

**Lessons of the Post-Socialist Transition  
for the Iraqi Economic Transformation**

Testimony of

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Mr. Chairman, members of the Committee, I am David Ellerman, recently retired from the World Bank<sup>1</sup> where I was an economic advisor to the Chief Economist. Prior to joining the World Bank ten years ago, I started and ran for two years a consulting firm in East Europe to assist in the transition. While in the World Bank, most of my work was on the post-socialist transition with only a small part on the Middle East and North Africa region. The bulk of my remarks today will be based on the many hard lessons learned in trying to help the post-socialist countries make the transition to a private property market economy. While I am not an expert on Iraq, I imagine that many of these lessons would also apply to the post-Baath-socialism transition in that country.

**1. The Case for Humility, Caution, and Incrementalism.** Western economic advice to the former Soviet Union was partly responsible for the debacle in that region. Professor N. Gregory Mankiw of Harvard, the newly appointed head of the Council of Economic Advisors, noted in a recent book review that the book's author blamed much of the debacle in Russian on the shock therapy advice which came from some of the best and brightest of the economics profession (mostly from Harvard in this case). While Mankiw was more agnostic about the blame, he noted that if the advice "was a mistake..., its enormity makes it one of the greatest blunders in world history."<sup>2</sup> After a debacle of such historic proportions, surely we should have some humility about "nation-building" and be skeptical of those academic economists, brimming with self-confidence from building castles in the air, who now think they can socially engineer a new "shock therapy" program for a quick economic transformation in Iraq.

**2. Pragmatism about Party Affiliation.** The disastrous advice for institutional shock therapy in the FSU arose partly out of very understandable concerns that most of the people in positions of any power were in the Communist Party. Hence much of the western policy advice was wrapped in a cloak of Cold War self-righteousness: "Let's wipe the slate clean of the evil from the past to make a fresh new beginning." But we might recall the results of the Jacobins in the French Revolution or of the Bolsheviks in the Russian Revolution. For whatever reason, the U.S. supported the slate-cleaning "market Bolsheviks" in Russia to use the same methods for the reverse transition from Communism to the Market—with predictable results. Yet many of the professional, scientific, technical, and otherwise educated people were in the Party because it was the only way to get the jobs. If the qualified people hadn't join the Party, then the jobs would have gone to complete Party hacks. In Iraq, an organizational line should be clearly drawn so that above that line are the people who have to go. Below that line are the people whose professional knowledge and best energies will be needed for the reconstruction. They should not be thrown out along with the "dirty Baath water."

**3. New Leaders Should Come from Within.** It is important to understand the "returning-exiles" dynamics that played itself out in Eastern Europe and the FSU. When the old system collapsed, many who had been in exile (including various types of internal exile) returned to try to take over. They lead the chorus to demonize everyone who was a Party member, even those who had stayed in the country and worked for decades for reforms from within. Only those who were outside were presented as being sufficiently "clean" and untainted by involvement in the

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<sup>1</sup> My remarks are solely in personal capacity.

<sup>2</sup> Mankiw, N. Gregory 2003. Review of: Reinventing the Bazaar (book by John McMillan). *Journal of Economic Literature*. XLI(March): p. 257.

old system. By disqualifying those in the country who had any capabilities, the returning exiles tried to fill the power vacuum. But it did not work. Those in the country, in effect, said: "We who stayed suffered under the old system and tried to get along as best we could with passive resistance and active reforms. You got out and had a wonderful life in the West. Now that the system has finally collapsed, you want to come back in and take power." In all the post-socialist countries (with a few minor exceptions that were quickly discredited), the new governments were run by leaders who had grown up from within.

**4. Avoid Symbolic Cargo-Cult Reforms.** During WWII in the Pacific, the natives on many of the islands saw wonderful cargo being disgorged by the huge silver birds that came from the sky. After the war ended and the refueling stations were gone, the natives started cargo cults to "go through the motions" to get the cargo. They ran crude model airplanes up and down runways and talked into leftover orange crates with vines attached to "radio" to the birds to come back—but all to no avail. After the post-socialist revolutions, many aid agencies promoted similar Hollywood-storefront "stock markets" along with voucher privatizations so people could "go through the motions" of trading vouchers and shares—and thus "get the cargo" like in the West. What better photo-op for aid officials than cutting the ribbon in front of the Great Totem of the Stock Market? Never mind that after a century of perfecting the watchdog institutions, the U.S. still has its ENRONs. Aid officials should not have been surprised when their voucher privatization schemes and ersatz stock markets quickly degenerated into wall-to-wall ENRONs. People who lost their national patrimony in voucher ripoffs and lost their savings in Ponzi schemes expressed their despair with black humor: "Everything the Communists told us about communism was false, but everything they told us about capitalism was true."

