "reforms" were successful in denying the de facto property rights acquired during the earlier decentralizing reforms. For instance, outside of a small elite, most Russians encountered the market not as something that strengthened their capabilities and empowered them to do more but as something that took away what they were capable of doing and left them in a position where the rational choice was to grab what they could in the face of a very uncertain and uncontrollable future.

These points are perhaps easier to understand when applied to dwellings. Here pragmatism tended to prevail over market Bolshevik ideology. People also acquired various de facto prop-
roperty rights over their flats in the socialist countries (analogous to “squatters’ rights” in de Soto’s work). Since the distribution of housing also partially reflected the power relationships under communism, one might pursue the same logic to suggest that the slate should be wiped clean of the communist past, and all apartments should be put on the market and auctioned off to the highest bidder. Just think of the efficiency gains by jump-starting the housing market! Instead, most of the postsocialist countries figured out ways to arrive at formal rights that were the closest socially fair approximation to the de facto rights.

Moreover, this analysis and critique is not just “hindsight.” The following was written almost a decade ago in 1992 and published (outside the Bank) in 1993.

After the collapse of the socialist idea in the late 1980s and early 1990s, the question of institutional change strategies came to the forefront. Broadly speaking, two opposed strategies emerged. The Big Bang approach advocated just drawing a big X over the old half-reformed institutions and then legislating new “ideal” institutional forms.

The old de facto property rights embodied in the half-reformed institutions would not be recognized in any significant way, and the new de jure property rights would be legislated by the new “revolutionary” democratic government.

What is wrong with moving in one great leap to some desired ideal form? Nothing—if institutional change could actually take place in that manner. But it usually does not. People will resist and “drag their feet” in countless ways when their de facto property rights are canceled or trivialized. The imagined great leap breaks down in chaos. Instead of
disappearing overnight in favor of the new ideal institutions, the de-legitimated old institutions break down in favor of a shadowy anarchy of ad hoc opportunist forms. The Big Bang becomes a Big Bust.

The alternative is a strategy of incremental institutional change. Instead of an imagined great leap forward over the chasm between socialism and capitalism, incentives would be devised to move people incrementally but irreversibly from the existing quasi-reformed institutions towards the “ideal” institutions. Instead of just negating the de facto property rights of managers and workers, they can arrive at a nearby set of legitimized de jure property rights by moving in the right direction.

**INCREMENTAL INSTITUTIONAL CHANGE**

<table>
<thead>
<tr>
<th>de facto property rights</th>
<th>Nearby de jure property rights</th>
</tr>
</thead>
</table>

These two strategies are posed as opposites. No country would adopt a totally pure strategy, and one country might use both strategies in different parts of its reform program. For instance, the privatization-by-liquidation program in Poland is based on an incremental strategy while the Polish mass privatization plan originates from a Big Bang approach. The Czech voucher plan is a Big Bang strategy, while small business privatization in the Czech Republic (and in most other countries) is based on an incremental approach. Aside from the lease buyouts and other MEBOs, the Russian mass privatization program is a Big Bang program, while the Chinese reforms in agriculture and industry are the clearest example of a thoroughgoing incremental approach. (Ellerman 1993, 27-28)

**The Lease Buyout Counterfactual**

What are the forms of privatization that try to move to a set of formal property rights that are a socially acceptable approximation to the de facto property rights that resulted from the earlier reforms during the socialist era? In Stiglitz’s “Whither Reform?,” the general strategy was called “stakeholder privatization.” Look at the parties who actually have to cooperate in order for an
enterprise to succeed regardless of the "ownership structure." These include the workers, managers, and local authorities. They do not include voucher fund managers sitting in Moscow. Then "shrink-wrap" the ownership structure around those stakeholders to arrive at a minimal agency-chain structure where the owners have to cooperate on a day-to-day basis. In the above passage written almost a decade ago, the Polish privatization-by-liquida
tion (also called "Polish leasing") program, the Soviet lease buyouts, and the Chinese reforms in agriculture and industry (i.e., household responsibility system and township-village enterprises, or TVEs) were all picked out as examples of this strategy to strive for formal rights close to de facto rights and to minimize the distortions of information and effort involved in long agency chains and absentee ownership.16

