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Lessons from the Victory of Capitalism over Communism



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EARLY REFORMERS

Poland

Stabilization and Reforms under Extraordinary and Normal Politics¹

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Until the summer of 1989 I was not planning on a career in politics. But the historical change under way in Poland persuaded me otherwise, and I entered politics, or rather public service, that year and remained there until early 2007—albeit with a brief “holiday” in 1992–95. Over the course of that career, I served in the following positions:

- deputy prime minister and minister of finance (September 1989–December 1991)
- leader of the Freedom Union, the largest free market party in Poland (April 1995–December 2000)
- deputy in the Polish Parliament (September 1997–December 2000)
- deputy prime minister and minister of finance (October 1997–December 2000)
- governor of the National Bank of Poland (January 2001–January 2007).

In this chapter I describe my role as minister of finance in charge of fiscal policies and deputy prime minister responsible for the overall coordination of economic reforms. I devote much attention to this first “romantic” period when Poland was the first postsocialist country to launch and implement a radical stabilization and reform program—also called the period of “extraordinary politics.”

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1. This chapter is based not only on my personal recollections but also on the numerous documents, notes, memos, and items of media coverage I reviewed while writing a book on my public activities over the last 25 years. I benefited from comments from Stanisław Gomułka, Stefan Kawalec, Jerzy Koźmiński, and Ryszard Petru.

I also cover another period of stabilization and accelerated reforms in Poland from October 1997 through late May 2000, when I was again deputy prime minister and minister of finance, as well as leader of the Freedom Union. These reforms took place under completely different political conditions—“normal” politics. This second reform period is less well known than the first, but in some respects it is more interesting; it offers some illuminating contrasts with the first period of reform.

In discussing both periods, I deal with three interwoven topics: the content of policies, the managerial aspects of their launching and implementation, and the political economy of stabilization and reforms. I try to be as honest as possible in identifying any errors in the policies for which I was responsible. Here I define errors as negative deviations from a certain empirically possible model. They can occur in the construction or in the implementation of reform and can take the form of errors of commission and errors of omission.

My Intellectual Journey

Until the late spring of 1989 I was convinced that the Soviet Union would continue to exist during my lifetime and that Poland’s institutional system would therefore have to retain its basic features such as a one-party state and the dominance of the nonprivate sector in the economy. This expectation was shared by the vast majority of the Polish people. Nevertheless, as a young economist in the 1970s I believed there was substantial scope for improving the performance of the economy through reforms that would—by necessity—respect these fundamentals. If one assumed that the political system would remain basically unchanged, the only logical way to achieve reform was to persuade the party authorities. As a member of the Polish United Workers Party (PUWP), I felt a moral obligation to do just that.

In 1978 Józef Soldaczuk, the head of the Institute for International Economics at the Central School of Planning and Statistics (CSPS; since 1990 the Warsaw School of Economics, WSE), where I worked, asked me to help him establish an economic policy unit at the central party institute. I was very unhappy about the name of the institute, the Institute of Marxism and Leninism. However, the work we did had nothing to do with Marxist ideology; we were warning that Poland was facing a grave economic crisis resulting from the inherent inefficiency of its socialist economy and its accumulated foreign debt, and we called for radical changes in economic policy.

During this time, I pulled together at the CSPS an informal group of younger economists from various institutions to work on a blueprint for a more efficient economic system that would respect the geopolitical constraints and thus have at least a minimal chance of being put into practice. The group met once a week. I tried to ensure that we would discuss in depth all the important segments of the institutional system: the enterprise sector, the financial system, the foreign trade regime, local governments, and so forth. The model that emerged from our discussions was a market economy based on labor-

managed firms. It went further than the Yugoslav system by calling for the elimination of the right of the party to nominate directors or intervene in the management of enterprises (the *nomenklatura* mechanism). In this respect, it breached the assumption of geopolitical realism.

The proposed reforms were publicly presented in September 1980, just after the emergence of the Solidarity movement. The new situation created a huge demand for “social” (that is, unofficial) proposals for reforms, and we were the only ones who had systematically worked on them for more than two years. As a result, the media began to speak about the “Balcerowicz team,” and Solidarity largely accepted our economic proposal.

The excitement generated by Solidarity ended with the introduction of martial law on December 13, 1981. The previous day I had traveled to Brussels to attend an international conference. The following morning I saw on television tanks on the streets of Warsaw. Without the slightest hesitation I decided to return to Poland. Just after my return I gave up—with great relief—my party membership card. Many people did so during the Solidarity period, but I felt to join this exodus would not have been honorable.

The meetings of our group continued in the 1980s. By this time we no longer cared about political realism and discussed fundamental topics such as liberalization, privatization, capital markets, and the foreign trade regime. We dedicated less time to the tax system and the social welfare state. Our discussions were an interesting hobby, but we did not see any light at the end of the tunnel. By chance, however, an important part of our homework became practically relevant in the second half of 1989. A general lesson is that one should be prepared for the window of opportunity by pursuing what appears to be a useless hobby.

Besides our group seminars, individual studies also influenced my views on the proper economic system and how to reform a socialist economy:

- I graduated from the foreign trade faculty of CSPS, probably the most open economic faculty in the socialist countries. In the textbooks and lectures on international economics, we were warned against the perils of import substitution and taught the virtues of an open economy. I strongly internalized these beliefs.
- My doctorate, which I defended in 1975, was based on an extensive study of the Western literature on technical change. I also read works published in the socialist countries. The conclusions I drew from this literature were that technical change is fundamentally important for economic growth, that it requires free entry and competition, and that a socialist economy by its very nature cannot meet these institutional conditions. I continued to study these ideas in the late 1970s and 1980s. Meanwhile, my conviction grew that the Soviet economic system, and even reformed systems of the Hungarian type, were anti-innovative (Balcerowicz 1995, 59–83).²

