Why Russia Failed to Follow Poland: Lessons for Economists

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1 Introduction

Following elections in summer 1989 the Polish intellectual Tadeusz Mazowiecki became the first non-communist premier in the former Soviet bloc. Beginning of 1990 his government introduced a package of policy measures which tried to move the Polish economy as swiftly as possible towards market capitalism. The approach was labelled "shock therapy" or "big bang" – foremost by western economists – for its radical nature.

Almost two years later the direction of Russian economic reforms became clear when Boris Yeltsin unexpectedly appointed Yegor Gaidar as the head of an economic team to design Russia's reform policies. In January 1992 the western economist Jeffrey Sachs attested that Gaidar's plan was a "comprehensive package of measures, which follows the pattern of the radical reforms under way in Eastern Europe." [The Economist, 4 January 1992, p. 110]

However, despite the intention of Yegor Gaidar and his team to follow the Polish reform model, the two countries fared very differently. After a sharp slump in output, the Polish economy recovered relatively swiftly and reached its pre-transition real GDP level within seven years. The Russian economy on the contrary was in steady decline for four consecutive years, recovered in 1997 only to be hit by severe economic crisis in 1998.

Given similar reform plans at the starting point of transition the divergence of economic performance is surprising. The first goal of this article is to explain this divergence. A natural starting point for such an analysis is the economic theory that was the basis for "shock therapy". These early theoretical works give us an insight into the dominant world view within mainstream economics during the early phase of transition. A detailed analysis of the reform paths thereafter reveals that especially the institutional and political background for reform played a role that had not been foreseen by the theory. It is the second goal of this article to identify these failures.

The article is structured as follows. Section two presents theories surrounding the "shock therapy" approach itself and the theory on the politics of reform. Section three explains the historic context of these theories. It can be shown that significant parts of the theory stem from the specific Polish context – a context that did not apply to Russia. Sections three, four and five discuss the three main building blocks of radical reforms – stabilization, liberalization and privatization – in detail. An analysis of the diverging reform paths in Poland and Russia shows that the political and institutional context of the reform attempt was decisive for its success. Section six concludes.

2 Some Economic Theory

In order to understand the shock therapy approach and the underlying view on economic reform it is useful to look at its theoretical origins. In the context of this article two aspects are most important. Firstly the theories underlying the shock therapy approach itself and secondly the view of economic theory on the politics of reform.

2.1 Shock Therapy, U-Shape of Growth and the Window of Opportunity

The early theoretical foundations for shock therapy were laid in the work of David Lipton, Jeffrey Sachs[2] and Leszek Balcerowicz[3]. All three economists were themselves experienced in the practice of reforms and therefore mostly interested in deriving practical policy conclusions for the optimal choice and sequencing of reforms. However, they argued for their policy advice on theoretical grounds.

Lipton and Sachs stress the importance of an early and radical price and trade liberalization and swift stabilization, i.e. a fight against inflation. Both reforms had some negative effects for the economy. The liberalization of prices usually led to an explosion of prices since most goods were relatively scarce. Once liberalization led to an outbreak of open inflation, stabilization measures had to be taken. Stabilization meant that the real money supply had to be cut significantly, this was a very painfull step as it entailed policies like abolishing subsidies, controlling a rise in wages and strict control on state credits to regional budgets, banks and enterprises. As formerly subsidised state enterprises had to close down and fire workers, output fell significantly and unemployment increased.

One main rationale behind "shock therapy" is that a more gradual reform will not prevent the painfull consequences of economic transition into a market economy. Radical liberalization and stabilization allow for the quick emergence of market forces and swift economic recovery. In the logics of this theory a more drastic economic decline at the beginning of transition therefore raises growth later and makes a quicker recovery possible. The result is a

[2] See for example Lipton and Sachs (1990a, b)
[3] See for example Balcerowicz et al (1997)

U-shape of output development that can be tested once data on reform speed and output are available[4].

In addition, Leszek Balcerowicz argued that slow reforms bear considerable political risks. His argument has been captured by the concept of a "window of opportunity". According to this view the population of a country is willing to accept difficult and radical economic steps in the first phase of transition due to its large support for its leaders linked to political change. This "political capital" decreases soon and is replaced by "normal" political concerns that make some economic reforms impossible because interest groups opposing change will start coordinated resistance. Thus, liberalization and stabilization have to be initiated immediately to make use of the political capital.

2.2 Models of Resistance to Reforms and the Underlying View on Politics

Economic thinking about politics was governed by the concern that influential groups like the communist nomenklatura would stop or reverse the reforms process. Indeed, these groups fit well to the concept of interest groups and their influence on politics introduced by Mancur Olson[5] and commonly used in political economy. In comparison with the potential benefactors of market reforms the old elite was relatively small and well organized. Therefore, it was important to circumvent their influence, to break the groups apart or - as a second best option - to build strong interest groups in favor of market reforms.

