

# Was Shock Therapy Consistent with Democracy?<sup>1</sup>

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**Abstract** The transition process in Russia and Eastern Europe was dominated in the literature and in policy making by the shock therapy process. However, shock therapy was short-lived. Governments that implemented shock therapy were not able to sustain the reform program since they lost power after the first term as a result of unfavourable electoral results. The new governments implemented gradualism. While after the first term shock therapy governments were substituted by gradualists, a government in favour of shock therapy never substitute any gradualist governments. The aim of the paper is to demonstrate that shock therapy was inconsistent with a democratic process of decision-making. Actually shock therapy was only consistent with a pluralistic political structure in the tradition of Hayek, Buchanan and Friedman. Foreign aid was inadequate to ensure the continuation of the shock therapy reforms within a democratic environment.

**Keywords:** shock therapy, democracy, foreign aid, economic reforms

## INTRODUCTION

The shock therapy model of transition from central administration to markets highlighted the urgent need to shift from the position of shortages and hyperinflation to a situation where the quantity demanded and supplied reached equilibrium. This involved reducing the high levels of inflation and

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rapid depreciation of the exchange rate, reversing the budget deficit and stopping the decline of output. It required the removal of all restrictions to allow prices and wages to equilibrate. To eliminate hyperinflationary pressures the budget deficit had to be reduced by abolishing subsidies and increasing taxes substantially. Monetary policy had to be restrictive, abandoning the cheap credits provided by the central bank, and also the money supply had to target the growth rate of real GDP to reduce inflation. To introduce competition, a free trade regime was imperative to counter-balance the highly monopolised domestic industry. Concurrently, a fully convertible currency would have reduced inflation and made free trade feasible. Hence the objective was to cut aggregate demand by reducing the budget deficit, the money supply, real money balances and real wages. In essence the shock therapy model was an orthodox macroeconomic stabilization program emphasizing price liberalisation and strict budgetary policy (Aslund 1995: 66).

The aim of this paper is to demonstrate that a democratic political process was inconsistent with shock therapy. Every government that implemented shock therapy in Russia and Eastern Europe lost power after the first term. The newly appointed governments implemented gradualism. In actual fact, foreign aid within a democratic political process and authoritarian governments are, in effect, substitutes, in the sense of ensuring the continuation of reforms through the “short term pain” period to “long term gain”. The foreign aid provided by international financial institutions and governments of mature market economies was inadequate to sustain the shock therapy reforms. Under these circumstances shock therapy governments had to resort to authoritarianism or consent to their own demise through the electoral process.

### WHY SHOCK THERAPY?

The aim of the shock therapy model was to remove social obstacles to development driven by anti-social self-interest. The result would have been a free market, free enterprise economy, which, as the supporters of the model argued, in the long run guaranteed full employment, stability and growth. With regard to the associated costs of the reform process, “these costs are exaggerated” (Lipton and Sachs 1992: 216). In addition Woo (1994: 290) argued that “recently available data suggest that the initial estimates of the economic costs of the shock therapy have been overstated.” Consequently, “the more radical a reform has been in these terms, the smaller the fall in total output, the earlier the rise in output, the smaller the decline in standard of living, and the more even the income distribution. Only the rent-seekers

benefit from slow reform, while there are definitely no socially beneficial effects arising” (Aslund 1997b: 186).

The implementation of the shock therapy approach, particularly in Poland, was a success, the shock therapy supporters claimed. Poland enjoyed the elimination of hyperinflation and of shortages and queues; the establishment of money as a medium of exchange; the development of a substantial private sector; state enterprises restructured; output reflected consumer sovereignty; rapid technological modernisation took place; international trade reflected market signals and pollution was reduced (Balcerowicz et al. 1997: 131). Due to the implementation of the shock therapy model in Russia, “the main goal of the Russian economic transition has been accomplished: Russia has become a market economy. The essential feature of such an economy is that the market is the main instrument of allocation” (Aslund 1995: 3). It was argued that the radical reforms of shock therapy did not increase unemployment, did not halt the development of the private sector and did not hinder the evolution of the institutional structure. The countries performed better, even though they suffered a larger decline in output in the beginning of the transition, than countries, which adopted gradualism. Those transition economies which implemented shock therapy were the first ones to achieve positive economic growth (Aslund et al. 1996: 226).

The course of economic development initiated by the shock therapy process could be considered radical in a historical context, since the experience of mature market economies demonstrated gradualism was the appropriate procedure (Polanyi 1944, Murrell 1992: 80, Bardhan and Roemer 1993: 16, Rosati 1994: 429). The implementation of the shock therapy process went further than the presumed “benefits” associated with the free market economies as discussed. Transition economies were surrounded by the mature market economies with a dominant world ideology of free markets. Transition economies entering economic development at a later stage would be influenced by the strategy of economic growth adopted by mature market economies.