2. My 1995 book contains papers I wrote in the 1970s and 1980s (before I entered the government).

- In the early 1980s, I studied the debate on the efficiency of socialism (the “socialist calculation debate”). I was struck by the naiveté of the “socialist side,” represented by Oskar Lange et al., and the reasonableness of the “antisocialist” camp, represented by Ludwig von Mises and Friedrich Hayek (Balcerowicz 1995, 35–50). I fully shared Mises’s ironic prediction that the effective reform of socialism entails a return to capitalism.
- Also in the 1980s, I became very interested in “growth miracles,” especially in South Korea and Taiwan, and I studied the relevant literature. The popular view was that a special kind of state intervention was behind the phenomenal catching-up of these and other countries. I, however, came to the conclusion that the true reason was an unusual accumulation of growth fundamentals, such as predominantly private ownership, a high rate of savings and investment, low fiscal burdens, and an export orientation. I had always been skeptical, on empirical grounds, of intrusive state intervention.
- The studies of the Asian miracles as well as of the socialist economies led me to a strong Hayekian belief (before having read Hayek) in the virtue of the general rules of capitalism and the related equal treatment of firms and individuals. This standpoint was later one of my fundamental principles in economic policy.
- I also spent a lot of time studying reforms under socialism, all of which failed. These reforms were usually short-lived and produced negligible if any improvements in efficiency. I came to the conclusion that the socialist system had a special constructional logic. It relied on targets, rationing, and administrative prices that required monopolistic organizational structures that could be maintained only if property rights were largely in the hands of the state. To break this logic, the package of reforms had to have a huge critical mass: it had to eliminate the remnants of central planning, break up domestic monopolies, introduce freedom of entrepreneurship, and liberalize prices and foreign trade (Balcerowicz 1995, 51–58).
- I studied Ludwig Erhard’s 1948 reforms of West Germany, where I spent the autumn of 1988. Erhard’s policy consisted of massive liberalization of the economy and radical stabilization via currency reform. I noted that reforms after socialism would have to be even more comprehensive. Besides liberalization and stabilization, they would have to include deep institutional changes (for example, privatizing state firms or setting up a stock exchange). The reason: under the war economy in Germany capitalism was only suspended, whereas socialism entailed the destruction of its institutions.
- My studies in the 1980s included the stabilization problems in countries with high budget deficits and high inflation, especially in Latin America. Not surprising, I came to the conclusion that such situations required quick, radical actions on the fiscal and monetary fronts. I believed that macroeconomic stabilization in socialist economies should include tough

wage controls to help to break the wage-price spiral, something that became part of Poland's stabilization of 1990–91.

- In the late 1970s and 1980s, I spent a lot of time thinking about the reasons behind massive shortages in the economy. Unlike Kornai (1980), I came to the conclusion that they are caused by the rigidities of the controlled economy, not by soft budget constraints. Massive liberalization is therefore both necessary and sufficient to remove shortages (and to make the economy more efficient). I believed that Kornai's soft budget constraints were responsible for open inflation and that they contributed to inefficiency of the economy. But I also thought this factor had deeper roots, especially the detailed political control of the economy via dominant state ownership. Getting rid of soft budget constraints therefore required eliminating this feature.

In the spring of 1989, I wrote a paper on policies for Poland's economy. These policies included rapid and massive liberalization, convertibility of the zloty, tough and quick macroeconomic stabilization, and the fastest possible stabilization.³ I had no idea that a few months later I would be in charge of Poland's stabilization and transformation program.

* * *

In February and March 1989, the Round Table discussion between Solidarity and the authorities took place. It culminated in a historic agreement that was signed on April 5 and approved by Parliament a few days later. The agreement provided for the legalization of Solidarity and other associations and for quasi-free elections. The results for the economy were mixed. The private sector was to receive the same rights as the public sector, but there was no mention of privatizing state-owned enterprises (SOEs) or of any other deeper institutional reforms. Solidarity managed to get a generous indexation of wages of 80 percent of the price increases the preceding quarter, and it presented this concession as a major victory. The largest groups—miners, railways workers, farmers—had their own negotiating tables and achieved various concessions. These concessions reflected the lack of overall coordination of the economic talks on the Solidarity side, the “trade unionist” nature of Solidarity's economic experts, and the assumption that it would be up to the party to deliver on the economic promises.⁴

The Round Table agreement was a historical and political breakthrough, but its legacy for the economy was doubtful. Inflation was accelerating, and the wage concessions added fuel to a raging fire. Later, they were scrapped. The privileges bestowed on powerful and well-organized groups fueled their grievances and created pressures during implementation of the radical program.

3. Stefan Kawalec, a member of the original Balcerowicz team and my closest economic advisor, wrote a similar paper in 1988 while I was in Germany (Kawalec 1989).

4. I did not participate in the Round Table talks, and I was critical of their economic aspects.

Later, the political groups and leaders not represented at the Round Table talks turned out to be the most populist critics of the economic program launched in early 1990.

The elections on June 4, 1989, produced a surprisingly large victory for Solidarity, led by Lech Wałęsa. During the summer, the party tried but failed to form a government. Then, after two months of hesitation, Solidarity decided to take responsibility for the government. One of its most influential advisors, Tadeusz Mazowiecki, was nominated as prime minister on August 24. He formed a coalition made up of Solidarity and two former satellite parties of PUWP, and his cabinet included two ministers (defense and interior affairs) from PUWP. The first postcommunist government in Poland after World War II was thus a grand coalition, though dominated by Solidarity.

Radical Stabilization and Reforms during the Period of Extraordinary Politics

In late August, the prime minister asked me to become his Ludwig Erhard. I knew from my studies of Erhard's reforms that the job in Poland was much more difficult and comprehensive. I therefore first refused, before ultimately accepting. There were several reasons for my final decision. First, I felt that by chance I had already done an important part of the homework needed for the job. Second, I knew I could rely on members of the team I had worked with for several years; without them I would not have accepted Mazowiecki's offer. Third, I made it clear that I was interested only in tough stabilization and radical transformation of the economy, a position the prime minister accepted. And, fourth, I asked to chair the Economic Committee of the Council of Ministers, so I could coordinate the economic policy of all ministers. The prime minister agreed to my chairmanship and also agreed to let me have an important say in choosing the economic ministers. Indeed, most of them were my own choice, and I did not object to any of them.

