SHOCK THERAPY VERSUS GRADUALISM TEN YEARS DOWN THE ROAD

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Review of

Grzegorz W. Kolodko. From Shock to Therapy. The Political Economy of Postsocialist Transformation. UNU/WIDER Studies in Development Economics. 2000, Oxford University Press. XII + 457 pages.

This book is written by the academic scholar and a policy maker that was in charge of economic policy of Poland in the most successful period of her transition history (vice prime minister and minister of finance in 1994-97). It is not so much about Poland, however, but rather about the decade long experience of postsocialist transformation and about the debates between shock therapist and gradualists that dominated academic and political discussions during this recent decade.

It may seem that these debates are already history. After the Washington consensus there emerged a post-Washington one with the understanding that no liberalization can be efficient without strong institutions. Both, shock therapists and gradualists, admit now the need for macroeconomic stabilization – differences in opinions here (5% or 15% annual inflation) do not seem to be crucial. Debates about the speed of reforms are currently much less acute than before: after most prices were deregulated and macro stability ensured, the remaining reforms, structural and institutional, by their very nature can be only gradual.

And yet, “the great transformation debate” is not over. The evidence may be found in numerous “AntiStiglitz” type articles that were written by liberals[1] as the critical response to widely debated papers by the former chief economist of the World Bank Josef Stiglitz[2]. Liberals, the advocates of shock therapy, argue with gradualists mostly about the interpretation of then recent transition events. While the former explain the high costs of reforms by the procrastination and inconsistency of some reformers, the latter put the blame on fast liberalization that was accompanied by the collapse of the institutions.

As far as today’s economic policy issues are concerned, the watershed between the shock therapist and gradualists (that now call themselves mostly right-center and left-center forces respectively) is determined by the attitude to the economic role of the state. The rightists (liberals) believe that the state in transition economies is still too large and should be downsized. They point out to the fact that the share of state expenditure in all

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[1] See, for instance: Mau V. Russian Economic Reforms as Perceived by Western Critics (Anti-Stiglitz). Manuscript, 1999; Dabrowski M., Gomulka S., Rostowski J. Whence Reform? A Critique of the Stiglitz Perspective. Manuscript, March 2000.

[2] Stiglitz J. More Instruments and Broader Goals: Moving Toward the Post-Washington Consensus. WIDER Annual Lecture. WIDER/UNU, 1998; Stiglitz J. Whither Reform? Ten Years of Transition. World Bank's Annual Bank Conference on Development Economics, Wash., D. C., April 28-30, 1999.

transition economies, with the exception of China, even now, after it decreased considerably during transition, is still higher than in market economies with similar GDP per capita. In Central European countries, for instance, the share of government expenditure in GDP – over 40% - is two times higher than in South East Asia countries with comparable GDP per capita, whereas in Russia (35%) it is nearly twice as high as in low-income Latin America countries with comparable GDP per capita. Hence, the conclusion made by the liberals – the financial size of the state in transition economies remains a burden and an obstacle for economic recovery.

The alternative, leftist, approach is different and it is exactly the one taken by the author. His arguments should be taken seriously if only for the reason that this leftist alternative became so successful in quite a number of countries - from Poland to China and from Hungary to Uzbekistan. In Hungary and Poland these were exactly the leftist, post-communist parties that were able to carry out reforms not introduced by the rightist, in particular, large scale privatization and pension reforms.

Out of 30 transition economies only several did not experience the sharp reduction of the share of government revenues/spending in GDP during transformation – Estonia, Vietnam and Central European countries (Czech Republic, Hungary, Poland, Slovak Republic, Slovenia); less dramatically than in other countries fell government expenditure/GDP ratios in Uzbekistan and Belarus. It is easy to notice that these countries are exactly the ones that exhibit the most favorable GDP dynamics: in Central Europe the 2000 GDP surpassed the pre-recession level of 1989, whereas Uzbekistan, Belarus and Estonia (exactly in this order) came closer than other Soviet republics to the restoring pre-transition GDP level, and Vietnam did not experience any transformational recession at all.

China seem to be an exception from this rule, since there was no transformational recession in China as well, but the share of government spending in GDP fell from 35% in 1978 to 13% in the late 1990s. However, firstly, the major decrease occurred in the second half of the 1980s, whereas in the first stage of transition the government spending was growing pretty much in line with GDP. Secondly, the decrease in the share of state expenditure was a controlled process, i.e. it occurred due to the initiative of the government itself, not despite its efforts. And thirdly, the expenditure for the "ordinary government" (excluding subsidies, investment and defense spending) grew in line with GDP.

On the contrary, in most CIS states the reduction of the government expenditure occurred in the worst possible way - it proceeded without any coherent plan and did not involve the reassessment of government commitments. Instead of shutting down completely some government programs and concentrating limited resources on the other with an aim to raise their efficiency, the government kept all programs half-alive, half-financed, and barely working. This led to the slow decay of public education, health care, infrastructure, law and order institutions, fundamental R&D, etc. Virtually all services provided by the government - from collecting custom duties to regulating street traffic - are currently the symbol of notorious economic inefficiency. There were numerous cases of government failure which further undermined the credibility of the state since many government activities in providing public goods were slowly dyeing and were only partly replaced by private and semi-private businesses.