The argument developed by Gerschenkron (1962, 1968) is relevant. He suggested economic development was determined by variables such as the degree of lateness in fostering economic development. The transition economies were determined to achieve similar standards of living to those of their neighboring mature market economies by adopting the dominant view of the free market. It was a sad reminder of the past because it seemed similar to the strategy of Stalin’s famous call in 1931: “We are 50 or 100 years behind the advanced countries. We must make good the distance in ten years. Either we do it or they crush us” (Berliner 1988: 161). The implementation of

the shock therapy approach can be interpreted as a voluntary decision made by the transition economies.

Gerschenkron's (1962, 1968) argument was applied to the experiences of the developing countries in the 1960s when Keynesian ideas strongly influenced economic policy. State property, government intervention, discretionary fiscal and monetary policies and restrictions on trade resulted in low unemployment and inflation and economic stability and security. Moreover, the economic ideas of the time tended to reject the benefits from trade and stressed the need for physical capital accumulation and infant-industry promotion (Rodrik 1996: 12). This period between 1950 and 1973 was considered to be the Golden Age of Keynesianism. The latecomers during this period aspired to narrow the income gap and sought to do so as quickly as possible and at any cost. This was extremely difficult, due to the pre-existence of poor economic conditions, which constrained their growth potential. There appeared to be a contradiction between the available resources and the ultimate goal, which resulted in tensions. The more backward the country was at the starting point, the higher the level of tensions (Ofer 1987: 1769). Tensions resulted in impatience, and impatience resulted in extreme, radical and rapid reforms. Thus, the latecomers in economic development, viewing the benefits associated with Keynesianism during the 1960s and being impatient to achieve the living standards of developed countries, adopted Keynesian policies to the extreme. The dominance of state property, the distorted market due to discretionary measures and restrictions on trade, were among the key characteristics. Interestingly the advantage of the latecomer was that they could borrow technologies from the mature market economies without being required to "reinvent the wheel." However it was not adequate to simply purchase technology, it had to be exploited. More importantly, is not without cost; it required a financial commitment.

In the 1990s the perception of economic policy had changed radically from that of the 1950s to 1970s. The dominant worldview was that of free market, deregulation, privatization and free trade. The latecomers, the transition economies of Russia and Eastern Europe, aspired to narrow the income gap as quickly as possible and at any cost, thus necessitating the shock therapy process. As discussed, this was because tensions resulted in impatience and impatience resulted in extreme, more radical and more rapid reforms, such as the shock therapy process, than those used by the mature market economies when they initiated their economic development. "Haste, impatience, and radical action translate into a high time preference, a high discount rate for future benefits for the sake of short-term achievements" (Ofer 1987: 1799). Hence the shock therapy process of transition can be interpreted as reflecting

the need of the transition economies, as latecomers, to achieve the standard of living of advanced economies. This resulted in the hasty introduction of reforms in the hope of immediate benefits.

Gerschenkron's (1962, 1968) argument helps explain the voluntary decision of the transition economies to implement the shock therapy approach. However, it is equally possible to argue that the strategy was in fact forced upon transition economies. Transition economies had to implement the shock therapy approach to satisfy conditions imposed in order to secure funding from the IMF, World Bank and mature market economies. Effectively this left the transition economies with no real choice. For example, the IMF and World Bank loans to Romania were stopped because the privatization strategy adopted limited foreign ownership (Gowan 1995: 34). How then can the implementation of a gradualist approach by a few countries be explained? The promises of substantial funding never materialized, as the shock therapy supporters noted. As a result few transition governments ignored the recipe for shock therapy imposed by the IMF and World Bank and chose to follow their own course.

### SHOCK THERAPY AND DEMOCRACY

It was apparent that a successful financial stabilisation and structural adjustment would be inconceivable without a change in the political structure in transition economies (Fedorov 1997 [1995]: 125). Shock therapy supporters favored a democratic process of decision-making. However the question arises as to whether democracy is consistent with the shock therapy approach. Shock therapy supporters argued that "for transition economies democratisation seems to be a necessary condition for a successful change towards a market based economic system" (Aslund 1994b: 63; 1997a: 14); thus, "the market revolution has gone hand in hand with a democratic revolution" (Sachs 1995: 50). The justification was that democratization was essential for the transition process, since it immobilized the transitional rent-seeking of the old elite by establishing new institutions to eliminate the power of the old elite and at the same time rendering the new policies credible (Aslund 1994a: 31). Otherwise, without democratization, civil society would be weak and the power of the old elite substantial, compromising the reform process and transferring power to the antidemocratic establishment (Aslund 1995: 11). Therefore, "the transition process is dependent on how well developed civil society is, because the better developed it is, the sooner other, more representative forces will defeat the state managers (Aslund 1992: 63). Aslund (1992: 169) summarizes the need for democracy, based on the achievement of

credibility and legitimacy, to fight vested interests so that “economics must gain superiority over politics”. Thus democracy and economic reform are complements (Aslund et al. 1996: 227). Correspondingly, the goal of the transition economies should have been to establish a democratic society as rapidly as possible (Aslund 1994b: 64).