I realized I was taking huge risks. I knew that Poland's economic situation was dramatic. I felt I had an intellectual grasp of the necessary strategy, but I knew I was ignorant about many of the important details. Moreover, I had never managed anything larger than a seminar, and I was untested in dealing with stress and with decision making under time constraints and risk. I knew from my previous studies that for radical reformers the honeymoon period is short and that the success of reforms depends on reformers persisting in the face of growing public criticism and protests. I was not planning to become a professional politician, but I was highly motivated to do the job, which I deeply believed was of historical significance for Poland. I was clearly a "techno-pol"—a technocrat in a position of political responsibility (Williamson 1994).

I had no problem articulating the goals of the economic program. The short-term goal was to eliminate the catastrophic imbalances and resulting hyperinflation. The longer-term goal was to catch up with the West. The first goal was to be achieved mostly by rapid and radical tightening of fiscal

and monetary policies, and the second by a comprehensive transformation, which I divided into massive liberalization, including currency convertibility, and deeper institutional change (privatization of SOEs, creation of a stock exchange, restructuring of the public administration, etc.). Liberalization was also necessary to deal with the massive shortages.

In working out and analyzing the policies, I used a simple analytical scheme, which consisted of four variables:

1. the initial conditions, which needed to be diagnosed
2. the external conditions, which needed to be predicted
3. the desirable end-state (the target system)
3. the policies that if implemented and sustained would lead from (1) and under (2) to (3).

As for the initial conditions in 1989, the Polish economy displayed the structural deficiencies common to all socialist economies: low and declining efficiency and the related backward economic structure. It was also the first country in the Soviet bloc to suffer extreme economic balances and near hyperinflation. The differences were especially striking when comparing Poland with Czechoslovakia and Hungary. In addition, Poland, like Bulgaria and Hungary but distinct from Czechoslovakia and Romania, had to deal with a huge public debt. In practical terms, these differences meant that the economic team had to devote much of its attention to problems other than institutional reforms.

The initial conditions in Poland turned out to be even direr than I had expected. On my third day on the job, I learned that the previous government had spent the substantial hard currency savings the people had deposited in the state banks (obviously, I had to keep that finding to myself; the surprising surge in our exports during 1990 helped pay back this debt). I also learned about another part of the domestic debt that consisted of the payments people made for cars and apartments without obtaining them.

The external conditions turned out to be difficult to predict. In 1991 they took the form of huge shocks as a result of the war in the Persian Gulf and the related increases in the price of oil.

I did not find it difficult to determine the desired end-state. For the macroeconomy, it was low inflation and a reasonably balanced budget. Except for the early 1970s when I was under the influence of Keynesianism, I never believed in the virtue of fiscal stimulation of the economy; I was strongly focused on longer-term growth and thus on supply-side reforms. The whole transformation after socialism was about the supply side. (This is why conventional Western macroeconomics, with its focus on the demand side, was ill prepared to deal with the reforms after socialism.)

I did not find it difficult in 1989 to determine what the targeted institutional system of the economy should be: It was clear to me that we should target a system capable of ensuring rapid, sustained catch-up with the West. This system served as a guidepost for reforms. Based on my previous studies, I

was pretty sure about the general features of such system: predominantly private with intense competition, outward oriented; based on general rules, macroeconomically stable. One could easily derive from this description the main directions of the necessary reforms, especially massive privatization and liberalization of the economy.

Starting in 1991, I came to the conclusion that there were important gaps in my knowledge about the target system. I did not know enough about the welfare state, especially the pension system. This gap probably helps explain why no deeper social spending reforms were included in the package of reforms enacted in December 1989 and—what was worse—why the economic team did not prevent implementation of the fiscally destructive proposals of the Ministry of Labor. I also did not know enough about the tax system. This second gap explains why in 1990 the team accepted the proposal of the International Monetary Fund (IMF) for a conventional progressive personal income tax with three rates—a policy that proved suboptimal.

The true intellectual and practical challenges arose around some aspects of the optimal transition policies—that is, the policies able to move the economy from the desperate initial conditions to the desired target system. I distinguish here the general strategy (the content and timing of the whole package of the policies) from the specification of some transition policies.

I always regarded the popular juxtaposition of “shock therapy versus gradualism” as pseudoscientific nonsense that obstructed clear thinking and served as an instrument of antireform propaganda. The very expression “shock therapy” frightens ordinary people, and indeed it has been often used for that purpose. For its part, “gradualism” is hopelessly vague. The “shock therapy/gradualism” dichotomy does not capture the most important problems faced in choosing an economic strategy after the collapse of socialism. For this reason, from the very beginning I used a different conceptual apparatus.⁵

First, I distinguished between two types of policies: macrostabilization and institutional transformation, which I divided into liberalization (that is, enlarging the scope of economic freedom) and deeper institutional change, such as privatizing SOEs, setting up an independent central bank, and transforming the public administration.

Second, I noticed that these policies differ in their maximum possible speed: macrostabilization and liberalization can bring much faster results than most of deeper institutional change. Reform strategies differ in terms of when they are initiated, their scope, and the speed with which they are implemented. Based on these distinctions, I defined a radical strategy as a package of macrostabilization, liberalization, and institutional transformation policies that are launched at the same time, are broad in scope, and are implemented as rapidly as possible. Less radical approaches can involve sequential timing of various policies, such as first macrostabilization, then institutional transfor-

5. For more on the criticism of shock therapy and gradualism and on the alternative conceptual framework, see Balcerowicz (1992, 4–6; 1995).

mation or vice versa, or a narrow policy scope, such as partial price liberalization, or slower implementation, such as case-by-case privatization.

Based on my previous studies of reforms and my realization of how dramatic the economic situation in Poland was in 1989, I was deeply convinced that only a radical strategy could succeed, even though risky, because Poland in 1989 was largely in uncharted waters. It was clear to me that a risky strategy was preferable to a hopeless one. It was this reasoned assumption and not an emotional radicalism that gave me the psychological strength to push and persist with radical reforms.