Inspired by this view on politics, the reform process was commonly modelled as the problem of pushing a reform package through the resistance by losers of the reform. A typical example of this view is Fernandez and Rodrik (1991). The authors formally explain blockade of a beneficial reform and the phenomenon of reform reversals. Due to the focus of the work, reform packages were assumed to be exogeneously given and the political process did neither include negotiation about the content of politics nor any compromise that would change the distribution of its benefits[6]. Generally, models of political economy addressed exclusively the conflict between economic winners and losers of transition – little was said about differences in political attitudes, the role of varying institutions and other social factors[7].

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[4] See for example De Melo et al (1996), Åslund et al (1996).
[5] Olson (1965)
[6] One important reason for this neglect was that redistribution schemes face considerable problems of time inconsistency. While a majority agrees to them ex ante, the winning majority disagrees ex post.
[7] Roland (2002)

The impact of these models on the way economists and politicians thought about economic reforms should not be underestimated. Western economists travelled to Central- and Eastern Europe as advisors for reform. In their view politics was indeed about a "beneficial" reform package that had to pass through a barrier of resistance. Interviews show that this view was also shared by both Leszek Balcerowicz and Yegor Gaidar[8].

3 Shock Therapy: How the Idea was Born

An important problem of early transition economics was that a real test of the theoretical ideas about the reforms under way was not available. Even after the first reforms had been implemented in Central and Eastern Europe it was difficult to derive clear conclusions about whether the visible effect was due to country characteristics or the reform[9]. Thus, it was very hard to estimate which reforms could be successfully transferred to Russia.

As a consequence advice to Russia overlooked that the Polish reform of shock therapy was itself to some extent endogenous. In other words, possibility and need to implement shock therapy in Poland was actually the result of its particular reform history and economic situation. Some important factors that led to the radical reforms in 1990 were the reform packages enacted beforehand, the political environment that contained a "window of opportunity", the outbreak of open inflation and the pressure to accept considerable involvement by the West. In order to understand why Russia did not follow the Polish reform path it has to be taken into account that its pre-conditions for reform were very different.

3.1 Reform paths under communist rule

Possibly the most important difference between Poland and Russia was that Poland had considerably more reform experience than Russia (the Soviet Union). The Polish government was experimenting with more and more radical steps of liberalization throughout the 1980s. This resulted in a share of freely negotiated prices in the value of consumer goods in excess of 60 percent in 1989[10]. Poland had kept a large share of land in private hands and liberalized agriculture significantly in 1989. With Polish agriculture being liberalized, food shortages were largely over in 1990. The reform package enacted in 1990 clearly followed a tradition of increasingly radical reform steps conducted under the communist regime until late 1989.

8 See for example Desai (2005), Blejer and Coricelli (1995) and Gaidar (1995).
9 See Murrell (1995) for a description of the resulting pathologies.
10 Kolodko (1989).

Given the history of the Soviet Union, the Peristroyka reforms in the mid 80s were a radical step. However, they were still very much in line with communist programmes and focused on retooling and modernization of industry. More radical steps, such as the law on cooperatives, which allowed for the creation of private entities, were not taken until the late 1980s. Before any further reforms could be planned and implemented, the Soviet Union started to break apart. This resulted in a chaotic institutional change in both Russia and the Soviet Union, with parallel legislative and constitutional changes on both levels and uncoordinated drafting and enaction of economic reform packages. As a result, the implementation of reforms was almost impossible and hardly consistent throughout 1990 and 1991. In contrast to Poland shock therapy as planned by Gaidar in late 1991 did not follow any historic context of reforms.

3.2 The Political Context

A brief analysis of the political context for Polish shock therapy reveals what Leszek Balcerowicz described as “political capital” in his theory of the “window of opportunity”. From the early 1980s on, the Solidarity Union had organized massive strikes among workers. The workers were broadly supported by academics and the Catholic Church. This pressure from a broad, well organized coalition finally gained enough strength to bring about the end of the communist regime. The Solidarity movement provided the Mazowiecki government with human resources and moral support. Policies were still supported after real wages had dropped radically in the first months of 1990 and as late as the summer of 1990 when frustration and pessimism started to spread among the population[11]. While the “window of opportunity” soon closed, Balcerowicz himself stressed in an interview that resistance never a derailed the reform process[12].

Political change in Russia on the other hand was not the result of a broad movement. A loss of power towards the Union republics made the Soviet government ineffective and caused severe political instability. Boris Yeltsin was elected chairman of the Russian Supreme Soviet in May 1990 and a month later the Russian Republic declared independance. After this declaration, four opposing groups played important roles in the struggle for power: a group around Yeltsin, which supported radical reforms, the more status quo oriented groups in Russia, the reformists in the Soviet Union around Govbatschev and the Soviet hardliners who tried to putsch in August 1991. It has to be stressed that all four groups were part of the

[11] Ziemer (1993)
[12] Blejer and Coricelli (1995)

former regime elites. Russia lacked the broad "bottom up" change that brought a new group of politicians to the top in Poland. While Boris Yeltsin enjoyed broad support after the putsch in August 1991, the way the regime had changed could not have led to any special trust of the population in its new elite – it had hardly changed[13].