In my view, a democratic political process was inconsistent with the shock therapy process of transition. This is because democracy requires the continuous responsiveness of the government to the preferences of the members of society. Policy-making reflects the variety of preferences and interests of the members of the society. The common will is not laid down in an authoritarian or totalitarian manner by the state but is determined through a plethora of different opinions that are freely discussed. Provided they find majority support they can be put into effect. The shock therapy model of transition to a market economy can only be consistent with a “light” government (Walters 1992: 101), not a democratic one. Woo (1994: 288) revealed that the literature about the experience of the transition economies demonstrated:

That political openness prevents sustained economic reforms. The reasoning is that economic reforms necessarily impose, at least temporary, costs on some segments of the population, and political openness would provide the avenue for the losers to form coalitions to thwart economic reforms. In order to prevent narrow interests from stopping the socially desirable economic restructuring . . . these narrow interests [should] be denied legal protection for their political actions i.e. the end justifies the means.

The government could not rely on requests for faith, patience and calm. Radical economic reform had to go ahead, based on some simple and specific principles, and as such did not require input by the members of society. Shock therapy supporters were in favour of speed, stealth and consequently of reform from above. The electoral process also posed the most severe threat to the reform process, since politicians with illusory promises could easily hijack voters. Within the democratic process, the ultimate aim of any government is to survive in political competition with alternative political parties. This would certainly result in the newly formed governments in transition economies succumbing to the pressure of political opinion to reduce the necessary negative outcomes of the reform program.

Hence, the shock therapy supporters argued, there should be no political interference, and the reform process should be implemented independently of the political process. The program must be implemented consistently in spite of criticism and without favouring anyone; everybody must follow the basic

rules. This could only take place by stripping the government of its discretionary power and assigning it the responsibility of maintaining the rules written in the constitution in the tradition of Hayek (1986) Buchanan (1986) and Friedman (1980). Consequently, the shock therapy model is consistent only with a non-elected government, which does not exercise discretionary power instead of one, which is democratic but intervenes in the market, distorting and thus withholding the attainment of a free market. Shock therapy supporters were implicitly in agreement with Walters (1992: 101) when he stated, referring to the transition economies, that “we should not claim democracy as either sufficient or even necessary for a liberal society with a market economy” since “democracy is neither necessary nor sufficient for good economic performance” (Intriligator 1998: 241). Consistently applied, shock therapy was deeply anti-democratic.

Therefore, since the political structure should not be democratic, should it be pluralistic? I am in agreement with Woo (1994: 290) “that sustained economic reforms do not require Stalinist-style political repression; what is definitely required is a commitment by the political leadership to economic prosperity and not to ideological purity.” It is my view that, first of all, there needs to be consistency between the economic structure and the political structure. Authoritarian political structures cannot exist alongside free markets in the long-term (Kornai 2000: 36–37, Marangos 1997, 1999). Furthermore, the political pre-requisites of the transition process demanded the establishment of a political structure, which constrained the employment of political power in the market, regardless of who exercised it. A written constitution specifying the minimal role of the government, the removal of its discretionary power and the establishment of political freedom necessitated a pluralistic political process. All individuals are obliged to be involved in the formulation of the constitution, motivated by self-interest not coercion. The constitution influences all individuals so it is beneficial for them to participate in the development process. Meanwhile it is in the interests of the government to encourage such participation through a pluralistic process, because only then will individuals be willing to comply with the restrictions on economic and political behavior that ensure the elimination of discretionary power. The development of the constitution does not require democracy, only pluralism.

### **THE ROLE OF FOREIGN AID**

The shock therapy model assumed large debt cancellations and large financial assistance in the form of grants and long-term loans. Instead, foreign aid was substantially below the necessary amounts, and in the form of export credits.

