Transitional Heresies of a Devil's Advocate

David Ellerman
World Bank*

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Doing the Devil's Work

In the matters of the post-socialist Transition, there is also a "Washington Consensus On Transition" (WCOT) forged on both sides of 19th Street and in the halls of the US Government--with an assist from the best and the brightest from some of our finest universities.

If the Knowledge Bank is seen, explicitly or implicitly, as a "Church" then the Washington consensus on the post-socialist transition has been the Gospel dispensed by our evangelists and missionaries to all who would listen on the far side of the former Iron Curtain. Yet Faith that is untried and untested in open discussion and debate will soon lead to arrogance and hubris. Seasoned Defenders of the WCOT Faith need to constantly sharpen their tools of argument lest they fall into an intellectual dullness more characteristic of highly ingrown and inbred groups--as in some isolated towns in Appalachia or remote islands of the Adriatic.[1]

Better yet, the Knowledge Bank need not function as a "Church of Development"; it could instead function as an open learning organization.[2] Part of the difference is the extent to which open discussion and debate are a vigorous part of the organizational culture. As we know all too well, this does not happen automatically in a large bureaucracy. New unaccepted ideas need to find a voice and old well-accepted Truths need to be constantly tested. All this is unwelcome to those who mistake the inertia of conventional wisdom for the weight of rational argument.

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* The findings, interpretations, and conclusions expressed in this paper are entirely those of a Devil's Advocate rendered in that unofficial capacity and should not be attributed in any manner to the World Bank, to its affiliated organizations, or to the members of its Board of Directors or the countries they represent.

[1] Before the War, the island of Susak off the Croatian coast was notorious for having a somewhat inbred population.

[2] This argument is spelled out in more detail in the paper "Knowledge-Based Development Institutions" (1998, World Bank, mimeo.) and in the abbreviated version for executives "Global Institutions: Transforming International Development Agencies into Learning Organizations" forthcoming in *The Academy of Management: Executive* journal (February 1999).

Attacks on the current Faith will usually be seen as "the work of the Devil." Therefore, in an open learning organization, the Devil must be given his blasphemous due in the function of devil's advocacy. In the words of John Stuart Mill's *On Liberty*:

> So essential is this discipline to a real understanding of moral and human subjects, that if opponents of all important truths do not exist, it is indispensable to imagine them, and supply them with the strongest arguments which the most skillful devil's advocate can conjure up.[3]

The sympathetic bureaucratic response would be to officially establish a "Devil's Advocate Office" but that would miss the spirit as well as the substance of the function. Official Dissent would soon be no dissent at all. Devil's advocacy by its nature needs to be "wild," spontaneous, and unofficial. Otherwise the hounds of heresy would soon be neutered into lapdogs of liberality trotted out on occasions to show how the Institution always "listens to both sides of the question."[4]

Thus it is necessary from time to time to take leave from our "team player" role and to play this blasphemous role of being the Devil's Advocate *conjuring up* arguments against the current faith, the Washington Consensus On Transition.

Voucher Privatization

Let's start with voucher privatization. Many are unhappy with the results, but the "standard" Washington Consensus is still the framework and the "devil" is thought to be only in the details. Yet, voucher privatization has deeper problems. It was more about post-socialist politics than "privatization" so let us begin with several voucher privatization arguments that are part of the WCOT Canon.

- **No-cash argument:** Lack of cash implies giveaways. But there is a third option besides cash sales or free vouchers: credit. There is also an alternative to third party credit: seller-supplied credit.
- **Speed argument:** It is not always the case the vouchers are fast and case-by-case is slow. Moreover the speed argument was hardly consistent with shutting down and even reversing some types of non-voucher privatization quite successful in CEE (lease buy-outs) in order for "some shares to be left to go into the voucher auctions."
- **Social justice argument**: Justice demands spreading shares across the population. But wealth takes other forms than shares, and shares in quasi-bankrupt companies have the least claim on the residual worth.
- **Share-privatization = Company-privatization argument.** Why do the experts on privatization sometimes seem to be so inured in a pre-Berle-Means fantasy-world that they didn't understand that privatizing shares in a mass distribution in fact "socializes" the

[3] John Stuart Mill, "On Liberty," in *J.S. Mill: Utilitarianism, On Liberty and Considerations on Representative Government*, ed. H.B. Acton (London: J.M. Dent & Sons, 1972), 105.