Yegor Gaidar's arrival into the government was rather surprising. That meant that he had very little time to draft his economic plans. While he was granted considerable powers by Boris Yeltsin he had to face large sections of the bureaucracy and the parliament opposing him from the very first moment. The situation was worsened by his lack of political experience that led to a quick deterioration of power[14]. One indication of how fast resistance to Gaidar built up, is the fact that the Speaker of Parliament, Ruslan Khasbulatov, called for the resignation of Gaidar's economic team as early as January 1992. If there ever was a window of opportunity in Russia, it was very small. It became apparent that without strategic preparations, the attempt of reform would soon lead to political stalemate or even the loss of power.

3.3 The Outbreak of Open Inflation

In Poland open inflation was a consequence of several measures decided on in the "Round Table" talks of spring 1989. The liberalization of prices in the food sector without changing its monopolistic structure led to a rise in prices in the food sector and attempts to control wages through taxes failed miserably. In addition, households were granted legal access to foreign currencies in March 1989. The result was a flight into harder currencies and thus reduced domestic demand for the Zloty. Inflation rose to 38.5 percent in August and 54.8 percent in October 1989[15]. According to Leszek Balcerowicz, the outbreak of open inflation may have convinced many people in Poland that the only possibility was a radical reform.

While the situation was fundamentally much worse in Russia, open inflation was far from the dramatic Polish levels. As long as price controls were in place, open inflation did not break out. Thus, inflation in Russia was mostly hidden until shock therapy introduced radical prize liberalization. In addition, Russia inherited a monetary union with other former parts of the Soviet Union – a fact that severely hindered the possibility to fight inflation.

[13] Szelényi and Szelényi (1995)
[14] Dabrowski (1993)
[15] Balcerowicz et al. (1997)

3.4 Western Influence

An important reason for radical reforms in Poland was certainly the Western influence on its reform package. The Polish government cooperated closely with the IMF in the design of its radical reforms. How significant the influence was can be seen in the fact that the stabilization programme elaborated in cooperation with the IMF contained detailed policy plans[16].

Next to important historical and geographic reasons, Western influence was assured by the critical debt problems of the Polish economy. Poland had started into the 1980s with a significant debt load and despite little new borrowing, the debt grew to around $45bn in 1991[17]. For a country like Poland, which was much smaller and did not have the raw materials Russia could offer, this was a dramatic situation. Its external debt as a percentage of exports for example mounted to 490 percent in 1989[18] and Polish debt service alone was at a staggering 90 percent of exports. The link between this debt load and the involvement of the IMF in drafting the Polish reforms becomes clear in the following statement of Balcerowicz:

The role of the IMF consisted, above all, in giving credibility to our economic programme. This was especially important in the Polish case, as negotiations with our foreign debtors and also the official assistance from western governments depended on the IMF's stamp of approval.[19]

Yet the Western influence on policies lasted far beyond the initial stage of drafting policies. It also prevented policy reversal to some extent. When Polish popular support for reforms started to shrink due to the large drop in output, price jumps and rising unemployement, opposition groups were still behaving cautiously towards Balcerowicz. Sanford and Myant (1991) assert that even the president Lech Walesa had to be careful not to attack Balcerowicz too harshly, as his removal from the government could jeopardize the needed support of the IMF.

In contrast, the Russian government neither received the same support nor did it feel the same dependance on it. Soviet external debt was high but not as decisive for the reform steps. Debt service was worth 23 percent of exports in 1989. Most importantly, coordinated Western

[16] Teubner (1999).
[17] Sachs (1993).
[18] IMF et al. (1990).
[19] Bleyer and Coricelli (1995), p.73-74.

support and influence on Russia was prevented by a chain of historic events. The chaotic situation in the Soviet Union led to a relatively late orientation of the West towards Boris Yeltsin. Likewise, it was not Yeltsin but Mikhail Gorbachev who was invited to the G-7 summit in London in July 1991. Gorbachev however, was either not able or not willing to present a radical reform plan that would secure western support.

But support did not increase drastically when Boris Yeltsin emerged as the winner of the internal conflict. Instead the West provided strikingly little support for the Russian transition. This treatment by the West was clearly linked to the expectation that Russian reforms would not be radical enough[20]. By the time the West had realized that Gaidar and Yeltsin were planning more radical reforms it was already too late for any coordinated support for and influence on the reform package.

In summary, radical reforms in Poland were the outcome of a very specific combination of factors that were not present in Russia. It has to be mentioned that the sheer size of the Russian economy and the complicated political situation after the dissolution of the Soviet Union raised suspicion with those involved in policy advice – a suspicion that was dismissed with the argument that a more difficult task should not alter the basic prescription. However, the following sections show that the change the context for reforms also meant that the underlying theory contributed little to an analysis of the Russian situation. It is surprising that the Polish theory of radical reform was applied so broadly, given the unique situation of its society and economy.