Meanwhile financial support by mature market economies was modest, if not totally inadequate. It was estimated that the Soviet Union would have required about \$30 billion annually in the first two years of the reform process and then \$20 to \$25 billion in each of the third and fourth years (Sachs 1992: 215). In 1995, Russia received roughly \$380 million in aid from the U.S.A., that is, one-sixth of the aid to Egypt (Sachs 1995: 57). Mature market economies and commercial banks gave more financial support to Gorbachev than to supporting the transition process (Aslund 1995: 282). The IMF and the World Bank, the only real financiers of the transition process, “have proven to be largely inefficient” (Sachs 1995: 61). Financial assistance has been very small and financial aid totally inflexible. Sachs (1994: 5) insisted there was a need for a change in the timing and character of foreign aid in the transition economies, in particular in Russia. Financial assistance should have taken the form of grants, not loans. The IMF had refused to support the establishment of a stabilization fund. Even when the IMF announced in 1995 the possible establishment of stabilisation funds, it continued to inform transition countries that these funds would be available only after inflation had been reduced (Sachs 1996: 150). In other words, when they were not required. In addition, the European Union’s response was far from desirable in assuring, in the initial stages of transition, full membership at a future date and opening the European market to East European products. “So far the European Community is more responsive to France’s small farmers and Portugal’s textile producers than it is to the great geopolitical opportunities for a united Europe and the great risks of political destabilisation in the East” (Sachs 1991: 32). Meanwhile Russia, for example, never had the possibility of stabilising without “massive foreign assistance” (Layard 1993: 32).

Sachs (1991: 31) was adamant with regard to the need of financial aid provided externally:

Passing through the valley of tears requires first and foremost, political leadership, and second, enough social consensus to sustain a stable set of policies. But even Moses and the Israelites would not have made it through the wilderness without some manna from heaven. External assistance can be vital in the perilous first years of change. And Moses did not face re-election for forty years (though he certainly faced a leadership challenge at the base of Mt. Sinai).

Sachs (1994: 512) criticizes economists that they tend to neglect the role played by foreign assistance in most of the major post-war reforms. The history of the economic reforms in post war Germany, Japan, Bolivia, Mexico, Chile, Poland, Israel, and Turkey, demonstrate the critical contribution of aid in each case. The aim of aid to “is help good governments



to survive long enough to solve problems” (Sachs 1994: 512). A heavy dose of conditionality would ensure the “correct” response by the borrowing governments.

Sachs (1991: 31) had argued that the reform program could be achieved “only if the reforms are given the time to work”. In reality, “Russia and the West have never missed an opportunity to miss an opportunity . . . . Unfortunately, the West failed miserably to speed the needed reforms” (Sachs 1997 [1995]: 127). Accordingly there was an internal contradiction in the reform program: the shock therapy process, while rapid, required some unspecified time to be operative, depending on fragile coalition governments based on a democratic process of decision-making. Under these circumstances it was impossible for a reform program of this magnitude and social cost to survive a democratic decision-making process. Balcerowicz (1994: 79) argued that “this ‘visibility effect’, absent in classical democratisations, was likely to encourage unfavourable assessments of the whole transition and, consequently, to influence electoral outcomes and the subsequent direction or pace of the economic transition.” On the other hand, though, Balcerowicz (1994: 87) argued that it was not necessary to assume that the discontent under shock therapy would be greater than with a gradual approach, as for example with Romania. The discontent over shock therapy was reflected in the electoral process, in which radical reform governments were replaced by governments in favor of a gradual approach. Fedorov (1997 [1995]: 126) recognised the electoral danger associated with the rapid transition process, arguing that “only a much faster reform movement can save the situation from deterioration which could be politically dangerous.” In contrast, the Polish experience showed that “severe stabilisation measures are not easily forgiven” (Bim 1992: 189).

It has been argued that a democratic political process was inconsistent with shock therapy. The shock therapy supporters hoped that this inconsistency could be avoided by the visionary actions of the leaders of mature market economies and the responsibility assigned to the international financial institutions to stabilize the emerging market economies. Actually, the problems associated with the reform process were political, not economic. Thus economic aid was mainly political aid required to support the frail governments that implemented the shock therapy process in a democratic environment. The purpose of foreign aid was to reduce the cost to individuals in continuing to apply shock therapy, and at the same time, maintaining support for the government. Support for the governments implementing the shock therapy process was very high initially but started to deteriorate when the social cost increased. The result was that governments, which

implemented shock therapy, lost power after only one term in office and the reform process was disgraced. The new governments, usually ex-communists, reversed the course of reform and proceeded with a gradualist transition approach. Graham (1997: 339) noted that “failure to resolve the poverty and safety net issues [in Poland] has eroded support for the economic reform process, and in part explains the victory of the former communists in the December 1995 national elections.” Przeworski (1991: 159) attributes this decrease in political support primarily to the rise in unemployment, which he argues was a terrifying prospect for most Poles. Lipton and Sachs (1992: 216) were aware of the necessary conditions for the shock therapy process to succeed: “in our view, the social basis for the reforms exist. The real test will be in the area of political reform and in the extent of Western support.”

The shift to gradualism took place in Poland on the 19 September 1993, in Russia on the 12 December 1993, in Bulgaria on 18 December 1994, in Estonia on 5 March 1995, in Czech Republic on the 1 June 1996 and in Latvia on the 25 July 1997. In all cases, this occurred after unfavourable election results for the shock therapy governments. Table 1 demonstrates the link between the countries that implemented shock therapy and foreign aid received the same period.