The economic case for a radical approach included the experience with previous reforms, the strong indivisibility of effective liberalization and the strong links between liberalization and macrostabilization, and the overwhelming evidence that hyperinflation requires a fast and radical stabilization policy (see Balcerowicz 1995). These were sufficient arguments for me to press for the radical strategy.

Noneconomic reasons also argued in favor of this approach. First, I was aware that the political breakthrough in Poland had opened the way for a brief period of what I called “extraordinary politics, when it is easier than during normal times to push through difficult reforms” (Balcerowicz 1995, 202–31). Implementing a radical economic strategy made the best use of this gift of history. Second, people often grudgingly change their behavior if they see a radical change in the environment they face and think that change is irreversible. I never believed one could engineer a massive change in people’s mentality, but I was convinced that radical reforms that strongly changed the incentives to which people were exposed were capable of inducing a radical change in mass behavior.

Several more specific issues gave rise to debates or uncertainties. I regarded privatization of the economy (that is, increasing the share of the private sector) as an absolutely necessary fundamental reform, both economically and practically. And fast “transformational” privatization—that is, privatizing the inherited SOEs—was its essential component. I was convinced from the very beginning that, to accelerate this process, we had to go beyond the traditional methods of privatization applied in Western countries. Indeed, starting in 1989 the economic team engaged in intensive debates on the relative importance of the traditional versus nonconventional ways of privatization, on exactly what methods should be used, and on whether privatization should be preceded by a massive corporatization of SOEs—that is, replacing workers’ councils with state-nominated supervisory boards). I decided against this option, fearing it would increase the government’s control over the economy and possibly strengthen the barriers against privatization.

Although I favored rapid privatization, it was obvious to me that the radical approach to reforms we chose—starting macrostabilization, liberalization, and institutional transformation policies at about the same time—implied that stabilization had to be introduced in a predominantly socialist economy because privatization unavoidably takes more time than macrostabi-

lization and liberalization policies. We never seriously considered a sequence (first privatization, then stabilization). We believed it was a hopeless option because the resulting chaos of hyperinflation would doom the whole program. And I still believe that because of the early hyperinflation we had to quickly introduce a tough stabilization program. Aware that SOEs lacking private, profit-oriented owners could not resist wage pressures, we introduced tough tax-based wage controls. However, I was still uncertain about the reaction of the state-dominated economy to the radical economic program, especially its supply response. We did not rule out massive bankruptcies of SOEs, a scenario that did not materialize in 1990.

I considered unification of the exchange rate and introduction of its convertibility within the current account operations a crucial element of the policy package. The rate of exchange introduced at the beginning of 1990 would serve as a nominal anchor in the stabilization policy and would thus be maintained for a certain time. The level of the exchange rate and the length of the period it should be maintained were extremely difficult issues. The Ministry of Foreign Trade pressed us to set it at 12,000 zloty per dollar, claiming that even at this level Polish exports to the West would suffer. However, together with the National Bank of Poland, we set the level at 9,500 zloty per dollar. Hard currency exports in 1990 increased much more than we expected, and the initial level of the exchange rate was kept until May 1991—much longer than we anticipated.

Around the middle of 1990 we recognized that the implemented program was more restrictive than planned. The economic team debated the appropriate policy response. Most of my advisors, including Stanisław Gomułka, whom I very much trusted (and continue to trust), suggested that some relaxation of fiscal and monetary policy was in order. So we relaxed both policies. When, after a rapid decline in the first half of 1990, inflation began to increase in the autumn, monetary policy was tightened again, despite the upcoming presidential election.

A description of the outcomes of the economic program implemented in Poland in 1990–91 is beyond the scope of this chapter. However, in the comparative assessment I wrote in 1993 I did point out that Poland’s “transformational recession” was the mildest among postcommunist economies and that its stabilization outcomes were relatively good (Balcerowicz 1995, 224–31). Radical stabilization and liberalization encouraged recovery and transition to a private economy. I believe these and other findings have withstood the test of time.⁶

In line with my expectations, the radical program quickly relieved the massive shortages and reduced inflation. However, the correctional rise in prices in January 1990 was much higher than forecasted and the statistical decline in GDP during 1990 much steeper. These data fueled some early criti-

6. For more on comparative analysis of the postcommunist transition, see Åslund (2013) and Hartwell (2013).

cism of the program. A bit later I realized that the official data exaggerated the decline in GDP because they largely omitted the fast-growing private sector.

On the political front, we enjoyed a period of “extraordinary politics.” Parliament passed the package of fundamental reforms in late December 1989 by an overwhelming majority, including deputies from the reformed postcommunist party. The extraparliamentary protests during 1990 were sporadic, organized mostly by the farmers’ lobbies. Nevertheless, during the presidential race in the second half of 1990 Prime Minister Tadeusz Mazowiecki surprisingly landed in third place, after Stan Tyimiński, who presented himself as a successful businessman from Canada and ran on a ticket of gloomy criticism of the economic program, and Lech Wałęsa, who won the election and became president. Mazowiecki resigned from his post, and Jan Krzysztof Bielecki was nominated as prime minister. My relationship with him during 1991 was harmonious (at the time he represented a liberal orientation).

The year 1991 turned out to be much more difficult than 1990 because of the interaction of economic and political factors. On the economic front, the benefits that could come quickly materialized in 1990. However, the response of the economy on the supply side was slower, even though the private sector continued to grow rapidly. GDP growth was considerably slower than assumed by those drafting the budget because the external shocks (the rise in oil prices and the collapse of the trade with postcommunist countries) were more powerful than expected. In addition, serious errors were made in pension legislation in 1990, producing a surge in pension spending. Taken together, these factors forced a revision of the budget: 80 percent of the shortfall in the revenues was compensated for by cuts in spending and 20 percent by increases in the budget deficit. All this was an unpleasant shock for me.