4 Stabilization

Fighting high inflation was a major concern of the shock therapy approach. But stabilization was also one of the most painful parts of the reforms as it entailed contractive fiscal and monetary policies. It also marked the most dramatic difference in policy outcomes between Russia and Poland. In Poland, inflation had emerged in 1989, rose in 1990 but was quickly brought under control in the following years. According to the IMF estimates, inflation (average annual CPI change in percentage) was at 585.8 percent in 1991, dropped to 70.3 percent in 1991 and then throughout the 1990s to 7.3 percent in 1999. Despite similar

[20] Åslund (1994)

intentions of the Russian government, Russia fared far worse. According to the EBRD transition reports Russian inflation peaked in 1992 with 1526 percent and stayed at the three digit level until 1994. Inflation was finally brought under control in 1995 only to rise again in the aftermath of the Russian crisis of 1997/98.

From today's perspective two factors were responsible for this divergence in reform paths and economic performance. Firstly, stabilization itself is actually a long term policy due to complementarities of the shock therapy bundle to issues like tax legislation, bankruptcy law and other market institutions. Secondly the importance of political factors in explaining the consistency and implementation of stabilization policies.

In order to understand how stabilization is a long term policy it is most useful to first acknowledge that stabilization policies in Poland and Russia were very similar at the respective starting points of their stabilization attempt. One of the major steps of Polish "shock therapy" was a radical cut in subsidies. Overall, the share of state subsidies to GDP decreased from 10.6 percent in 1989 to 7.7 in 1990[21]. It has to be kept in mind that this was despite a radically dropping GDP. The cut in subsidies was combined with tight rein on credit creation by the National Bank of Poland (NBP). Overall real money supply dropped by 20 percent between December 1989 and February 1990[22]. The Gaidar team followed the Polish example and tried a Russian version of "shock therapy" at the beginning of 1992. In the first quarter of 1992, the state budget had been balanced, first of all due to extensive expansion cuts[23]. Military spending for example was reduced by a staggering 70 percent[24]. In order to address the monetary side, reserve requirements for commercial banks and the refinance rate were raised considerably. Overall the central bank kept M2 growth below 14 percent per month between January and May 1992. All these measures had the projected result of a quickly decreasing inflation[25].

While policies were very similar in the starting shock therapy package, they diverged drastically in the following months and years. Most significantly, the Russian crisis of 1997/98 showed that the economy remained highly unstable even at the end of the 1990s.

[21] Balcerowicz et al (1997)
[22] Lipton and Sachs (1990a)
[23] Åslund (1993)
[24] Gaidar (1995)
[25] Inflation was fought despite a much more difficult situation in economic and institutional terms. Most importantly, the old economic ties to other former republics made independent monetary policies difficult and aggravated the shock on production chains.

What had Poland done to prevent a similar crisis? It can be shown that the key lies on the revenue side of the budget.

Despite the measures of shock therapy in 1990, Poland had significant problems in fiscal balancing afterwards. Thus, in the following years fiscal policy took a central role in stabilization. The Polish government kept on cutting subsidies and even fixed social transfers at a very low level. Most importantly, however, the Polish government undertook serious reforms of its tax system. As a result, the Polish tax system was completely overhauled between 1990 and 1993. While Poland had certainly not solved its fiscal problems in 1990, it had done so by 1994. Data from the IMF show that the state budget deficit as percentage of GDP was decreased considerably till 1994 when it reached 2.7 percent[26].

While the Russian government was radically cutting expenses, the revenue side of fiscal balancing was a disaster. After the dissolution of the Soviet Union the Russian government had to develop a tax system quickly in order to avoid financial breakdown. Boone and Fedorov (1997) argue that this is why the Russian tax system was designed with little regard for efficiency or thought spent on detail. It was structurally distorted and circumvented by the regions which cooperated with companies against the central authorities. The weakness of the federal authorities and the special characteristics of the Russian decision making process allowed for widespread exemptions for taxes and tariffs and even simple non-compliance. Still in 1998, 34 percent of all corporate and other taxpayers did not pay taxes, 49 percent sometimes and only 17 percent always[27]. The implications of the sorry state of the tax systems become clear in a simple comparison with Poland. Budget revenues as percent of GDP between 1992 and 1997 grew slightly in Poland but dropped by almost 10 percent in Russia[28].

What these numbers mean becomes clear once the political wars behind them are revealed. Russian enterprises especially in the energy and military sector were important political actors from the very start of transition on. When privatization linked industry and the financial sector into financial-industrial trusts with powerful oligarchs at the top the revenue side of the federal budget became a political battlefield. The first serious attempt in increasing revenue was started under Anatoli Chubais as the leader of a Commission for non-payment in late 1995. Measures taken in the following years included the threat of bankruptcy, sending of

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[26] IMF (2000a)
[27] Yeager (1998)
[28] Taken from Shleifer and Treisman (2000); World Bank and IMF data

police forces into regions with the largest debts, different decrees and the setup of another Commission in October 1996 - with little success. The situation became so tense that Yeltsin fired the industry-friendly Prime Minister Viktor Chernomyrdin and replaced him with Sergei Kirienko. Kirienko attacked the regions by cutting off federal transfers, suspending federal programmes and withholding export licenses for local companies. With Boris Fedorov as the new chief of the federal tax offices the government then targeted Gazprom which alone had run up 4.5 billion rubles of tax arrears. After a few half-hearted concessions by Gazprom this conflict became most serious in 1998. By that time a broad coalition in parliament stood against the government and put an end to the attempt to split Gazprom up.