Three major patterns of change in the share of government expenditure in GDP generally coincide with the three major archetypes of institutional developments, and even broader - with three most typical distinct "models" of transition. Under **strong authoritarian regimes** (China) cuts in government expenditure occurred at the expense of defense, subsidies and budgetary financed investment, while expenditure for "ordinary government" as a percentage of GDP remained largely unchanged[3]; **under strong democratic regimes** (Poland) budgetary expenditure, including those for "ordinary government", declined only in the pre-transition period, but increased during transition itself; finally, **under week democratic regimes** (Russia) the reduction of the general level of government expenditure led not only to the decline in the financing of defense, investment and subsidies, but to the downsizing of "ordinary government", which undermined and in many instances even led to the collapse of the institutional capacities of the state.

While in China total budgetary expenditure and that for "ordinary government" are much lower than in Russia and Poland, they were sufficient to preserve the functioning institutions since the financing of social security from the government budget was traditionally low. In Russia, however, though expenditure for ordinary government seem to be not that much lower than in Poland, the pace of their reduction during transition exceeded that of GDP: to put it differently, given the various patterns of GDP dynamics, while in Poland "ordinary government" financing grew by about one third in real terms in 1989-95/6 (and while in China it nearly doubled), in Russia it fell by about 2/3! The Russian pattern of institutional decay proved to be extremely detrimental for investment, and for general economic performance.

In Kolodko’s words “ there can be no doubt that *during the early transition there was a causal relationship between the rapid shrinkage in the size of government and the significant fall in output*” (p. 259). If the indicator of change in the share of state expenditure in GDP is added into regressions explaining output change during transition, it remains statistically significant even after factoring in the conventional variables, such as initial conditions (per capita GDP before transition, distortions in the industrial structure and in trade patterns inherited from central planning), the impact of wars, macroeconomic stability (inflation rates)[4].

Virtually everywhere in the transition world the reduction of government spending was accompanied by the increase in the share of the shadow economy. Equally unpleasant was the accompanying increase in income inequalities. Only countries with the lowest decline of the share of state spending in GDP (Central Europe, Estonia, Uzbekistan,

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[3] The “ordinary government” notion is borrowed from B. Naugthton (Naughton, B. Economic Reform in China. Macroeconomic and Overall Performance. - In: The System Transformation of the Transition Economies: Europe, Asia and North Korea. Ed. by D. Lee. Yonsei University Press, Seoul).

[4] Popov V. Shock Therapy versus Gradualism: The End of the Debate (Explaining the Magnitude of the Transformational Recession). – *Comparative Economic Studies*, Spring, 2000, No. 1, Vol. 42, pp. 1-57.

Belarus) managed to keep the increases in inequalities within reasonable limits (p. 203). In turn, the increase in income inequalities is detrimental for economic growth - because it contributes to social tensions and worsens investment climate[5] and because it creates lobbies that oppose structural reforms and macrostabilization[6]. Social inequalities create ground for macroeconomic populism – redistribution of funds from winners to losers, from competitive to non-competitive sectors, from rich to poor[7]. To put it in the simplest form, the greater income inequalities, the stronger is the lure to redistribute economic pie instead of increasing it.

In general, from all points of view, the dynamics of the government expenditure during transition seems to be by far the more important factor of successful transformation than the speed of reforms. Keeping the government big does not guarantee favorable dynamics of output, since government spending has to be efficient as well. However, the sharp decline in government spending, especially for the "ordinary government", is a sure recipe to ensure the collapse of institutions and the fall in output accompanied by the growing social inequalities and populist policies.

When real government expenditure fall by 50% and more - as it happened in most CIS and South-East Europe states in the short period of time, just in several years, - there are practically no chances to compensate the decrease in the volume of financing by the increased efficiency of institutions. As a result, the ability of the state to enforce contracts and property rights, to fight criminalization and to ensure law and order in general falls dramatically.

Thus, the story of the successes and failures of transition is not really the story of consistent shock therapy and inconsistent gradualism. The major plot of the post-socialist transformation "novel" is the preservation of strong institutions in one countries (very different in other respects – from Central Europe and Estonia to China, Uzbekistan and Belarus) and the collapse of these institutions in the other countries. At least 90% of this story is about the government failure (strength of state institutions), not about the market failure (liberalization).

This highly controversial idea is the one that unites the whole book. In addition to English, the book is being published in Chinese, Polish and Russian, which will make it available to the audience in the major transition countries and where it will certainly become controversial as well.

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[5] Alesina A., Perotti R. Income Distribution, Political Instability, and Investment. – European Economic Review 40 (1996), pp. 1203-1228.

[6] Alesina A. and Rodrik D. Distributive Politics and Economic Growth. – *Quarterly Journal of Economics*, 1994, May, Vol. 109, No.2, pp. 465-90; Fernandez R. and Rodrik D. Resistance to Reform: Status Quo Bias in the Presence of Individual Specific Uncertainty. – *American Economic Review*, 1991, Vol. 81 (5), 1146-1155; Persson T., Tabellini G. Is Inequality Harmful for Growth? – *American Economic Review*, 1994, June, Vol. 84, No. 3, pp. 600-21.

[7] Kaufman R. and Stallings B. The Political Economy of Latin American Populism. – In: Macroeconomics of Populism in Latin America. Ed. By R. Dornbush and S. Edwards. Chicago and London, 1991.