[4] See, for example, the discussion in I.L. Janis, *Victims of Groupthink* (Boston: Houghton Mifflin, 1972) of the "official dissenter" in some governmental organizations within the Beltway.

company (and yet why when it comes to arguing for voucher investment funds, they understand the point quite well)?

- **The 0.4% solution to the "corporate governance" problem.** Why does anyone really think that a "corporate governance" problem in a company is solved by having it controlled by an investment fund with an even worse corporate governance problem and with a minuscule interest in ownership income? (Hint: it has something to do with the politics of the different people who would have "corporate governance" in each case.)
- **Red directors argument**: Why do western advisors seem to assume the role of cold-warriors assigned to vet the Red directors instead of seeing to it that the directors of whatever coloration are bearing their own costs?
- **"Get the State Out" Argument**: "Getting the state irreversibly out" of the economy is not an argument for *voucher* privatization as opposed to, say, cookie-cutter case-by-case privatization. Moreover, the main thrust of voucher schemes was often to bring power back to the new "clean" state by *reversing* the earlier decentralizing reforms (e.g., Solidarity's self-management councils).

The No-cash Argument.

Since the citizens and workers didn't have enough cash, it was necessary to give away the shares for free. This is a wonderful argument coming from people who have credit cards, home mortgages, car loans, and so forth. Yes, there is a third option besides selling it for cash or giving it away for nothing; it is credit. Oh, but who would loan them the money? No banking system, much less the ones in these countries, could finance transactions on the necessary scale. But who said it had to be third party credit? The credit for non-cash and non-giveaway privatization is seller-supplied credit, i.e., seller-taking-paper financing with installment payments. Yet even to this day, we continue to hear the "no-cash" argument for voucher privatization.

The Speed Argument 1: Vouchers Need Not Be Fast

Voucheristas love to set up false dichotomies between "rapid" voucher privatization (part of fast-but-painful shock therapy) and "slow" case-by-case privatization (part of less-painful-but-slow gradualism). Even assuming that voucher "privatization" is privatization in any worthy sense of the long-suffering word, it is not necessarily fast. The laughing-stock of the Mass Privatization Program hit parade was the Polish case. It was originally billed by a Harvard professor as the "rapid privatization program" complete with a monthly time table based the academic guru's extensive experience in institutional transformation. Every year, World Bankers working on privatization would troop over to the annual conferences in Eastern Europe to get the "progress report" on the Polish MPP. After four or five or however many years (I lost count) and much arm-twisting from aid providers, the poor Poles have a rather pathetic scheme of essentially parastatal holding companies managed by Western portfolio managers collecting nice fees for doing almost nothing.[5]

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[5] But the Polish MPP does have a Purpose! It was "invented by God" as the test given to "privatizers" when they die and go to Purgatory. They will be asked "Did the Polish MPP scheme have anything to do with 'privatization'"? If the answer is "Yes, of course, it was even called a privatization plan" then they are instructed to go through one door. If the answer is "Are you kidding?" then they go through the other door. In case you are dying to find out what was behind each door, I am afraid you will just have to.

It was not just in Poland that voucher "privatization" was not "rapid." In Russia, voucher privatization's "great leap forward" over the chasm fell far short of the "market economy" on the other side, and it will take a long time for Russia to climb back out of the chasm. It would have been far quicker to incrementally build a bridge across the chasm.

The Speed Argument 2: Case-by-Case Need Not Be Slow

Meanwhile a "privatization by liquidation" program designed by Poles without the advice of western experts used seller-supplied credit and standardized “cookie-cutter” procedures to privatize thousands of SMEs as "de novo" firms in the manufacturing sector. These firms have been a key part of the Polish success story. The "privatization by liquidation" scheme is also called Polish leasing since the installment payments can be viewed as lease-purchase payments. Instead of dreaming up more schemes for "privatizing" the larger firms, many could be "busted up" into contractually-related SME-sized units which could then be privatized in the way we have seen actually works. The same holds for many large mis-bundled conglomerations of assets that have been "voucherized" (why waste a good word like "privatized"?).