On top of that, in the second half of 1991 another electoral campaign, this time leading up to the parliamentary elections, was raging. Of the more than 60 parties participating, most were critical of the economic program, condemning what they called excessive “monetarism” and the “Balcerowicz plan” and exploiting economic problems. In the new Parliament, now occupied by 28 parties, 6–8 parties were required to form a government. I left government office on December 18, 1991, very tired and with no intention to return. I was still convinced that adopting any strategy other than a radical one would have been a terrible error, but I was uncertain about the supply-side response of the economy. Later, however, some good news emerged: GDP was on its way back to growth.

Looking Back on the Period of Radical Reforms

Looking back on the period September 1989 through late December 1991, I think the choice of a radical strategy was correct. I base this statement on my reading of the empirical literature on postsocialist economies: I am not able to find a single example of a nonradical strategy (delaying reform or stabilization, slowing the pace of macrostabilization and liberalization policies, etc.)

that in similar initial and external conditions would have produced superior outcomes. In particular, I have always regarded the assertion that “institutions were neglected” as a pretentious claim directed against a radical strategy, similar to the juxtaposition of shock therapy and gradualism.

Particularly important and successful were the liberalization and early and massive organizational demonopolization of the Polish economy, the substantial hardening of SOEs’ budget constraints, the unification of the exchange rate, the introduction of convertibility of the Polish zloty, and the establishment of an independent central bank. Outside the reform package, I would single out the agreement in the spring of 1991 with our creditors to reduce Poland’s huge foreign debt by 50 percent in net present value terms in two rounds, in 1991 and 1994.

The implemented policies deviated in some important respects from the economic team’s original intentions. Some of these deviations were caused by certain preconditions being different from what we expected. All the major errors were errors of omission: the economic team, including the Ministry of Finance, accepted bad proposals from some other ministries, especially the Ministry of Labor, which was in charge of social policies.

By far, the greatest error concerned the pensions. This error, made in early 1990, had explosive ramifications in 1991 and later years. At the time, Poland was experiencing a retirement boom coupled with a rapid increase in the ratio of the average pension to the average wage—from 43 percent in 1989 to 63 percent in 1992 (Balcerowicz 1995, 223). Pensioners in Poland were thus over-protected. However, the popular view, strengthened by populist politicians, was that pensioners were especially hard hit by the shock therapy.

Other errors included approving the proposal for a special pension system for farmers (this system is still awaiting reform) and failing to rein in the overly generous system of unemployment benefits proposed by the Ministry of Labor that extended benefits to graduates of secondary schools and universities, thereby inflating the number of unemployed.

These errors of omission probably reflected a combination of the following factors: the economic team’s relative lack of knowledge about social policies; the inherited economic situation, which absorbed a lot of the team’s attention; and the existence of a well-intentioned but technically incompetent team at the Ministry of Labor.

I realized several years later that we probably could have introduced a simple flat tax in the early 1990s instead of accepting the IMF’s proposed conventional progressive personal income tax, which we introduced in 1992. This error grew out of the team’s lack of knowledge (I do not remember anyone proposing a flat tax in Poland in 1989–91). I pushed a flat tax proposal as a part of comprehensive tax reform during 1998–2000, but the flat tax met strong resistance and was not introduced.

The pace of SOE privatization was much slower than I wanted. The slow pace was very difficult to avoid because of the political calendar in Poland. The comprehensive bill on privatization was adopted in February 1990, but it was

accepted by Parliament only in July 1990 because of competing views on privatization methods. The new minister of privatization, Waldemar Kuczyński, a close aide to Tadeusz Mazowiecki, was in office only three months, resigning in December 1990. The new minister, Janusz Lewandowski, who took over in early 1991, tried to develop a scheme of mass privatization.⁷ But before it could be implemented, parliamentary elections were held in the autumn of 1991, and Lewandowski resigned. Later, because of populist politics, the scope of mass privatization was reduced and its introduction delayed.

We were much more successful with other processes of privatization. The small-scale privatization was rapid. The new private sector was growing quickly, fueled by asset privatization: SOEs facing a much tougher environment—thanks to tough macrostabilization and liberalization policies—were selling or leasing some of their machinery, equipment, or buildings to private firms (for an early analysis, see Rostowski 1993). I took some extra measures in 1990 to support the growth of the new private sector: I exempted the new private firms from taxes, supported microlending schemes, and persuaded the Polish-American Enterprise Fund to focus on funding schemes for small and medium-size enterprises.⁸

All in all, I always believed that the performance of the Polish economy would have been even better if the SOE privatization had been faster, which would have required the early introduction of some scheme of mass privatization. I had been critical of Kornai's view that the growth of the new private sector was sufficient to privatize the socialist economy (Balcerowicz 1995). Notwithstanding evidence that SOEs in Poland made a substantial adjustment in response to tough macrostabilization and liberalization policies (Pinto, Belka, and Krajewski 1993), I remained convinced that in the longer run a large state sector would tend to return to its old ways, poisoning both the economy and politics.

I cannot emphasize enough the importance of a cohesive economic team with clear and determined leadership. Our team consisted of some members of the original "Balcerowicz group" of the late 1970 and the 1980, the new ministers in charge of economic developments, and selected individuals from the Ministry of Finance I knew from my studies at CSPPS. There were also two groups of advisors: one in my deputy prime minister's office and another consisting of selected academics. The first group focused on current matters, the second on strategic economic advice. In addition, a special group, ably directed by my former student Jerzy Koźmiński, dealt with the political environment, public opinion, and the media. Cooperation with the National Bank of Poland was very good, and there were never any major disagreements between us. Without these personal arrangements and some special mecha-

7. Lewandowski was a co-author of the concept of the voucher privatization, introduced in 1988 (Lewandowski and Szomburg 1989).

8. As a result of these measures, the share of private sector employment outside agriculture and excluding cooperatives increased from 13 percent in 1989 to 34 percent in 1992.

nism for coordination (Balcerowicz 1995, 340–70), we would never have been able to act as rapidly as we did or to sustain a radical economic program.

The economic team was able to radically change the direction of economic policy while working with a basically unchanged public administration. Its experience revealed that leading from commanding heights can sometimes alter the behavior of the whole army.