Listed is a summary of how the shock therapist governments fared in Eastern Europe and Russia:

- **Poland:** The Mazowiecki government and to a lesser extent the Suchocka government, with the support of the President of Poland, L. Walesa, implemented the shock therapy approach. The growing dissatisfaction over the reforms, which failed to attract adequate foreign financial aid, resulted in the both governments losing early elections to gradualist coalition governments. Walesa also lost the presidential elections; he was a victim of the implementation of the shock therapy approach in a democratic environment without substantial foreign financial support.
- **Czech Republic:** The implementation of shock therapy by the Klaus government, without any substantial foreign assistance, resulted in the loss of its majority in the parliament after only one term in office. Klaus managed to remain in power but the minority government had to substantially alter the shock therapy program in order to retain its position. Ultimately Klaus was forced to resign, signalling the end of the shock therapy process.
- **Bulgaria:** The democratic process in Bulgaria did not facilitate the implementation of the shock therapy approach. It has been stressed that the shock therapy process required a strong government to be able to

Table 1: Shock Therapy and Level of Foreign Aid

<i>Country</i>	<i>Transition type</i>	<i>Reforms commenced</i>	<i>Gradual shift</i>	<i>IMF agreements start</i>	<i>—Financial support end</i>	<i>Million SDR's</i>	
<i>Poland</i>	Shock therapy	1 Jan 1990	19 Sep 1993	*18 April 1991	17 April 1994	1224.0	
<i>Czechoslovakia</i>	Shock therapy	1 Jan 1991	<i>Slovakia:</i> <sup>6</sup> 1 Jan 1993 (after the break up of Czechoslovakia Slovakia pursued a gradualist approach). <i>Czech Rep:</i> 1 Jun 1996 slow down of some economic reforms—mainly privatisation of health system & railways	*8 Mar 1993 – standby <sup>a</sup>	7 March 1994	476.0	
				<i>Slovakia</i>			257.4
				1 Jan 1993 (IMF quota total)			115.8
				22 July 1994—standby —STF			64.5
			<i>Czech Rep.</i>				
				1 Jan 1993 (IMF quota total)		589.6	
<i>Bulgaria</i>	Shock therapy concept—slow implementation	1 Feb 1991	18 Dec 1994	*17 April 1992—standby	16 April 1993	155.0	

(continued overleaf)

Table 1: (continued)

Country	Transition type	Reforms commenced	Gradual shift	IMF agreements start	—Financial support end	Million SDR's
				* 11 April 1994—standby —ESAF	11 April 1995	116.0 69.7
Russia	Shock therapy	2 Feb 1992	12 Dec 1993	*5 Aug 1992 *30 June 1993—STF <sup>b</sup>	4 Jan 1993	719.0 1078.3
Albania	Initially gradual then shock therapy	June 91— gradual  July 92— shock therapy	19 June 1997	*26 Aug 1992—standby  *14 July 1993—ESAF <sup>c</sup>	25 Aug 1993  13 July 1996	20.0  42.4
Estonia	Shock therapy	Sept 1992	5 Mar 1995	*16 Sept 1992—standby *27 Oct 1993—standby and STF  *12 April 1995	15 Sept 1993 26 Mar 1995	27.9 23.2  13.9

(continued overleaf)

Table 1: (continued)

<i>Country</i>	<i>Transition type</i>	<i>Reforms commenced</i>	<i>Gradual shift</i>	<i>IMF agreements start</i>	<i>—Financial support end</i>	<i>Million SDR's</i>
<i>Latvia</i>	Shock therapy	5 June 1993	25 July 1997	*15 September 1992 October 1993 – standby - STF	15 September 1993 March 1995  March 1994	54.9  11.6 11.6
				*December 1993 - standby - STF		22.87 22.86
				*24 May 1996		30.00

<sup>a</sup> Standby credit

<sup>b</sup> STF: Less demanding than standby credit. New temporary IMF financing facility designed to provide assistance to member countries facing BOP difficulties

<sup>c</sup> ESAF: Enhanced Structural Adjustment Facility

*Sources:* Economic Survey of Europe 1993–1994, Economic Commission for Europe, 1994: 138–139.

Keesing's Record of World Events Vol. 40, No.7, July 1994, Longman, UK.

EIU Country Report, Slovakia, 2nd Quarter 1995, Economic Intelligence Unit, UK: 29.

implement the necessary reforms. This was not the case in Bulgaria. The lack of foreign financial assistance made it impossible to enforce radical reforms.