What was a counterfactual or alternative to the market Bolshevik program in Russia? If the logic (minimizing agency chains and building on de facto property rights) is sound, then the Soviet lease buyouts and related experiments seem to be the closest thing to a counterfactual to grow out of the reform experience in the FSU.17 As noted above, this option was argued for at the time and on the basis of roughly these arguments. Martin Weitzman also at the time gave a pragmatic argument for the worker-ownership version of stakeholder privatization.

Under worker ownership, the workers themselves, or their agents, will have to control pay and negotiate plant shutdowns. The most acute "us vs. them" stalemates may be avoided. Ownership is more concentrated relatively close to management decisions and can put more immediate pressure on performance. Regulatory capture may be avoided. Hard budget constraints may be more acceptable. There is less opportunity for financial manipulation. (Weitzman 1993, 267)

Note Weitzman’s version of the minimal agency chain and "shrink-wrapped ownership" argument in his statement: "Ownership is more concentrated relatively close to manage-
ment decisions and can put more immediate pressure on performance.” Unfortunately, the IFIs chose to promote privatization in the way that Soviet-expert Weitzman recommended “How Not to Privatize.”

Moreover, the IFI specializing in the region, the European Bank for Reconstruction and Development (EBRD), not only was aware of the leasing option but sponsored a set of pilot projects to show how lease buyouts could be done using modern corporate forms (Lloyd 1993). The structure of these deals and a host of other examples were presented in an EBRD technical note (1993), so all these ideas were known in the early 1990s to those in the IFIs who wanted to know.

The counterfactual is often caricatured as arguing “that institutional and regulatory reform should have preceded privatization.” However, the point is that stakeholder privatization minimizes the need for the institutions to police long agency chains so that the appropriate forms of privatization can go forward as those institutions are being developed and can, indeed, drive that institutional development through the endogenous Hirschmanian linkages (in contrast to the IFI conditionalities).

For instance, it might be argued against the Russian lease buyouts that “Russia did not have a sufficiently well-developed national or regional institutional environment, as in Poland, to prevent large-scale managerial expropriation of assets under such a scheme.” But the stakeholder theory did not depend on a “well-developed national or regional institutional environment” (such as securities and exchange commissions and auditing agencies) to protect the self-interest of those who have to cooperate on a daily basis to earn their economic livelihood. The stakeholders are all “mutual hostages” to the success of the enterprise so they can exercise their de facto property rights directly, not by trying to get “national or regional” institutions to enforce any formal rights.
Unfortunately, the “experts” did not seem to have understood the argument then—or now.\textsuperscript{16} When the “experts” have a quasi-religious faith in ersatz national or regional watchdog institutions enforcing long agency chains and fail to see how people will try to enforce their de facto property rights in their concrete day-to-day self-interest, then the “experts” seem to have “failed in their understandings of the core elements of a market economy” (Stiglitz 1999).

There is also the argument that the stakeholder privatization option would have been too slow. In the Bank, we often heard a speccious dichotomy of mass privatization (meaning vouchers) versus “case-by-case privatization” where the latter meant pains-taking negotiation of each deal. Yet the lease buyout schemes were a form of “mass” privatization in the sense that each deal simply had to satisfy certain cookie-cutter requirements in order to go through. Polish leasing was not slow, and the 10,000 or so Soviet lease buyouts before 1992 when the door was shut indicate that they were also not slow.

Indeed, one of the “problems” with the lease buyouts is that they were too fast and too popular at the firm level, not that they were too slow. The stream might swell to a river. If the lease buyouts had not been stopped, then the market Bolsheviks feared that there would not be any good firms left to go into the voucher auctions. Thus the stream was dammed and the waters diverted into the Kremlin-preferred channel of voucher privatization.