But did the Russians at the time have a real alternative to their Great Leap Forward? They would, for example, need something like the Polish leasing model to seed the crucial SME or Mittelstand sector. The Soviets had such a model called the "lease buy-outs" developed during the Gorbachev perestroika era.[6] But surely these lease buy-outs were just case-by-case privatizations which "everyone knows" are so slow. Actually, it was the other way around. The lease buy-outs were too fast, not too slow. In Russia and in many of the countries of the FSU, the lease buy-out programs were stopped so that there would be "something left to go into the voucher program."

Thus to summarize, the Russians (and other FSU republics) had a home-grown privatization method (lease buy-outs) that with some easy improvements would be more or less equivalent to one of the most successful programs in Eastern Europe (Polish leasing) in terms of speed and depth of privatization. Yet it was abolished by the "reformers" with the full approval and indeed insistence of the western advisors. In addition to stopping the leasing programs in the FSU, some of the lease privatizations were even partially undone so there would be more shares to put into the voucher "privatization" program (but the western experts did not convince the Poles to undo their insider-owned lease buy-outs or the Chinese to undo their TVEs which functioned largely as producer co-ops[7]). It seems difficult to argue that either speed or depth of privatization were serious goals of the post-socialist voucher programs.

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[6] The early leasing models had a technical problem with "social ownership" but this could be easily fixed with a limited liability company as in the German GmbH or with a closely-held joint stock company. Indeed the problem was fixed both in indigenous cases and in the EBRD's pilot lease buyouts done in Moscow in the pre-voucher time period. And even that "flaw" was not that important since the Chinese township-village enterprises (TVEs) suffer from that social ownership problem and yet have fueled the spectacular Chinese growth.

[7] See Martin Weitzman and Chenggang Xu, “Chinese Township-Village Enterprises as Vaguely Defined Cooperatives,” *Journal of Comparative Economics* 18 (1994): 121-145.

The Social Justice Argument

Before the so-called "reformers" in Russia went on from voucher privatization to the loans-for-shares scheme in their quest of "social justice", we used to hear much about the "equitable distribution of the national patrimony." But we really need to pay more attention to the difference between debt and equity, or, more generally, between shares and other forms of wealth. If one wanted to distribute what little wealth there was in quasi-bankrupt companies to the citizens, why would one give them shares which have the least claim on the assets of a distressed company as opposed to, say, senior debt instruments which might have some prayer of being paid off? Or better yet, since atomized citizens have little power to enforce bondholder rights (forget shareholder rights), why not have the government solve that collective action problem by collecting the wealth (e.g., installment payments from privatization with seller-supplied credit) and then distribute that non-share form of wealth to the citizens, e.g., as part of an overhaul of the pension system? In addition to assuming that wealth could only be distributed as shares, the "social justice" argument was a shallow play upon the sentiments of primitive communism ("Let's split it up equally and start all over again").

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

The Share-Privatization = Company-Privatization Argument.

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

To review some of the basic attributes of the Anglo-American model of managerial capitalism, there is a separation of ownership and control. Shares are owned by the dispersed and atomized shareholders (including institutional holders) who exercise little de facto control over the companies. The separation of ownership and control means there is a difference between the "ownership of companies" and the "ownership of shares." Shares are still privately owned. The shareholder exercises full "clear-cut property rights" over the shares, i.e., buy, hold, or sell the shares. But who "owns" the company as their private property? No organized decision-making unit "owns the company as its private property." The "ownership of the company" has been dispersed, as it were, by the four winds of the mass stock market. Thus the large US company becomes in fact a "social institution" that is nonetheless touted to the post-social-ist world as the exemplar organization "based on private property." It is easy to see why this is such a touchy topic and why the fantasy-world of shareholder capitalism promoted by much of the business press, corporate mandarins, the brokerage industry, and finance professors is so preferable to the reality of managerial capitalism.