- **Russia:** Shock therapy was short-lived in Russia. The Gaidar-inspired government lost the support of the public and of Yeltsin because of the social impact of the reforms. The foreign financial aid was not adequate enough to encourage public support for the Gaidar program. The disappointing election result forced Gaidar and his fellow reformists in the government to resign, putting an end to the shock therapy process.
- **Albania:** Due to inadequate financial support, the shock therapy approach was introduced with authoritarianism. With the violent overthrow of Berisha, and with him the shock therapy approach that was directly linked with authoritarianism, the reform process was discredited. Gradualism was the natural course of the new government.
- **Estonia:** The sharp decline in living standards to an unacceptable level prompted the Estonians to oust the Mart Laar government, which had pursued a shock therapy model of transition with limited foreign financial assistance. An alliance of impoverished peasants and unskilled workers, the prime victims of the free market and radical foreign trade regime defeated the Mart Laar government.
- **Latvia:** Latvia was an interesting case. It was able to sustain the shock therapy process and the government managed to remain in power after the resignation of Prime Minister Andris Skele. Skele was successfully renominated for Prime Minister and was able to form a new government with the approval of the parliament. The Latvian case highlighted the crucial role of foreign aid, as well as authoritarian rule. Latvia benefited from a total of 153.83 million SDRs from the IMF while Estonia received 65 million SDRs and Albania, 62.4 million SDRs. In other words, Latvia received more financial assistance than Estonia and Albania combined, despite being similar to Estonia in terms of population, size and level of industrialization. The IMF justified the large amount of aid because it considered Latvia was a country displaying “a remarkable degree of stability” (Economic Commission for Europe 1993: 233). This implied that both the Birkavs and Skele governments implemented a reform process consistent with IMF guidelines. As a result, Latvia was able to sustain the burden of the reforms because of the level of foreign assistance coupled with accusations of authoritarian rule. In Latvia foreign aid helped maintain the authoritarian rule for some time. Prime Minister Skele was accused of authoritarian-style leadership. Skele was famous for his dictatorial pressure to coalition partners into following the

government line. Some coalition members complained that Skele had forced them to make unethical decisions in the name of the reform. However, authoritarian rule does not last for long and in Latvia, the Skele government only lasted five months after the formation of the new government, before it was forced to resign under serious accusations of corruption. Skele when he was Deputy Minister for Agriculture was responsible for the privatization of the food-processing industry and at the same time found himself a major shareholder and board member of companies to be privatised. Skele privatised a large number of monopolies for himself and his family (Nissinen 1999: 202–203). Latvia's experience also highlighted the problem associated with the provision of ample financial assistance under authoritarianism to facilitate transition; it encouraged corruption. Thus, as of August 1997, when Skele's government resigned and Krasts's took power, the economic reforms slowed dramatically. The social costs of sustaining the reforms made it very difficult to balance the budget and to privatise state enterprises, thus allowing the government to create a budget deficit.

#### **HOW DID SHOCK THERAPY SUPPORTERS INTERPRET THE ULTIMATE COLLAPSE OF THE MODEL?**

Parker et al. (1997: 8) and Boone and Fedorov (1997) recommended a better political management of the reform process in Russia. They argued, surprisingly, that in-depth political reforms would have improved the outcome and the credibility of economic reforms. Nevertheless accepting an argument like this does not solve the contradiction. The argument is tautological. By identifying reforms as unsuccessful, they are also being branded as non-credible (Ickes 1996: 302). Could it be argued that a better political management of the market reform process, or more credible policy makers, would have made possible the survival of the shock therapy model in a democratic environment without any substantial financial support? I would argue that the answer was no. In contrast to my view Boone and Federov (1997: 185) argued that “these benefits must be contrasted with the Russian reality that very often foreign assistance has slowed reforms—because it allowed Gorbachev, and then Russian president Boris Yeltsin, to temporarily postpone making needed policy changes”. However, as I have argued, the amount of foreign aid was so inadequate, as demonstrated in Table 1, that it was unable to influence the political decision-making process.

Aslund, Boone and Johnson (1996: 227) argued that the shock therapy process did not lead to public discontent. According to their interpretation of events, the public demanded faster reforms and the dissatisfaction with gradualism was greater than it was with shock therapy. As a result, gradualists were more likely to lose elections than shock therapy governments. However, Aslund et al. (1996) noted the shock therapy supporters lost elections because they were less well organized than the former communists, and also it was not uncommon for incumbent governments to become unpopular irrespective of the economic outcomes. It was worth noting that while gradualist reform governments replaced shock therapy governments, a 'radical' leadership never replaced the gradualists. Other gradualists always replaced gradualist reform governments.