**5. Reverse the Disenfranchisement of War/Revolution/Shock-Therapy.** The revolutions in the socialist countries and the shock therapy that followed in many of them quickly destroyed the "old way of doing things" but then found that it would take years or decades to construct new working institutions. A type of chaos ensued and a variety of economic and political thugs took over. The old system had never worked well but people got along in a twilight system held together "with chewing gum and baling wire." They knew that if they did X and Y, they could get something like Z. But after the old way was destroyed, they were disenfranchised and discombobulated. Things that never worked right, now didn't work at all. The helplessness and despair that followed in many countries lead to extremism and the election of neo-communist governments. Instead of going down this road again by naively trying to socially engineer new institutions overnight, it is better to start by seeing what worked before in some tinkered way and to see how it could be revived in some more legitimate retinkered way—which can then evolve. Instead of trying to jump over the chasm between the old and new institutions in one great leap forward (only to fall into a chasm of chaos), it is better to incrementally build a bridge—even though one foot of the bridge must always rest on the old ground.

**6. Promote Small and Medium-sized Enterprises.** In the current situation, the Iraqi people feel helpless. The first aim of economic transformation should be to promote and stabilize small and medium-sized businesses where people can regain some measure of control over their lives. Small business support organizations such as chambers of commerce can give businesses an organized voice, incubators can help new firms get going, domestic franchising can rapidly multiply successes in the retail businesses, and business education can give hope to a new

generation. Instead of setting up cargo-cult stock markets, what is required is quiet and patient work with the banking system so that it can serve small businesses. Where businesses are informal and property rights are *de facto*, they should be formalized and protected as urged by Hernando de Soto so that people can use these "erector sets" to build more. In the small business and family farm, ownership is closely tied to control. There is no long hard-to-police and ripoff-prone chain of authority from shareholders to boards of directors to managers to middle managers and finally to workers. People feel they are empowered and responsible. For larger firms or organizations to be restarted and privatized, the same principle applies. Try to find pragmatic arrangements so that the formal structures of ownership and responsibility are "shrink-wrapped" around the set of stakeholders who have to co-operate in order for the firms to function again. On that basis, they can build a better economy.

**7. Don't give aid to the Iraqi people; give them the tools to help themselves.** Lincoln said he would like to be neither a slave nor a master. In like manner, just as Americans would not like to receive charity from others, so we should not aspire to bestow charity upon others. Instead we should aspire to get the tools into the hands of the Iraqi people so they can sow and reap on their own—so they can help themselves. Aid recipients in the former Soviet Union sometimes complained that they were being treated like a conquered people. Since the Iraqi people are in that unfortunate position, we must be doubly careful to show respect rather than benevolence. Charity corrupts, and long-term charity corrupts long term. For instance, there is the short-term rush to supply aid in commodity form (e.g., food and supplies) but that will tend in the longer term to undercut the markets that might provide those goods. Phasing in something like a food stamp program would help to restart the Iraqi supply chain of businesses that used to supply those goods. Or, for another example, there will be the temptation to demonstrate American goodwill and know-how by paying U.S. firms to do the reconstruction work. But the Iraqis will see this as adding the insult of presumed helplessness to their injuries. Instead the contracts should go to the Iraqi organizations and firms that can reconstruct local infrastructure perhaps with some additional learning as the work goes along.

**8. A Regional Bank for Reconstruction and Development.** One of the strokes of genius in the Marshall Plan was that the resources for European reconstruction were channeled through the Organization for European Economic Cooperation where the European countries had seats but not the United States. The Europeans had to come to a *modus vivendi* and justify to each other how the scarce resources would be allocated. The U.S. role was indirect. If we look at the Middle East and North Africa (MENA) region today, it is the only region in the world without a regional development bank. The idea is an old one but there have been a few problems with "regional cooperation." Perhaps the time for this idea has finally come. Reconstruction efforts will be more successful if they come from within the region as part of regional self-help rather than from Washington. I suspect that the direct strategy: "We'll stay here until we have finished the job" is not viable for Americans and is not welcomed by Iraqis. Perhaps the U.S. Government should adopt an indirect strategy: help the countries of the region work out a *modus vivendi* in the concrete form of a regional development bank so that those countries can better help themselves.