It is striking that despite these deeply rooted problems, the Russian economy looked well on the surface in 1997. The government was assisted by the IMF, growth turned positive and inflation was finally brought down by tight monetary policy anchored by a narrow exchange rate band. The EBRD transition report of 1997 gives the impression of a country with considerable problems but on a healthy path. The outbreak of the crisis can only be explained by more institutional issues. The OECD names taxation, fiscal federalist relations, competition, corporate governance, regulation of natural monopolies and small business development. These weaknesses resulted in a high pressure on the federal budget and the perception of a weak Russian economy despite relatively good macroeconomic data[29].

In summary, it can be stated that institutional factors led to instability in Russia and continued stabilization was the result of a continued reform effort in Poland. It was a bundle of reforms that were implemented over a four year period that made the difference between Poland and Russia. Any discussion of “shock therapy” and “gradualism” was misleading in this respect. But why did Russia not follow the Polish path? The key for the divergence lies not in economics but in politics[30].

It was politics that fired back at the Gaidar team. The Russian economy had already shrunk in 1990 and 1991 the process accelerated considerably in 1992. While Yeltsin’s support for Gaidar had been strong at the start, he now came so much under fire that Gaidar increasingly had to defend himself. As his team was politically inexperienced, single ministries managed

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[29] OECD (2000)

[30] One could raise the question whether reforms as conducted in Poland could have had the same effect as in Russia. This question is justified if one tries to answer the normative question of the theoretically suitable reform package. The point made here is that implementation of the shock therapy package was prevented.

to resist his reforms and bureaucrats prevented changes. The only way for Gaidar to respond to attacks was to make compromises. Thus, in the second quarter exceptions for agriculture and industry were made. In May 1992 one member of the Gaidar team was abruptly dismissed by Yeltsin and replaced by Viktor Chernomyrdin; only the first change in a series. After six months in position, the chairman of the central bank, Georgi Matyukhin, was made to resign by the speaker of the Supreme Soviet. Unexplained for outsiders remains Gaidar's decision to promote Viktor Gerashchenko - the former head of Gosbank - as head of the Russian Central bank (CBR). When Gerashchenko became head of CBR in July, he raised monetary growth instantly and ended hopes of stabilization in 1992.

October 1993 there was another attempt to stabilize by Fedorov and the returned Gaidar. For the first time in Russian stabilization history the real refinance rate turned positive in November and December. And again it was politics that brought stabilization down. Political conflinct took on a new dimension, with the Supreme Soviet and the Congress of People's Deputies becoming more aggressive and now attacking Yeltsin more directly. The conflict led to a stalement of policy and was ended through the dissolution of parliament by Yeltsin. New elections and a referendum for a new constitution were held in December. This was what Western economists had hoped for - free elections. Anders Åslund for example wrote with regard to the incredible power of interest groups in Russia

"*Therefore, it is doubtful that a stabilization is politically feasible before parliamentary elections have taken place*." [Åslund (1993), p. 33]

However, the result of elections showed a very different preference amongst the Russian population. Yegor Gaidar's party, "Russia's Choice", received 15 percent of the vote. All votes for liberal parties together added up to 30 percent, a disastrous result. While Chernomyrdin stayed Prime Minister, the only liberal minded reformer in the cabinet was now Anatoli Chubais, responsible for Russia's privatization programme.

If one looks at polls from these days it is surprising that economists assumed free elections would lead to more liberal reforms. Russians were not as convinced of markets as the Poles were. The Central Eastern European Barometer (CEEB), a survey sponsored by the European Commission and conducted in the years 1990-97, gives enlightening results in this respect. It asked about 1000 persons each in Poland and Russia the following question:

”*Do you personally feel that the creation of a free market economy, that is one largely free from state control, is right or wrong for (our country´s) future?*”

That Poles and Russians thought differently already becomes clear if one compares the same year. In 1991 56 percent of Poles answered “right” and 20.8 percent “wrong”[31], in Russia it was 46.7 percent and 33.5 percent respectively. It should be noted that at this time shock therapy had partly taken place in Poland. The effect of similar reform attempts in Russia had a very drastic effect on the opinion in the following years. Support for reforms collapsed in 1992 and led to clear opposition in 1993. In the year of the election 30.7 percent supported the free market while 53.2 percent opposed it. That this resistance can not be explained by an economic “winner” and “looser” model is likely as evidence presented by Brainerd (1998) suggests that voting behaviour in the parliamentary elections of 1993 was not significantly influenced by the development of personal income. Russians were simply not convinced of the market concept.