As minister of finance I was in charge of the huge tax apparatus. I quickly dismissed all the heads of the regional offices and replaced them with new people selected in open competition. This action probably helped us break up the connections between the tax apparatus and the state enterprises and thus harden the budget constraints they faced. It may also have helped us avoid widespread corruption in the tax administration.

While the radical economic program was being drafted and implemented during the period of extraordinary politics, which ended in the spring 1991, relatively little criticism was heard from politicians or the media. However, the economic establishment was either unsupportive or critical. With the passage of time, the criticism and protests from politicians and the interest groups grew stronger, especially in 1991.

The radical economic program was introduced over the period that Poland was holding three elections: local government elections in the spring of 1990, the presidential election in the autumn of 1990, and parliamentary elections a year later. The most vocal protests were from of the radical political groups, which were not invited to the talks at the Round Table in the spring of 1989, and from the best-organized lobbies (coal miners, railway men, and farmers). Paradoxically, most of the protests were by private farmers, who during the last years of socialism owned about 70 percent of the land. They did not experience any problems selling their produce under the shortage economy and were shocked when such problems appeared in early 1990. In addition, in 1989 they enjoyed large windfall gains because the last communist government sharply increased the prices for their products while raising the prices of their inputs much less. Farmers lost these gains under the radical economic program adopted in early 1990, which was criticized as harsh or destructive.⁹ Meanwhile, I focused on policies and spent little time explaining them to the public. I believed that was the best use I could make of the short period of extraordinary politics.

9. Public opinion in 1991 was polarized (*Gazeta Wyborcza*, October 30, 1991). More Poles were for free prices than against them, for privatization than against it, and for foreign capital than against it. As for the polls on the appropriate role for me, 23 percent of respondents declared I should not hold my position in the government and 4 percent thought no person who would continue my policies should be in the government. By contrast, 6 percent wanted me to be prime minister, 21 percent wanted me to stay in my present job, and 26 percent wanted me to remain in the government but in a less important post.

Activities While Out of Office

The period of extraordinary politics ended in the spring of 1991, when normal democratic politics, including a greater role for political parties, took over. However, normal politics in Poland during 1992–97 was rather peculiar (at least according to Western standards). Three successive coalitions governed Poland. The last coalition, which governed between late 1993 and October 1997 and included postcommunist parties, had three different prime ministers.

I left office with no intention of entering normal politics. I was aware, of course, that reforms in Poland were not finished and that their future depended on the constellation of political parties. But, as noted, I regarded myself as a techno-pol, who was called on to act during the phase of extraordinary politics.

Other activities kept me very busy during 1992–94. I followed developments in Poland and continued to be active in the Polish media, among other things, writing an essay every second week for one of the most popular Polish weeklies, which I continued to do until 2005. I also prepared a book on Poland's transformation (*800 Days of Controlled Shock*), which sold 50,000 copies and was the subject of wide commentary. And I spent a great deal of time abroad (including stays as a visiting scholar at the IMF, the European Bank for Reconstruction and Development, and the World Bank) and conducted research on developments in the former socialist economies. I visited a few of them, meeting the top politicians. Finally, I caught up on my studies on the welfare state (including the pension system), privatization, taxation, education, economic growth, law enforcement and justice systems, and other issues.

I enjoyed all these activities; however, on the home front I was increasingly convinced that the necessary reforms in Poland were being blocked or slowed. In 1994 some members of the Freedom Union, the reformist party headed by Tadeusz Mazowiecki, urged me to compete for its chairmanship. I believed this party best reflected my views and needed strengthening. But it was still psychologically very difficult for me to enter normal politics. After long hesitation, a couple of weeks before its congress I decided to join the Freedom Union. In early April 1995, I was elected chairman of the party by a wide margin, starting a new phase of my professional life as a leader of Poland's largest opposition party. My goal was to make the Freedom Union a disciplined, modern party in order to give a new push to reforms in Poland.

The job was not easy because the party included three former prime ministers and most of the former dissidents. We lost the presidential election in late 1995. In early 1997, the party's popularity declined to about 5 percent, but in the parliamentary elections in September 1997 we obtained almost 14 percent of the vote, campaigning on the "second Balcerowicz plan." I won a parliamentary seat in Silesia, a heavy industry region, running on a free market ticket against Marian Krzaklewski, the leader of the Solidarity trade union.

While in opposition, the Freedom Union systematically criticized the post-

communist government for slowing reforms, including privatization. However, working with the postcommunist parties (and against Solidarity), we pushed through a new constitution, adopted by referendum in May 1996. Based on a proposal from the Freedom Union, it prohibited public debt from exceeding 60 percent of GDP and offered reasonably good protection of economic and civil liberties. The constitution proposed by Solidarity was much weaker in these and other respects.

Even though we had cooperated with the postcommunist parties in proposing a new constitution, I had no intention of forming a governing coalition with them; that would have undermined the political chances of the Freedom Union. I had many objections to their policies. Marian Krzaklewski had managed to build a huge political conglomerate (Solidarity Electoral Action, or AWS) dominated by the Solidarity trade union and composed of about 40 small parties, many of which were very critical of the Balcerowicz plan. The AWS won the election in September 1997, but it needed the Freedom Union to control a parliamentary majority. When the time came, I was ready to enter this uneasy coalition, supported by the majority of my party.

Stabilization and Reforms during the Period of Normal (but Peculiar) Politics

After difficult negotiations, in October 1997 I once again became minister of finance and deputy prime minister in charge of overall coordination of economic policies as chairman of the Economic Subcommittee of the Council of Ministers.

I had a clear view of the economic situation and the related goals. The main goal was to increase long-term economic growth by speeding up reforms, especially privatization, as well as pushing deregulation and reform of the pension system, education, the justice system, local government, and the loss-making sectors, especially coal mining.

Meanwhile, the current account deficit was growing quickly, and I wanted to avoid a macroeconomic crisis. Thus I pressed for reduction of the budget deficit through lower spending, which was also important to strengthen longer-term growth.

On the labor front, Poland was entering a period of a growing labor force, thanks to the increased flow of graduating high school students. This opportunity strengthened the case for speeding up long-term economic growth. I also wanted to push through liberalization of the labor code.