I oppose the view of Szuk (1996: 57) who argued that "nostalgia" for the social benefits associated with the centrally administered economy brought former communists back into office. The rationale was inadequate because it failed to examine the fundamental reasons, which were mainly political, for the return of ex-communists to power. Generous financial support by mature economies could only prevent the return of ex-communists to power; it could not eliminate nostalgia. For example anti-reformist ideas prevailed in Poland in both the September 1993 and December 1995 elections due to people's anxiety mainly over welfare issues (Graham 1997: 339). As Szuk (1996: 57) argued, "the political leaders must work hard to convince the voters of their seriousness as reformers and to explain their policies to an electorate that is understandably chafing at the painful socio-economic measures." Under the economic conditions described, "hard work by political leaders" would not be sufficient without some manna from heaven.

In contrast to my argument, Aslund (1994b: 73) maintained that "there is no crippling contradiction between the political and the economic requirements for a successful political-cum-economic transition." The contradiction could have been avoided by timing the elections appropriately (Aslund 1994b: 72–73). Correspondingly, after the restoration of democracy at an early stage of the transition, a reformist government would have been very likely to win the elections, which took place in most transition economies. There should have been subsequent elections after the reforms had reduced inflation and eliminated shortages, and before people had become disillusioned by the social costs involved. This was not the case and shock therapy governments were not reinstated. Therefore the shock therapy supporters could only be satisfied with putting the foundations of the market economy in place and making the reforms irreversible. Wherever radical reform took place, the succeeding ex-communist government continued the reform process (Aslund



et al. 1996: 273), but at a slower pace. As a result there might have been instability but not a total reversal of the reform (Fedorov 1997 [1995]: 126).

Interestingly enough, at subsequent elections, “radical” reformers returned to power such as Mart Laar in Estonia and, Balcerowicz in Poland and “radical” governments replaced gradualist ones in Bulgaria in 1996, in Romania in 1996 and in the Ukraine in 1999. However, the “radical” reformers have implemented a gradual process. There are no examples in Russia and Eastern Europe of a shock therapy process being implemented by the “radical” reformers returning to government. The momentum was lost following the electoral defeats after their first term in office.

I agree with Woo (1994: 289) that “we think that it is wrong, or at least premature, to claim that political liberalisation undermines economic reforms.” Political pluralism did not undermine the shock therapy program; democracy did, as experience demonstrated. Shock therapy supporters are not willing to admit that a democratic process undermined the shock therapy transition model. The implicit “assumption is that correct economic theory must subordinate democracy” (Glasman 1994: 79). Correspondingly, “the processes of liberalisation and democratisation in the society will survive only if they are completed by a strong executive power that exerts control over the entire Russian Federation. I believe that this power is not only desirable, but inevitable” (Mau 1992: 273). Strangely enough Woo (1994: 306) concluded his paper with the statement that, “the effective one-party rule in Japan, Korea, Singapore, Malaysia, Indonesia, and Taiwan are testimonies to the compatibility of a market economy with many political forms.” This implies Woo preferred one-party rule, which is consistent with the shock therapy approach. Aslund (1997c: 191), citing China as an example, argued that a developing economy could function sufficiently without democracy. At the end, Przeworski (1991: 9–10) argues that “even if neo-liberal reform packages make good economics, they are likely to generate voodoo politics.”

An alternative way for shock therapy economists to avoid the contradiction with the democratic process was by arguing “real shock therapy” was never implemented. As Sachs (1997 [1995]: 127) claimed about Russia: “Despite the uproar in recent years about ‘shock therapy’ in Russia, knowledgeable observers understand that it simply never occurred, an obvious point when one compares Russia’s disorganised and partial stabilisation efforts with the decisive actions in the Czech Republic, Estonia, or Poland”. In reality, “real *laissez faire* for the benefit of the private sector persisted only for a period of three months, from February to April 1992” (Aslund 1997c: 200). In addition, “in Lithuania, Russia, and Hungary, radical reform never came close to being adopted” (Balcerowicz 1994: 87). Despite

these arguments, Aslund (1997a: 316) was adamant: "...the case has nevertheless been made: Russia could (and did) reform, and it has become a market economy."