If there is any culprit in the drama of managerial capitalism, it is the key institution that transformed the shareholder from a proprietor into a punter[8] and that "socialized" the ownership of the large companies. Yes, it is that same institution that is presented by so many experts as the key to "privatization"--the stock market. The mass stock market privatizes shares, but it socializes companies. Voucher privatization and stock market development are often presented as necessary for each other. Voucher privatization is a good idea because it will kick-start the stock market, and a stock market is necessary for post-privatization trading of the shares. It's like a chicken-and-egg thing! But I am afraid the "chicken" is a turkey and the "egg" is rotten. Vouchers privatize shares, not companies, and the mass stock market socializes, not privatizes, companies. Indeed, it is precisely the socializing tendency of widely dispersed shareholding that leads to the next "bright idea" by western experts and their reformer counterparts, namely voucher investment funds.

Digression on So-called "Capital Markets"

Before turning to voucher investment funds, let me comment on the phrase "capital market" which is often heard uttered in the same breath as "Russian financial sector." But I am afraid I don't see the connection. In my old-fashioned texts, I read that the "capital market" intermediates between household savings and investment by firms. Is that what the new Russian financial sector has been doing?? I see outfits called "banks" that specialize in money laundering, expediting capital flight, serving as shells for oligarch power plays, and other forms of stealing. Perhaps the Russian banks have been "intermediating" between the "savings" of the oligarchs and their "investments" in foreign accounts. Not too many ordinary Russians were foolish enough to put their savings in the new Russian banks, and even they are fools no longer.

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

I'm still looking for that "capital market" in the Russian financial sector. Perhaps it is the "stock market"? Even in developed western economies, the stock markets are rather minor players in net capital investment. "To a large extent equity markets are an interesting and fun sideshow, but they are not at the heart of the action. Relatively little capital is raised in equity markets, even in the United States and the United Kingdom. One cannot expect equity markets to play an important role in raising funds in the newly emerging democracies."[9]

The Totemic Role of Post-Socialist Stock Markets

Why, then, all the emphasis on the "stock market" in post-socialist countries? I am afraid that one of the main reasons is totemic or "religious" in an anthropological sense. The "Wall Street"

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[8] See *Economist*, May 5, 1990. Capitalism: In Triumph, in flux. 5-20.

[9] Joseph Stiglitz 1994, *Whither Socialism?* Cambridge: MIT Press. p. 228.

mentality found in the post-socialist world is reminiscent of the cargo cults that sprung up in the South Pacific area after World War II. During the War, many of the glories of civilization were brought to the people in the southern Pacific by "great birds from Heaven" that landed at the new airbases and refueling stations in the region. After the War, the great birds flew back to Heaven. The people started "cargo cults" to build mock runways and wooden airplanes in an attempt to coax the great birds full of cargo to return from Heaven. Post-communist countries, with hardly a banking system worthy of the name, have nonetheless opened up "stock exchanges" to supposedly kick-start capitalism. Government officials in East Europe, the FSU, and even Mongolia proudly show the mock stock exchanges, complete with computers screens and "Big Boards," to western delegations (with enthusiastic coverage from the western business press) in the hope that finally the glories of a private enterprise economy will descend upon them from Heaven. Indeed, a "fun sideshow."

The 0.4% Solution to the "Corporate Governance" Problem

Getting back to voucher investment funds, the main argument was that the VIFs were necessary to provide the "corporate governance" to restructure the voucherized firms. This seems to me to contain several infelicities in reasoning--which have now been also revealed by the developments in the Czech Republic. My point is to focus on the problems in reasoning which were apparent all along (not on the facts which only in hindsight seemed to become clear). The assumption seems to be:

Bad "Corporate Governance" = 10s of thousands of shareholders in a firm leaving corporate managers with much de facto control (even though many of the shareholders are also stakeholders with some real interest--aside from the shares--in the firm), and

Good "Corporate Governance" = 100s of thousands or millions of shareholders in an investment fund leaving the fund management company almost total de facto control.