It has most probably led to some misunderstandings that the theory of shock therapy led to a neglection of history and political background. As the numbers show, Polish stabilization was carried by an entirely different political attitude that allowed institutional changes and a consistent reform path over years – even though reforms had painful effects in the first phase of its implementation. Stabilization in Russia failed not because of too much or not enough radicality but because it was entirely inconsistent. The application of the theoretical concept of a big bang to stabilization is questionable as it neither explains Polish success nor Russian failure.

While theories of political economy are of some value in explaining blockade strategies by important interest groups, the reliance on a “winner vs. loser” story could have been misleading. More importantly, policy packages themselves were under constant modification. Decisions in Russia were directly influenced by lobbies that formed around the large industrial complexes. Both president and government founded much of their power on these lobbies. The central government did not have the power to define policies alone. Likewise the Russian way out of inflation in 1997 was the result of a carrots and sticks process in which the Russian government managed to win over important interest groups for stabilization. This

[31] Missing percentage is “Don´t know”.

process is described in detail in Schleifer and Treisman (2000) and has little to do with the models of reform that guided economic thinking. Policies were more the outcome of coalition building as covered in cooperative game theory than a blockade or reversal by economic losers of a fixed reform package.

5 Liberalization

Liberalization meant the introduction of free price setting and trade. It was seen as very important, as the free movement of prices and free contractability is an essential for a functioning market. The distorted price sturcture in centrally planned economies had to be changed in order to make a development of private supply possible and thus reduce shortages. Fixing prices through subsidies was very costly and posed a heavy weight on the budget. In addition, large elements of liberalization were relatively easy to accomplish as they meant simply to not control prices. Liberalization also faced less political resistance as the usually implied rise in output prices benefited important interest groups.

As a first step it is usefull to try and find some relatively objective measures for the reforms in Poland and Russia. The European Bank for Recunstruction and Development (EBRD) tries to measure the success of transition countries in their efforts to liberalize through two indexes: the price liberalization index (PI) and the trade and foreign exchange system index (TI). Strikingly both indexes have the same level in the first years of reform in the two countries. Poland reached a level of 3.0 in both PI and TI in 1991. Russia followed to the same level in 1992. The two countries diverge in 1993 when Poland liberalized trade to western standards leading to an index of 4.0 in the TI. However, the two PI measures stay equal until 1997.

Overall the indexes show that this relatively easy to accomplish reform was implemented at similar speeds in both countries. In the first years of reform the most important difference appears to lie in foreign trade and the exchange rate system. Turning towards foreign trade it shows that import restrictions in Russia were almost identical to Poland and due to the high restrictions on Polish agriculture even less protectionist. Until 1995 Russian average weighted import duty was comparable to Poland, at about 13-14 percent[32]. However, exports were subject to considerable administrative intervention, quotas and tariffs. What was the reason for this divergence?

[32] EBRD (1995)

A main problem for the liberalization of external trade stemmed from a complementarity between liberalization and stabilization. An obvious example is the liberalization of trade with coal, oil and gas in Russia. The Russian government had followed the Polish path and kept prices for energy under state control. When the Russian economy came to hyperinflation levels in 1992 domestic prices got extremely low by international standards. This directly affected liberalization in this sector. Prices of gas and coal were at only 4 percent of the world price in May 1993[33] and domestic oil at 30 percent[34]. When the exchange rate dropped, exports in these sectors became too attractive and had to be controlled. Poland stabilized quicker and more importantly its exports contained more goods whose prices were not controlled on the domestic market.

But there was probably more than econmic reasoning that led to export restriction. Again one important feature of Russian policies was that the central government was not in control concerning important features. In autumn 1992 important “strategic” goods (oil, gas, metals and timber) were only to be exported by “special exporters”. The list of these “special exporters” grew rapidly, was cut again and grew again till it contained almost all relevant enterprises so the administrative regulation posed no visible restriction. The point was, however, that this scheme probably provided burocrats with a steady flow of bribery. Government experts estimated that bribery for foreign trade was about $0.5 bn in 1993[35].

Similar facts about domestic trade have been observed. The harassment of local enterprises by local authorities and burocracies or the survival of price controls and rationing at the local level send a clear message - the liberal minded central government was not in control of policies concerning liberalization[36]. The survival of grown structures of decision making and the confusion caused by the collapse of the Soviet Union all took control out of the hands of authorities in Moscow. Overall, it is striking how pronounced the difference in liberalization in Russia was between spheres of complete central control and spheres where interest groups, administration and other levels of government held formal or informal control rights.

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[33] Åslund (1994)
[34] Aven (1994)
[35] Åslund (1994)
[36] See Hanson (1995) for a detailed analysis of the regional differences in policies.

The problems of the Gaidar team were the lack of control over its policies and unfavourable historic conditions that restricted the policy set. Parts of Polish liberalization built on pre-conditions that were simply not given in Russia. Complementarities to other policies and initial conditions likely caused the little difference in liberalization between Poland and Russia.