---

**“Employee Ownership” in the Voucher Program**

But, it is asked, if stakeholder privatization such as worker ownership was such a good idea, what about the substantial employee ownership that resulted from the Russian voucher program (Blasi et al. 1997)? Didn’t “employee ownership” get its chance and fail? The advice of advisers favoring employee

owners to form ESOPs was well-intentioned, but the program was made so burdensome that it made it difficult or impossible to create ESOPs.

Repealed the Mass Purchase Act of 1989 that prevented worker cooperative formation of a new district cooperative union. All working cooperatives that were cooperative unions would have their membership co-op district cooperative union. This would help them with the EESOP program.

Of course, the employee ownership shares were restricted by law to those with a right of directors and those with a right of director (e.g., the Russian government). The law permitted directors of the ESOP to sell 10% of their stock, but not to sell any stock to employees. Thus the ESOPs required diluting the rights of directors with no (or very) limited interest in selling their stock.

Those who sold to an ESOP had, in effect, sold to a collective entity that was a private person. They did not simply sell the shares to another person. They could not be on any shareholder list without the shares would lose their ownership status.
ownership (the author included) was unanimous that any genuine attempt to use a worker ownership as a part of the voucher program would require a mechanism for collective decision-making such as the U.S. or UK employee stock ownership plan or ESOP (as was roughly built into the lease buyout firms).

Repeated attempts to allow an “ESOP option” in the Russian Mass Privatization Program (MPP) as Option 4 were specifically prevented by the GKI (Russian Privatization Agency) and Western advisors in the IFIs who wanted the worker ownership to be strictly temporary and not subject to collective decision-making. All at least agreed that by allowing individual sell-outs, there would be a prisoners’ dilemma situation with the eventual non-cooperative solution of most workers selling out individually (particularly when helped by managers withholding wages and offering to buy shares instead). The GKI even outlawed shareholder agreements, which might have functioned as “home-made ESOP trusts” to prevent individual share sales without a collective decision, since the GKI wanted to avoid workers’ having any enforceable collective decision-making about selling shares.

Moreover, the Dream Team, the Kremlin’s arch-defenders of shareholder rights, pushed through a Yeltsin executive order that restricted the employee-owners to, at most, one-third of the board of directors—even if the workers had majority or super-majority (e.g., 80 percent) share ownership. Thus the stakeholders who could have helped to prevent managerial looting in the voucherized firms were deliberately prevented from legally coalescing as a stable decision-making group with a common interest in bettering the enterprise.

Those who deliberately designed the MPP to prevent the collective empowerment of the stakeholders in the enterprises were not simply displaying antiworker animus (although that should not be discounted). They entertained the hope that this attempt would lead to the concentration of ownership (“real owners”) and
the top-down power to restructure enterprises and reallocate assets. The MPP often worked as planned to concentrate ownership—in this case usually in the hands of the top enterprise managers. But the top managers had little reason to follow out the rest of the hoped-for “logic” since they had little confidence that any increased value of the enterprise as a profitable going concern could be capitalized upon their impending retirement. This created the situation where many managers felt the most rational response was just to grab what they could while they could. Since the stakeholders were formally disempowered, they were somewhat less assertive about stopping the attempted plunder (although there have been hundreds of plant occupations in Russia by workers trying desperately to stop managerial looting). New schemes of plunder could be arranged with the other major holders of formal rights (called “tunneling” in the Czech context).

Since the MPP was deliberately designed and implemented to undo insider social capital and to legally disempower the insider coalition of stakeholders (even if workers were majority owners) with the collective interest in preserving and improving the enterprise as a going concern (all dismissed as “impediments to restructuring”), it is a bit disingenuous to picture the asset stripping by the top managers and their outside colleagues as a failure of “employee ownership.” After deliberately tying up the watchdog at hand (in favor of some ersatz and distant “watchdog institutions”), the Russian “reformers,” the IFIs, and the Western advisers shoulder much of the responsibility for the foxes’ having the run of the chicken coop.