There is of course the formal "concentration of ownership" by the funds but the point is that the funds themselves are run by fund management companies and that 100s of thousands of shareholders of the funds have even less influence on the fund management company than would the stakeholders of an operating company with shares dispersed among employees, local residents, suppliers, and some merely financial investors. Given the situation of an investment fund controlling an operating company, the actual decision-maker is the fund management company who has an almost negligible ownership relationship to the firm. For instance, if the fund can own at most 20% of the operating company (e.g., Czech Republic), and the fund management company's fee is 2% of the value of the assets under management, the amount of the ownership value that filters through to the actual decision-maker is 2% x 20% = 0.40% or 4/10ths of 1%. This "0.4% solution" is the magic "desirable concentration of ownership" that was supposed to drive restructuring in the economies voucherized with powerful investment funds.

Let us suppose that a fund management company had put in all the time and effort to figure out how to restructure a portfolio company and to figure out how to actually implement the restructuring plan. Its gross return from this time and effort is 0.4% of the increase in value! And 99.6% of the increase in value would go to free-riders. And that is the gross return to the actual decision-maker. You have to subtract off the explicit costs and implicit opportunity costs to get the actual net return to the fund management company. Thus there is negligible or negative ownership returns from restructuring so one should not be surprised when it was finally "revealed" (by suitably sophisticated regression analysis) that the Czech fund management companies had found more "efficient" ways to extract or "tunnel" value out of their portfolio companies.[10] Even if the tunneling is stopped by 'perfect' regulation, that does not mean that the funds will undertake restructuring activities. They can collect their fees by doing next to nothing (taking a lesson from the Polish funds?).

One moral of the story is that a "corporate governance" problem in a firm is not solved by having concentrated ownership of the firm by an institution that has an even *worse* corporate governance problem.[11]

The Red Directors Argument or "Privatization" as the Cold-War by Other Means

We are told that voucher privatization was desired because otherwise (e.g., in lease buy-outs) the Red directors would end up with all the power. We will not criticize voucher privatization because so much power ended up in the hands of the managers anyway since that was an untoward outcome genuinely against the intent of the Russian reformers. There are two other problems in the Red directors argument, a small problem and a big problem.

The small problem is the cold-war stereotypical image of the Russian manager as an incompetent hack or demonized communist ideologue selected by the Communist Party for political reasons. I think a non-ideological examination of Russian managers would find a large spectrum of competence--just like in some other countries. It is said that Russian managers are clueless about many aspects of operating in a market economy (--like bureaucrats or academics everywhere without experience running a private business). There is some truth to that judgment, but then most western managers would be clueless about operating in the bizarre "virtual economy" that has evolved in Russia (as shown by many of the business advisors parachuted by aid agencies into the Wild East). But the question of the accuracy of the simplistic cold-war stereotypes of Russian managers is not such a practical question because there is no supply of well-trained

[10] It is wonderful that we now have the data and the powerful regression techniques to give us 20-20 hindsight about what was really going on with the Czech voucher investment funds (see Andrew Weiss' paper with Georgiy Nikitin, *Performance of Czech Companies by Ownership Structure*, World Bank, mimeo. 1998). All this was well covered in the Czech press and well known to the Czech public but safe and sane social scientists cannot jump to conclusions based on such "anecdotal" evidence. Yet there is the lingering question of why this wisdom came only as hindsight. Why must the "Owl of Minerva only take to flight as the shades of night are falling"? Yet the experts are earnestly engaged in learning lessons. Now I am told that some of the "better designed" voucher fund schemes had a "lead fund" which had 33% ownership share in some portfolio companies and that some "management fees" were 3%. That "better design" would give a 33% x 3% = 0.99% (gross) income incentive. We have almost broken the 1% barrier with "only" 99% of the would-be gains from restructuring going to others. One wonders what a poorly designed incentive scheme would be.