The coalition agreement included most of these reforms, often in general terms. More specifically, the government agreed that privatization should be accelerated to strengthen economic growth. It also agreed to finance the transition to the funded pension system to be introduced within the framework of comprehensive pension reform. This was my idea as a way of making privatization more attractive politically. The coalition agreement stressed the need for

simpler and lower taxes but was not specific on tax reform. I added it—amidst much conflict—in the second half of 1998.

Governing with the AWS was quite an experience. After a relatively smooth first year, tensions and conflicts began to surface, mostly because the AWS itself was a heterogeneous coalition. As a result, groups within the AWS started to vote against the government's proposals or to push through Parliament bills that were contrary to the agreed-on program. The postcommunist parties supported both kinds of measures. I called this phenomenon double opposition: one official and one by the AWS.¹⁰

This was a very different political situation from the one I had faced during the period of extraordinary politics. Nevertheless, I was determined to pursue a disciplined fiscal policy and reforms.¹¹ To do so I used various mechanisms:

- I created another excellent economic team. I picked up very good deputies in the Ministry of Finance, and once again I had two groups of advisors: the strategic team, chaired by Jacek Rostowski, and a group that advised on current issues and helped coordinate the policies of various ministries. I also had an excellent group of young assistants, usually former students.
- I put great emphasis on public communication. I organized a very good communications team made up of younger people, and I played an active role in dealing with the media. We constantly monitored protests and tried to be on the offensive. For example, before protests by medical personnel, we published and widely publicized *A Black Book of Waste in the Health Service*. We also anticipated the most drastic forms of demonstrations. So I was not shocked when the businessmen who enjoyed absurdly generous tax breaks for employing disabled people organized their demonstration in wheelchairs in front of the Ministry of Finance. After a hard fight in Parliament, we reduced these tax privileges.
- We prepared the strategic documents meant to serve as coordinating and disciplining devices for coalition policies and convinced the government to accept them. The most important was the long-term strategy of economic growth and public finance, adopted in 1998. Another was the law on public finance, which increased its transparency and introduced two lower ceilings for public debt, 50 and 55 percent of GDP (if these ceilings were exceeded, specific automatic fiscal measures had to be taken). I also introduced the practices of publishing a “black list” of enterprises with the largest backlogs of taxes and making public all decisions by the tax office to defer or reduce tax payments.

10. I tried to enlist the support of the opposition for some measures that seemed to be relatively uncontroversial, but it usually refused and supported the fiscally destructive bills even when it became increasingly likely that the opposition was going to win the elections in 2001 and to take on responsibility for the government. This model of destructive opposition became the norm in Poland.

11. In this pursuit, I was supported by Hanna Gronkiewicz-Walz, the chair of the National Bank of Poland, and the newly created monetary council.

- I linked less popular reform (privatization) to more popular reform (creating a funded pension system).
- I tried to mobilize various groups or institutions in support of specific reforms. I organized a deregulation commission, which I chaired. It consisted of government officials, nongovernment experts, and journalists. When I discovered that local communities that had coal mines in their territory were very unhappy with them because of unpaid taxes, I formed a coalition with local officials from these communities to press for faster restructuring of the coal mines. I accepted a loan from the World Bank to finance this process, hoping that the Bank's experts would help me monitor this process and press for the privatization of the coal mines.¹²
- I developed alliances between the Freedom Union and selected groups and their organizations, especially the business community but also moderate ecologists, reformist teachers, managers of hospitals, reformers in local government, and selected journalists.

In view of the uneasy coalition as well as the external economic shocks of 1998 (the East Asian crises, the Russian crises), the macroeconomic and systemic outcomes of policies during November 1997 and May 2000 do not look too bad in retrospect:

- Fiscal deficits were substantially reduced, and the public debt to GDP ratio began to decline. It is true that the current account deficit continued to grow because there were time lags between policies and outcomes and we were hit by external shocks, but additional constraints on public debt were introduced.
- Privatization was radically accelerated. It included most of the banking sector, the large metallurgical sector, telecommunications, and many of the remaining SOEs in manufacturing (but not mining or railways).
- We introduced a fundamental pension reform that radically streamlined the pay-as-you-go system and introduced the mandatory funded system. The transition to this system had begun to be financed by privatization revenues. The link between privatization and pension reform worked during 1998–2000.
- Despite protests by the miners' union, coal mining was largely restructured. The number of miners was radically reduced, albeit with less efficiency than I had sought.
- Similarly, despite protests by the railway workers' union, the railway infrastructure was separated from other operations.
- Regarding deregulation, we were more successful in eliminating various

12. I was disappointed with the passivity exhibited by the World Bank's experts. Even worse behavior was on display in 2011 and 2013 when the Polish government under Donald Tusk began to dismantle the funded pension system introduced on the Bank's advice.

ministerial regulations than in scrapping unnecessary or harmful legislation. The comprehensive liberalization of the labor code, prepared by the deregulation commission, did not pass through the political system. As I feared, failure to liberalize the labor code has contributed to the increase in unemployment among young people. Politics in Poland wasted a demographic dividend.¹³

- During the summer of 1998, I proposed comprehensive tax reform, which included a flat personal income tax, a reformed corporate income tax, and changes in some other taxes. The proposed reform was described in the *White Book on Taxation*, a comprehensive diagnosis of and proposals for the tax system. The proposed reforms, especially the flat tax and the elimination of various tax breaks in exchange for lower rates, was demagogically criticized by the opposition and badly received by parts of the AWS.¹⁴ After lengthy negotiations with AWS leaders, I agreed on the two rates for the personal income tax, and the package of reforms was passed by Parliament, after much obstruction, in November 1999. However, President Alexander Kwaśniewski vetoed the reformed personal income tax, accepting other changes. Ironically, while in power in 2004 the postcommunist parties introduced changes to the personal income tax that made it very close to the flat or even the proportional tax (self-employed people could opt for one rate and almost anyone could be declared self-employed).