Closing Remarks

In summary, the Soviets (and the EBRD) experimented with the lease buyouts as a more home-grown option, but the Yeltsin-era Russian reformers, with the full support of the IFIs and other Westerners, stopped all the shareholders from getting assets, because they were afraid of property rights and “tunneling” into bottles. The private outsider-linked shareholders rather than the even fewer union-based workers ceded control.

Those who had long ago waited for the Western experts, such as Tawney, to popularize their perspectives.

The situation was not bad, but holding it in check? It is a great improvement (1954).

The time to act quickly

to burn the old books, be expected. A new American nation is under threat once more. The old model is no longer working.

Notes

1. Tawney, R.H. [1954] (1931), Shleifer, 1999. The IFIs were led by Andrew Shleifer. The IFIs are a part of the “Chernobyl” strategy of foreign aid and foreign stimulus, the same strategy that the US aided to bring about the fall of the Soviet Union.

loyal MT
Western advisers, stopped those experiments and deliberately stopped attempts to include some reasonable version of stakeholder privatization in their new master plan for Russia. Instead, they wiped the slate clean of people's accumulated de facto property rights and capabilities (in favor of vouchers worth a few bottles of vodka) so that most Russians "met the market" as an alien and disempowering force. The so-called "reformers" legislated a new system of corporate governance using long, multi-linked agency chains and ersatz watch-dog institutions that don't even function that well in advanced economies after many decades of development.

Those who wish to learn from the Russian debacle should not wait for any deep understanding to come from the institutional experts and academic advisors who engineered it. Richard Tawney noted well that historical understanding requires the perspective of distance.

The student can observe the results which these cataclysms produce, but he can hardly without presumption attempt to appraise them, for it is at the fire which they kindled that his own small taper has been lit.

(1954, 227)

The institutional and academic advisers whose torches seem to burn with the same fire as the Russian conflagration cannot be expected to shed much new light on those events; their inclination is to blame others and to move on to other places and concerns.

Notes

1. The "Harvard wunderkind," Jeffrey Sachs, Larry Summers, and Andrei Shleifer, together with the Kremlin "Dream Team" (Summers's memorable label) led by Anatoly Chubais, played a role in Yeltsin's Russia roughly analogous to that of the "Chicago Boys" in Pinochet's Chile. Peter Murrell has referred to their general strategy as "The Transition According to Cambridge, Mass." (1999), but (as a loyal MIT alumnus) I must point out that the wunderkind were all at Harvard.
2. My main focus is on privatization prior to the Russian reformers’ “loans-for-shares” scheme, which played a major role in creating today’s oligarchs and which was not publicly opposed by the IFIs. Many commentators seem to avoid learning difficult lessons from the earlier voucher privatization by focusing on the loan-for-shares scheme as the “Mother of All Debacles” instead of simply as “Dream Team: The Sequel.”


4. Quoted in Harding (1987, 318). Thus do Chinese socialists instruct market Bolshevists on the non-Bolshevik methods of institutional transformation. A related “pave the paths” metaphor is used by Christopher Williams (1981, 112). In a complex of new buildings, let grass grow between them, see where footpaths develop, and then pave the paths. While voicing Hayek’s ideas about the market as a spontaneous order, many market Bolshevists (such as Vaclav Klaus) labored to totally stop spontaneous privatization instead of trying to find the closest socially acceptable channel so that those market forces might swell from a stream to a river (see Ellerman 1993).

5. Deng Xiaoping’s pragmatism “It is not important if the cat is black or white, but that it catches the mice” was echoed by Ralf Dahrendorf’s 1990 call “to work by trial and error within institutions” (41; quoted in Sachs 1993, 4). Dahrendorf’s book was a deliberate updating of Edmund Burke’s anti-Jacobin tract Reflections on the Revolution in France (1937 [1790]). Sachs argued against Dahrendorf’s pragmatism, noting that “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, 5). To avoid “costly and dangerous wrong turns,” the then-Harvard wunderkinder promoted the scheme of mass privatization through voucher investment funds.