### THE POLITICAL ECONOMY OF ECONOMIC REFORM IN TRANSITION ECONOMIES

Economic reforms tend to make the economic situation worse before they make it better. In the case of shock therapy a lot worse, since the shock therapy process required the rapid implementation of austere economic policies and introducing hard budget constraints. For the reason that the net benefits from economic reforms come too late for politicians to reap the gains before the election date arrives, shock therapy governments were doomed to fail, even if shock therapy was the "correct" package of reforms in the long run. The question then arises: if the shock therapy package of reforms was really desirable, interpreted to be that the netting out of short-term costs from long-term benefits results in an outcome that is a pareto improvement, then why is it that those same people who would benefit in the long run resisted the reforms? The straightforward answer is that voters are simply shortsighted, unable to consider the long run implications of economic policies. It is the mental inabilities of people that constraint them to make assessments about economic policies. Rodrik (1996: 37) does not find this an acceptable explanation: "myopia, to which many observers ultimately resort, appears to me to be as unsatisfactory an explanation here as in any area of conventional economics." But Rodrik (1996: 30) also asserts that "the obvious fact that the reforms do arouse opposition, and that the opposition often tends to be strongest early on." Nevertheless, this does not seem appropriate for transition economies. During the period of "extraordinary politics" the level of readiness to accept radical economic measures is extremely high. The collapse of Stalinism produced a special state of mass psychology and corresponding political opportunities. The succinctness of the "extraordinary politics" period means that a radical economic program, launched as quickly as possible, had a much greater chance of being accepted than either a delayed radical program or a gradual program (Balcerowitz 1995: 161 – 162). Thus, the people in transition economies did not suffer from short-sightedness but rather long-sightedness. People in transition economies were not concerned with the short run costs during the period of "extraordinary politics" but only with the long run benefits of transition. But when people experienced the short run cost of the shock therapy approach, their distorted eye sighted changed from long-sightedness (undervaluing short run costs and valuing long run benefits) to

short-sightedness (valuing short run costs and undervaluing long run benefits). As well, the Fernandez and Rodrik (1991) analysis in which they argued that that political systems in general have a bias toward the status quo even when the status quo is inefficient and individuals are risk neutral is again not applicable for transition economies. During the period of “extraordinary politics,” the new political structures are fluid and the older political elite is discredited.

Thus, it appears that the implementation of shock therapy required a “strong” and “autonomous” (not to say authoritarian) government in the absence of foreign aid. This would ensure that the political leadership could only concentrate on economic reforms and be able to effectively supervise the bureaucracy to ensure that they assisted and not hindered the development of a private sector. In contrast, a democratic political structure was an absolute condition of the gradualist approach to successfully change the economic system. The shock therapy approach highlighted how speed could constrain the government- and self-interest groups, whereas the gradualist approach tried to design the sequencing of reforms so as to build, through the democratic process at each stage of transition constituencies for further reform. In this way, a sequence of reforms in different policy arenas may be politically sustainable by building a social consensus for reform. However, Sachs (1994: 506) insisted that “in deep crises, there is simply no consensus to build upon, only confusion, anxiety, and cacophony of conflicting opinions.”

Hake and Neale (2001: 40) argued that Polanyi’s interpretation of market transformation—not transition—is applicable to Russia and Eastern Europe. Almost from the start of the introduction of market relations in Russia and Eastern Europe, consistent with Polanyi’s argument, a countermovement (the second half of the “double movement”) emerged. Democratization, in most transition economies, went hand-in-hand with the introduction of market relations. Democratization was a valuable element in Russia and Eastern Europe specifically because it gave political voice to those segments of the population that were negatively affected by the reforms. As in the nineteenth century, the countermovement tended to limit the power of the self-regulating market. The social backlash was an unavoidable consequence of the introduction of the market in Russia and Eastern Europe. Individuals resisted the “obsolete market mentality” of the shock therapy approach because they perceived the reforms as an assault to their way of life and values. The appreciation of the double movement (movement and countermovement) and the significance of the combination of obsolete market mentality with democratisation makes possible, as in the nineteenth century, to understand the transition process in a new and more enlightened perspective. It provides a better understanding of the complexities involved

and the linkage between economics and politics during the transition process which the shock therapy supporters tended to ignore.

### CONCLUSION

The implementation of the shock therapy model was short-lived. After the substantial initial support by the people in transition economies for governments initiating the shock therapy process, during the period of “extraordinary politics,” the process resulted in considerable undesirable outcomes such as unemployment and low living standards, which led to the government’s unpopularity. The high inflation which was allowed to take place by the mature market economies and international organizations, as the shock therapy supporters argued, resulted in social and political instability, threatening the fragile democratic governments and putting at risk the reform process. The risk was substantially increased by the adoption of proportional representation as the basis for parliamentary delegation, which resulted in multiparty coalitions that were weak, fragile and easily pressured governments. As Boycko (1991: 44) indicated that

no matter how strong the purely economic case for ‘big bang’ price decontrol is, this measure cannot be recommended to a politically weak government whose primary objective is to stay in power. We, however, tend to favor a different conclusion: the social costs of having a weak government that does not dare to (or does not want to) decontrol prices are tremendous.

These governments had to make a head-to-head confrontation with the powerful political and economic blocks, populism and the disillusionment of the public. Intrinsicly, these governments did not really have the power to pursue the policies required by the shock therapy platform. In a democratic environment the substantial reduction in output and employment associated with the shock therapy process of transition resulted in the ultimate downfall of these governments through the electoral process. Consequently, “reforms cannot be treated as purely economic” (Bim 1992: 190), especially during the transition process. In the end, “the problem is political” (Aslund 1995: 312).

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