6 Privatization

The third pillar of radical reforms was privatization. It was widely accepted that it would take much longer than liberalization and stabilization as it required a whole chain of steps to transfer a formely state owned enterprise (SOE) into private hands. Anyhow there was considerable debate about the optimal speed of privatization as a part of the shock therapy package. In the analysis of Russian and Polish growth the concentration on privatization speed was certainly misleading. Most strikingly, Poland seemed to privatize more slowly than Russia and still grew quicker. What had gone wrong in the analysis? Firstly the focus on large scale privatization neglected the important role of small scale privatization and creation of small businesses – a crucial ingredient of Polish growth. Secondly it focused on the transfer of ownership and assumed that private ownership was closely related to restructuring of enterprises. That turned out to be wrong.

Little thought was spent on the role of policies in promoting small scale privatization. While large scale privatization filled chapters and articles, small scale privatization was generally dealt with in a few paragraphs[37]. However, research was missing out on something important. Positive trends in the first years of transition in Poland were dominated by the small and medium sector and the sector remained of crucial factor for Polish growth in the years to come[38]. Despite modest success with the privatization of large enterprises, in 1991 3 million people were employed in the non agricultural private sector – 26 percent of entire non-agriculture employment. The share of small firms privatized was already 86 percent in 1991 and rose to 95 percent in 1992[39]. How important the small businesses alone were for providing work possibilities during these times of severe economic crisis is shown by the fact

[37] The book ”Privatizing Russia” by Boycko et al for example does not contain a single chapter covering small scale privatization.
[38] See Duchêne and Rusin (2003) for a detailed analysis of the sector and its role.
[39] EBRD (2000)

that 80 percent of all employment increases in 1990-91 were due to increases in individual firms with an average of only 1,7 workers[40].

Small-scale privatization in Russia was less successful. Estimates suggest that only 75 percent of small enterprises were privatized by June 1994[41]. While small private businesses already had their beginning under Gorbachev in 1990/91 and had gained momentum after Chubais took up work in November 1991, the private sector did not play an important role as a compensation for employment losses in 1992. The OECD estimates that the number of small businesses grew by only 60.2 percent between 1992 and 1994 and even stabilized already in 1995[42].

A main reason for these differences is the behavior of local authorities in Russia who hindered privatization and creation of small scale enterprises[43]. The underlying reasons for this behavior were constitutional, namely the incentives arising from local government finance[44]. Polish local governments had to rely on local taxes and fees, with grants from the central government playing only a minor role. Thus they had strong incentives to support growth in their area in order to broaden the tax base, and it therefore made sense to give them the responsibility for small scale privatization. In contrast, Russian governments received two-thirds of their revenues from taxes collected by the central government. Instead of broadening the tax base by supporting small-scale businesses Russian regions and local governments thus concentrated on negotiations with the federal government. This imporant difference between the two countries had not been captured in any of the theories commonly applied to transition.

While the privatization of small scale businesses was rapid, large scale privatization in Poland turned out to be far from radical in speed. In the first years of privatization the programme heavily relied on the careful evaluation of the enterprises through the administration followed by public offerings. Lack of personell, the complexity of the task and the unwillingness of the burocrats to sell at low prices led to a privatization at snales pace. In addition, privatization faced resistance from within the SOEs. The underlying reason was most likely that concessions made to managers and workers were too low and thus the groups that controlled the enterprises had no incentive for (capital) privatization. Other - more radical - privatization

[40] Blanchard (1993)
[41] OECD (1995)
[42] OECD (1997)
[43] See Frey and Shleifer (1997), OECD (1995), Fischer (1992)
[44] Zhuravskaya (2000)

schemes were blocked in parliament. The privatization programme in Russia on the other hand was often seen as more successful than the Polish counterpart. In its first wave the programme followed a voucher scheme which started in December 1992. The scheme allowed insiders to buy 51 percent of the enterprise at the low book value of the enterprise and thus was very popular by workers and managers. By June 1993, 2869 enterprises had already been sold. One year later it was 15052 with a share in total industrial employment of 83 percent[45]. At a first sight this was a major success in Russian "shock therapy".

But the quick privatization in Russia did not seem to yield the results the government had hoped for. Authors favouring a radical approach of quick privatization implicitly assumed that privatization of enterprises meant restructuring of industry and a more efficient use of resources. It was argued argued that large SOEs considerably hampered the development of a market economy through their inefficiency linked to the persistence of the soft budget constraint. Thus, raising the efficiency of SOEs through restructuring was seen as a major task. Large Scale privatization was seen as a major step towards doing so. However, the link between raising efficiency and privatization was not as clear cut in reality. A simple indicator for this is the development of labour productivity in Poland and Russia. Data published by the EBRD in 2000 shows that labour productivity in Poland grew significantly from 1991 on while it was much lower in Russia and actually dropped in 1993 and 1994 despite rapid privatization. Russian enterprises were at a miserable state and actually deteriorated. The share of Russian enterprises that were making losses rose from about 20 percent in January 1994 to almost 50 percent in March 1998[46]. Again, the discussion had underestimated more fundamental factors.