7. Actually, it was more than PR, at least in the usual sense. Some Bank economists churned out reams of accommodating econometric studies “scientifically” showing how “successful” the Czech privatization and restructuring was. Later, when Stiglitz had the econometrics redone outside the Bank, the results were negative or insignificant (see Weiss and Nikitin 1998). For a thoughtful rethinking of the Bank’s experience by the then head of the Bank’s thematic group on privatization, see Nellis 1999.

8. The voucher funds were typically restricted by law to owning at most 20 percent or 30 percent of a portfolio company, and the annual payoff of the fund management companies was typically fixed at 2 percent of the value of the portfolio under management. Hence the “ownership interest” of the controlling fund management firms was on the order of 2% × 30% = 0.6%, or sixth-tenths of 1 percent. This was not some “secret” design flaw discovered later, this was in the legislation of the voucher programs. Surely the experts, wunderkinder or not, could “do the math.” Yet the globe-trotting “institutional design experts” seemed surprised to later find in their voucher programs all across the transition economies that the fund management companies devised more efficient ways to “tunnel” funds out various “back doors” of the firms.

9. An “agency chain” is a multilinked chain of principal-agent relationships.
For instance, in the large publicly traded U.S. companies, the theory is that the shareholders are the ultimate principals who "supervise and control" the board of directors as their agents (in theory through board elections, but in fact dissidents tend to use exit—selling shares—rather than voice). The board, in turn, is supposed to select and supervise the top managers (rather than the other way around) in another link in the agency chain. Then the top managers supervise the middle managers and so forth, eventually down to the workers on the office or shop floor.

10. For instance, managers have much more relevant information about what they are doing and about the company than their "principals," the board members and the shareholders.

11. In 2001, Stiglitz received the Nobel Memorial Prize in economic sciences for his work in information economics.

12. The superficiality of interpreting "passing laws" as institutional change (unfortunately, a common practice in the IFIs) was noted long ago by Richard Tawney after visiting China in 1930. "To lift the load of the past, China required, not merely new technical devices and new political forms, but new conceptions of law, administration and political obligations, and new standards of conduct in governments, administrators, and the society which produced them. The former could be, and were, borrowed. The latter had to be grown" (Tawney 1966 [1932], 166).

13. The attempts to use vouchers to kick-start "stock markets" in transition economies from the Czech Republic to Mongolia are best viewed as "cargo cult" reforms driven by the totemic or "religious" significance of Wall Street rather than by any real economic function (see Ellerman 1998, 2001). In this case, the U.S. Agency for International Development (USAID) presented a strong challenge to the World Bank/IMF to be "more Catholic than the Pope"—to be the true "Vatican" of the stock market cargo cult. Now that the historical moment for voucher privatization has passed, the leading institutions of the stock market cargo cult—the Bank and USAID—are promoting mandatory defined-contribution pension plans in order to re-kick-start the moribund securities markets in the transition and developing economies. Such plans are funded with obligatory deductions from workers' pay, and the funds are invested with workers bearing the risk. Thus, these agencies "promote free markets" with schemes that force people to indirectly "buy" securities that they would not buy voluntarily. For example, as if the Bank-sponsored voucher privatization were not enough of a disaster in Kazakhstan, the World Bank and USAID sponsored a 100 percent "second-pillar" pension system in that country, a system that has already put over a billion dollars from workers' pay into the private "pension funds" to be invested in Kazakh securities. But, as a new pension system, it will take more than a generation for this debacle to unfold, long after the relevant Bank/AID officials have retired on their defined-benefit pensions. Then it will be time to further "help" the country by indebting it with another pension loan. In this way, the government could meet its "implicit pension liability" to the workers, whose forced savings would then have disappeared in the maw of the cargo-cult securities market.

14. James Scott's book Seeing Like a State (1998) argues persuasively that states use simplified pictures of reality to administer their affairs but that these simplified pictures lead to disaster when they are the basis for large-scale social engineering schemes to change reality. Global development bureaucracies have even less contact with local realities than national governments do, and thus they tend to be even more driven...
by bureaucratic common-denominator stereotypes or cartoon models of reality.