Given the political constraints, I doubt we could have achieved better macroeconomic and systemic outcomes. Perhaps we should have tried to remove various occupational pension privileges and increase the retirement age.¹⁵ But I am skeptical that we could have achieved sufficient support from the AWS, not to mention the opposition. In hindsight, I realized that it was probably an error to introduce the second tier of local government (*powiaty*) and—no doubt—to create such a large number of local units at this level. I tried to limit this number, but I was overruled in the government.

Starting in the early 2000s, the parliamentary coalition with the AWS practically stopped functioning because some of its deputies regularly voted with the official opposition against their own government. In March 2000, I presented to the AWS leadership two lists: the “negative” list (the bills proposed in Parliament that the AWS should reject) and the “positive” list (the measures it should support). The party refused to make any firm commitment. This was the main reason why in late May 2000, in response to my proposal, the

13. The main (and sufficient) reason why the reform was blocked was that trade union federations were very influential in the two largest competing political blocs, the postcommunists and Solidarity.

14. The opposition claimed that the flat tax would benefit the rich at the expense of the poor, whereas the proposed tax—thanks to the increased quota free of taxes—benefited people with lower income.

15. Both reforms were introduced by Prime Minister Donald Tusk's government.

Freedom Union left the government. We promised to support in Parliament all initiatives consistent with our program.

I focused on preparing the Freedom Union for the 2001 parliamentary elections. The prospect we faced was being in opposition after the elections. I was far from enthusiastic about serving as the leader of the opposition party, but I felt a moral obligation to stay with the Freedom Union and to continue doing my job as well as possible. However, opposition to my leadership emerged within the party. It consisted mostly of people who thought that the Freedom Union had to change its image from what they thought was an excessively “economic” one to a more traditional “caring” one. Another group wanted to continue on the previous course. I could have won the competition in the party congress held in December 2000, but I came to the conclusion that the emerging situation in the party released me from the moral duty to continue as its chairman.¹⁶ I therefore announced that I would not stand for election in 2001.

After I made this decision, the position of head of the central bank became vacant. President Kwaśniewski nominated me for this position, to which I was elected by Parliament in late December 2000. I started the job in January 2001 and served until January 2007. I chaired two successive teams in the monetary council and also chaired the banking commission. I was assisted in that job by a competent banking supervision, which was then part of the central bank. By gradually decreasing previously increased official interest rates, we brought down inflation from more than 10 percent in 2000 to about 2 percent in 2005–06. The relatively restrictive monetary policy, together with some extra supervisory regulations, helped Poland avoid a housing boom, which in turn helped make it the only country in the European Union to avoid the recession after 2008. In my supervisory job, I encouraged privatization of some banks and the restructuring of the largest state-owned bank.

During my tenure, the National Bank of Poland faced two successive unfriendly governments, the postcommunist one and then the government led by Jarosław Kaczyński. Both governments launched vicious attacks against the central bank’s monetary policy and independence.¹⁷ Assisted by the European Central Bank and most of the Polish media, I managed to repulse these attacks, which have strengthened the independence of the National Bank of Poland.

16. The more traditional wing prevailed at the congress but did not get into Parliament in 2001. It gradually disappeared from Poland’s political scene. The liberal wing left the party after the congress and merged with some other political groups to form the Civic Platform. It obtained almost 13 percent of the vote in 2001, going on to become one of the two largest parties in Poland, led by Donald Tusk.

17. The leader of the postcommunist government, Leszek Miller, wanted us first to lower interest rates more quickly and then to abandon the free float. He threatened to add some new members to the monetary council. The Kaczyński government, unhappy with some of my decisions as chairman of the banking commission, created a special investigative commission in Parliament with the purpose of investigating all the bank’s privatizations in Poland. I refused to appear before the commission because I did not want to create a precedent that would weaken the independence of the central bank. My decision was later fully supported by the Constitutional Tribunal.

Concluding Remarks

Poland's experience shows that stabilization and reforms are possible under both extraordinary and normal politics, if certain conditions are met. During a period of extraordinary politics, speed is of utmost importance. Being able to act quickly requires that a plan be prepared before the window of opportunity opens. Speed and previous work are also important in a period of normal politics.

In both periods, the analytical problems were relatively easy to solve. The more challenging problems were managerial and political. To be successful, a reformer must have an intellectual grasp of the economic strategy. He or she also must have the personality and skills to deal with the managerial and political aspects of launching and implementing radical reforms. Few people combine the intellectual, managerial, and political qualities necessary to be successful reformers. Whether such people take on leadership positions is largely a matter of chance. Sometimes, they may emerge but face obstacles that no one can overcome. The success or failure of radical reforms thus results from the complex interactions between personality and situational variables. Under both extraordinary and normal politics, success depends on the existence of a cohesive, well-organized, determined team with clear leadership.

In Poland as in other postcommunist countries, reforms were faster and more successful in the enterprise sector than in other sectors thanks to privatization. The remaining SOEs in Poland have incurred financial losses or have quasi-monopolistic positions. Reform of public institutions and systems turned out to be much slower and less effective, especially in health, higher education, law enforcement, and the justice system. Thus it is in the public sector where most problems remain. The pension system underwent the most reforms, but major reversals occurred, culminating in the *de facto* destruction of the mandatory funded system under the Tusk government during 2011 and 2013.¹⁸

Political criticism of stabilization and reforms in Poland came almost exclusively from the statist side, which opposed fiscal consolidation, privatization, and deregulation, especially of the labor market. When in government, the political opponents of stabilization and market reforms tended to postpone fiscal adjustment and privatization. However, they did not engage in aggressive fiscal stimulation or any major reversals of reforms (except restoring the pension privileges for the uniformed services and miners).

Monetary policy played an important disciplinary and stabilizing role on the whole. It was possible thanks to the independence of the central bank, which was defended and strengthened by throwing off political attacks.

Poland's GDP more than doubled between 1989 and 2013—the greatest achievement of the transition policies, in my opinion. This extraordinary growth resulted largely from the accumulated reforms of the enterprise sector and from the macroeconomic policies (especially monetary) that prevented the emergence of boom-bust episodes.

18. The related legislation is to be examined by the Constitutional Tribunal.

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