There were three main reasons why Russian privatization did not trigger the wanted effects. The first reason was that regardless of the ownership change, control over enterprises often remained in the hands of insiders. Voucher privatization had in many cases given insiders a majority of the shares. In addition, managers effectively controlled many enterprises with substantial outside ownership. The reasons were the survival of the old directors and labour collective meetings instead of shareholder meetings, lack of share registers in most enterprises, manipulation of voting procedures for the board and - where possible - complete disregard of the shareholders' decisions[47]. While the protection of minority shareholder rights

[45] OECD (1995)
[46] EBRD (1998)
[47] Clarke and Kabalina (1995), EBRD (1997)

was very weak, even the voucher funds that evolved had not much control over enterprises. A survey conducted in 1995 finds that only 10 percent of Russian voucher funds reported having regular access to financial data on companies in which they held large equity stakes, 12.5 percent reported having no information at all (EBRD (1995)).

The second reason for the relatively weak effect of Russian privatization was that tax arrears, inter-enterprise arrears, wage arrears and barter trade provided enterprises with a soft budget constraint despite a sharp cut in subsidies. While Poland came to grips with most problems by conducting comprehensive reforms in the mid 90, the problem was still growing in Russia at that time. Tax arrears amounted to 10 percent of GDP at the end of 1996[48] and total overdue arrears of the enterprise sector were 43 percent of GDP in August 1998[49]. Barter trade developed into a means to allow sales of old fashioned goods[50] and thus further decreased the incentives for restructuring.

Finally, the threat of bankruptcy is required to make enterprises restructure. It is likely that this threat was more important in Poland than in Russia. As soon as 1992 there were 314 bankruptcy procedures completed in Poland[51]. Even in the Eastern European comparison Poland had an extremely high share of bankruptcy procedures completed to procedures filed, a clear sign of the effectiveness of legislation. While more of the Russian large enterprises were privatized, bankruptcy proceedings were relatively rare and still not one had been completed in 1995[52].

Overall analysis of later years showed that the applause for the Russian privatization had been pre-mature. The radical approach had proven to ignore too many constraints and complementarities and even became a political liability towards the end of the 1990s[53]. The forces that made Polish economy grow were not coming from large scale privatization but from a mix of historical and institutional factors that were not present in Russia. History shows that the early concentration on privatization had not grasped the most important aspects for restructuring and growth.

[48] EBRD (1997)
[49] EBRD (1998)
[50] See Shleifer and Treisman (2000) for details.
[51] OECD (1998)
[52] EBRD (1998)
[53] EBRD (1999)

Given the analysis above, it is hard to see early Polish privatization as a conscious choice for gradualism – an interpretation followed by Stiglitz (2002), for example. Polish privatization was clearly going slower than expected and planned by the government – the slow pace was not a choice. Similarly, the explosion of Polish SME numbers was not due to a specific industrial policy.

7 Conclusion

This article reviewed the differences in Polish and Russian transition in the 1990s in the light of economic theories applied to the process. It has been shown that some of the most influential economic theories cannot explain crucial features of the reform process in Russia. The theory supporting "shock therapy" or "big bang" was based on the quite specific Polish circumstances and failed to provide a feasible plan of action for the Russian context.

The consistent reform path of Polish shock therapy might have been the result of a swift reform on several frontiers. However, the most important factors in Russian reform failure were either not present in Poland or taken care of years after the big bang. It was the coherence not the speed of reform that made the decisive difference between the two reform paths.

As a matter of fact, the Russian central government indeed made attempts of shock therapy. However, the approach failed miserably – most likely due to the political and historic particularities of the country. Despite the slow pace of reform, it is denying reality to state that Russia was a gradualist. The little progress in market reforms was not due to a reform strategy but clearly the result of struggles for political power within the country.

Despite the fact that models of politcial economy usually assume majority voting, public opinion on reforms rarely played a role in economic articles. Until the late 1990s the political processes of decision making were by and large ignored in the literature. Most theoretical contributions focussed on concepts that dealt with political institutions only on an aggregate institutional level. This left a conceptual blank spot within the profession. The result was neglect of political constraints, particular country charakteristics and outright misinterpretation[54].

[54] See Murrell (1995) for an early analysis of some shortcomings.

Lastly, it is an important misconception to believe that categorizing countries along the lines of “shock therapy” and “gradualism” is useful for learning from the transition experience[55]. The analysis of this article has shown that important mistakes in the early analysis were driven by the desire to derive clear conclusions about the optimal speed of reform. It is relatively simple to show that this conflict between “gradualism” and “shock therapy” was misleading for Russia and Poland.

The present author believes that economic policy-making in one country can be effectively informed by the experience of another. However, the empirical and theoretical study of specific political and market institutions and their interaction has to be at the heart of this approach. A classification of reforms and institutional arrangements on an aggregate level – as in various reform indicators – rarely leads to real understanding of their effect.

[55] A belief, shared across contributions as diverse as Åslund (1993) and Stiglitz (2002).

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