[11] Fable/Story: Stephen Hawking in bygone days was giving a public lecture on cosmology. An old lady in the front row finally burst out with: "Why all this fancy talk? Everyone knows that the Earth is resting on the back of an elephant that is standing on a turtle." Hawking took a deep breath, and said; "Yes, but one has to ask: on what is the turtle standing?" The old lady immediately shot back: "Don't get smart with me, young man. Everyone knows it is turtles all the way down." The investment fund is like the first turtle that solves the elephant's problem, but the first turtle needs another turtle to solve its (corporate governance) problem, and you can't have "turtles all the way down."

doppelgänger managers to take over (e.g., no "West Germany"). At best the top managers can be replaced by the current middle managers (cut from essentially the same mold). Moreover the political motivation for the Red directors argument became quite clear when it was used in countries such as Slovenia where the managers had demonstrated their overall competence over a period of decades.[12]

The bigger and more interesting problem in the Red director argument is the presupposition that owners need to be vetted by the authorities in a private property market economy--as if there was some "GMAT" or competence test given to private owners in market economies before they were allowed to start or buy companies. I am afraid that is not how the system works. The private property system works not by insuring that owners are smart or well-trained or ideologically vetted but by insuring that owners pay the costs of their own actions. Pain smartens. Thus advisors to the post-socialist countries should not be worrying at all about whether the directors are red, white, or green but whether they are bearing the costs of their actions. If the argument was that "Red directors" were bad because their old party connections would allow them to socialize the costs of bad decisions, then that would be a plausible argument. And a plausible solution would be to internalize those externalities so that the people making decisions bear their costs.[13] Instead, the Cold War triumphalism that fueled the Red director argument lead to demonizing and moralizing that apparently tended to obscure basic market principles.

The "Get the State Out" Argument

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

In Poland, shock therapists used state corporatization to *reverse* the earlier decentralizing reforms and break Solidarity's hard-won power on corporate boards. In parts of the former Yugoslavia, voucheristas tried to bring power back to the state by *reversing* decades of decentralized social ownership. And as already mentioned, the reformers in Russia and some other former Soviet republics sought to *reverse* the decentralizing reforms of the Gorbachev's perestoika. In all these cases, where home-grown decentralizing reforms had already taken place, the shortest distance to the market would have been to proceed straight ahead in the same direction all the way to full privatization, not to reverse direction and renationalize or "corporatize" under state ownership. The effort to pull power and ownership back to the state to be "properly" redistributed betrayed the underlying political battle between the new "clean" post-socialist reformers and the old "embedded" decentralizing reformers. History will show that "voucher privatization" was essentially the cover-story for those political shifts in power.

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[12] This was even admitted by the most notorious of the western advisors: "Even if they [Slovene managers] are all Lee Iacoccas, does it make sense to simply give the country's industry to them?" Jeffrey Sachs quoted in *Washington Post*, May 15, 1991, p. G3.

[13] Incidentally, non-Red directors as well as business managers in market economies often try to get local authorities to "socialize" some of their costs.

A Case for Voucher Privatization?

We have now examined the main arguments for voucher privatization put forward in the Washington Consensus On Transition, and we have found them "wanting" if not altogether phony in some cases. One must sooner or later ask about the other "non-economic" goals of voucher privatization. That question can be answered based on the political transformations that took place in the post-socialist countries in 1989 and the early 90's. But Samuelson has quipped that perhaps the best way to help someone to learn a theorem is give them only half the proof and to let them reconstruct the whole proof. We have seen half the proof. We have seen that the sheaf of "arguments" traditionally trotted out in favor of voucher privatization was as phony as a wad of three-dollar bills. In spite of all the phony economic arguments, voucher privatization (particularly with investment funds) was a brilliant political strategy for certain groups. A little knowledge of the history of the region before '89 (decentralized socialist reforms) and after '89 (democratic post-socialist transformation) would allow one to work out the full picture. And part of the picture is the cold-warriors of the WCOT Faith jumping in, taking sides based on their stereotypes, and contributing to turning the dramas in Russia and a number of other countries into tragedies.