15. “Shrink-wrapped ownership” is a metaphor denoting a structure where owners are those “stakeholders” who—indeed, any formal ownership—would have an “up close” functional relationship to the operations of a firm, which would include the staff and major suppliers (including finance) or customers and perhaps local authorities but not, say, absentee buyers of second-hand shares. The idea is to match ownership to function with the firm rather than treat “ownership” as a tradable commodity that can be bought by otherwise unrelated parties. By “firm,” I mean the de facto firm that meets every working day, not the formal legal entity that meets once a year. The strikingly successful Chinese TVEs function with a “shrink-wrapped” ownership/control structure even without Western-style formal ownership—much to the bewilderment of the Western experts.

16. In the transition literature (e.g., Dabrowski et al. 2001), one sometimes finds the view that the industrial TVEs somehow sprang up de novo in the nonindustrial countryside of China during the 1980s and 1990s. In fact, they started as the conversion and expansion of the commune (= township) and brigade (= village) enterprises left over from the earlier attempts to decentralize industry to the rural areas (see Byrd and Lin 1990).

17. In a lease buyout, the enterprise—whether developed de facto property rights in the decentralizing reforms—were allowed to proceed “straight to the market” by purchasing the company with seller-supplied credit on an installment or lease-purchase basis. As in U.S.-style leveraged buyouts, the installment payments are made by the company (not the individuals) to the seller. The lease buyouts worked best as medium-sized (or smaller) firms. But the Soviet dinosaurs typically needed to be hustled up into a related set of medium-sized firms, so lease-buyout “spin-offs” or “breakaways” could also be used to restructure and privatize large firms.

18. The failure of elite academic and bureaucratic economists to “understand” this mutual hostage argument surely derived in part from their fundamental antithetical animus. This was clearly shown in the behind-the-scenes arch-paternalist view that “worker ownership” would just lead to workers’ destroying their own livelihood by stripping the assets of their own firms. They argued for strong absentee owners who would be “interested in maintaining the long-run health of the assets” and who would act as “asset advocates.” And then the elite advisors supported voucher investment funds—funds which, together with Enron-style managers, showed their great devotion to assets by promptly selling them out of the firms. However, some Polish critics of the “Stiglitz perspective” (Dabrowski et al. 2001) allow that “worker self-management” played an important part in limiting the fall in output and the amount of criminal asset stripping in the state sector in Poland and thus they are “Not Poles Apart” on the short agency chain and mutual hostage arguments (Stiglitz and Ellerman 2001).

19. Yeltsin Executive Order No. 2284, “About the National Program of Privatization of State and Municipal Enterprises in the Russian Federation,” was issued on December 24, 1993 (thanks to John Simmons and Olga Klepikova for the reference available [in Russian] at ttp://referent.ru:4085/1/5453 [particularly §§10.4]). One can surmise the hue and cry that would have been raised by the IIIs and other assorted “defenders of stockholder rights” had such a decree been directed at foreign investors instead of worker owners.
For Further Reading


---

To order reprints, call 1-800-352-2210; outside the United States, call 717-632-3535.

---

JEFFREY C. COHEN, Co-Chairman, Council on Foreign Relations, New York, has recently published *The Next Century: Where We’ve Been, Where We’re Going* (Tapen, NewYork, 2000). His previous book, *The Wealth of Nations: A History of the World Economy,* has been described by Paul Samuelson as "more than the sum of its parts." He holds a Ph.D. from the University of Chicago and is a member of the editorial boards of *Challenge* and *The Independent.*

---

CATHERINE BARTLETT, Associate Professor of History, University of Hong Kong, has recently published *Manchu Civil War: The Hidden History of the Manchu Restoration* (Macmillan, 2000). Her previous book, *The Manchu Conquest of China* (Macmillan, 1997), has been translated into four languages. She holds a Ph.D. from the University of California at Berkeley and is a member of the editorial boards of *Challenge* and *The Independent.*

---

CHALLENGE/MAY-JUNE 2003