Other countries such as China resisted the siren song of the WCOT. The Chinese ignored the shock therapy advice given by western experts about how to liberalize and privatize their economy. Being unenlightened by the Consensus, the Chinese "didn't know what they were doing" but they at least knew that--so they incrementally and experimentally worked out their own road to a "social market economy with Chinese characteristics." The result has been the most spectacular development of a market economy in the 20th century. The answer of the Defenders of the Faith is: "Oh, but imagine how much still better off the Chinese would be if they had followed the advice of the western experts--and, unlike the Russians, had followed it exactly to the letter!"

Institutional Blitzkrieg versus Incrementalism

The debate is not "fast versus slow" or "rapid versus gradual" methods. It never was; that was another phony argument. The argument was institutional blitzkrieg versus incrementalism. One of the best treatments of this debate about development strategy is in Hirschman's 1963 *Journeys Toward Progress* (republished by Norton, 1973) which far antedated the transition debate. Reformmongers in their strategies and even more so in their rhetoric could be divided into those who take an ideological, fundamental and root-and-branch approach versus those who take an incremental, piecemeal, and adaptive approach (in Spanish described as *criollo*). The incremental approach is well described by Woodrow Wilson in his First Inaugural Address using words that might someday find their translation into Russian.

> We shall deal with our economic system as it is and as it might be modified, not as it might be if we had a clean sheet of paper to write upon; and step by step we shall make it what it should be, in the spirit of those who question their own wisdom and

> seek council and knowledge, not shallow self-satisfaction or the excitement of excursion whither they cannot tell.[14]

In the far future, intellectual historians will see how little the Washington consensus on the Transition understood the critique of Bolshevism-Jacobinism by the conservative tradition of Hayek, Popper, and Burke.[15] It is a devilish thing to say, but so many of our best and brightest economists seem to have just thought the Bolsheviks had the wrong textbooks. With the right textbooks in their briefcases, the "market Leninists" thought they could fly into the socialist countries and use a peaceful version of Leninist methods to make the opposite transition.

The task was not resetting inflationary expectations with a dose of "shock therapy." The task was deep-lying institutional transformation. The origin of what became known as the "shock therapy" approach to the Transition was not a bad analogy with inflation-stopping therapies. Rather it was more the moral fervor of economic cold-warriors who sought to raze the evil institutions of communism and to socially engineer in their place (using the right textbooks this time) the new, clean, and pure "textbook institutions" of a private property market economy. Only a blitzkrieg approach during the "window of opportunity" provided by the “fog of transition” would get the changes in place before the population had a chance to organize to protect its previous vested interests. This mentality was not new. It was a reincarnation of the spirit and mindset of Bolshevism and Jacobinism. But, thankfully, the “radical reformers” had more benign and seductive instruments: aid, loans, conditionalities, and even young professors with world-class credentials.

There has been some recent criticism of the purveyors of WCOT for "ignoring institutions." How could anyone accuse the Gaidar-shock-therapists (or Bolsheviks and Jacobins for that matter) of neglecting institution-building? Institutions were not ignored. Institutions were just "built" Jacobin-style with bright young people (some from elite western universities and financed by aid dollars) drafting "new institutions" which were then "implemented" by the "democratic powers" of presidential decrees ("democratic powers" established by blasting an elected Parliament to rubble). Robespierre would have understood perfectly.

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

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[14] Quoted in Albert Hirschman, *Journeys Toward Progress* (New York: Norton, 1973), p. 249, who in turn quoted it from David Braybrooke and C. E. Lindblom, *The Strategy of Decision* (New York: Free Press, 1963), Chapter IV. Lindblom and Braybrooke's treatment of "disjointed incrementalism" is the context. Lindblom has recently returned to these general issues in his excellent *Inquiry and Change* (New Haven: Yale University Press, 1990).

[15] See Peter Murrell, “Conservative Political Philosophy and the Strategy of Economic Transition,” *Eastern European Politics and Societies* 6, no. 1 (1992): 3-16 for a development of this theme.

saw that “it’s not so much what you don’t know that can hurt you--but what you know that ain’t so.”