# Introduction

The fundamental basis of the neoclassical gradualist approach to transition in Russia and Eastern Europe was to establish economic, institutional, political, and ideological structures before attempting liberalization. Without this minimum foundation, radical reforms would have inhibited the development of a competitive market capitalist system. This was because "privatization, marketization, and the introduction of competition cannot be contemplated in an economy reduced to barter" (Carrington 1992, 24). Also, implementation of the reform program required minimum standards of living; otherwise the social fabric of the whole society would have been at risk. The reform had to foster a social consensus that endorsed a system of secure private property rights (Murrell, 1995, 171) and had to be guided by the principles of voluntariness and free choice (Kornai, 1992b, 17).

The aim of the transition process was to initiate a profound and unique change, a "transformational recession" (Kornai, 1993a, 182, 189; 1994, 41), and to overcome the "shortageflation" syndrome (Kolodko, 1993, 21) by initiating "preventive therapy" (Kornai, 1997a, 183). This was only possible by taking "the longest road" (Abel and Bonin, 1993, 230), or "rebuilding the boat in the open sea" (Elster, Offe, and Preuss, 1997).

The introduction of market relations to the centrally administered economies was not a simple task (Kornai, 1995e). In the transition economies, the market was underdeveloped, the private sector was immature and democratic institutions were weak. Institutions were changing rapidly and the behavior of individuals was adjusting constantly. As a result, "a special kind of dynamic analysis is needed" (Kornai, 1994, 2). Given the nature of the gradualist transition process it was impossible to solve the associated problems independently of the political and social aspects of the reform (Sutela, 1992, 95)—"so often, everything turns out to depend on everything else!" (Ridley, 1993, 352). There were political and social–psychological factors necessary for autonomy, freedom, and entrepreneurship, the primary driving forces of economic development (Kornai, 1992a, 19; 1993a, 220). Consequently, the analysis of the transition process, as adopted in this essay, is consistent with the tradition of political economy (Kornai, 1992a, 6; Murrell, 1991a, 62).

According to the gradualist neoclassical approach it was desirable to maintain a semicentralized system. The objective was to create a large class of people, with interests in the privatized state sector, through a process of embourgeoisement that developed genuine Schumpeterian entrepreneurs. Schumpeterian entrepreneurs adapted to demand, respected consumer

sovereignty, improved the quality of products, and introduced new lines (Frydman, Rapaczynski and Turkewitz, 1997, 86; Kornai, 1990, 140; 1992c, 155; 1993a, 188). According to Kornai (1997a, xii), this is why capitalism exhibits superiority over socialism. Yet Kolodko (1998, 24) warned that a successful transition process "requires a correct approach to reforms that does not mix the goals with the means."

The neoclassical gradualist transition process was implemented in countries such as Romania (Poirot, 1996, 1062); Hungary, which has a tradition of a gradual transformation starting in 1968 with the New Economic Mechanism (Kornai, 1993a, 199; Samonis and Hunyadi, 1993, 20; Szekely and Newbery, 1993, 7; Wolf, 1991, 48; Hare, 1991, 195); and Slovenia (Kornai, 1997a, 122). Table 1 reveals the progress of transition in the countries that implemented gradualism together with Poland, which implemented shock therapy. Hungary has better or the same transition indicators as Poland, while Poland has better indicators than Romania.

Gradualist transition supporters interpret the transition indicators as showing that the process clearly outperformed the shock therapy approach, rather than merely avoiding some of the obvious flaws. This was because it was naïve and premature to decontrol prices, float the exchange rate, and privatize and decentralize decision making before proper fiscal and monetary control over the economy had been established (Nuti, 1991, 158; McKinnon, 1993, 120; Gustafson, 1999, 7). Shock therapy failed and was wrong and dangerous; selective memory, statistical manipulation, and elastic use of the notion of success all failed to show that shock therapy had triumphed (Nuti, 1991, 159; Van Brabant, 1993, 77; Csaba, 1995, 240; Rana, 1995, 8).

In hindsight, Kornai (2000b) believes that his recommendations at the time with regard to ownership reform were correct, while with regard to macroeconomic stabilization he was partly right and partly wrong. He argues that the question of shock therapy versus gradualism was badly put and he recognizes that each element of the process has its own appropriate speed. Some processes required one–stroke intervention while others benefited from incremental changes. As well, Svenjar (2002) now argues that the initial conditions and the nature of reform are not adequate to explain the transition outcomes. He recognizes four leading transition economies— Poland, Slovenia, Hungary, and Slovakia—which have pursued a relatively complete set of reforms independently of speed.

Table 1: Progress on Transition in Hungary, Romania, Slovenia, and Poland

| Country | Large-Scale Privatization | Small-Scale Privatization | Governance & Enterprise Restructuring | Price Liberalization | Trade & Foreign Exchange System | Competition Policy | Banking Reform & Interest Rate Liberalization | Securities Market & Non-Bank Financial Institutions |
|---|---|---|---|---|---|---|---|---|
| Hungary | 4 | 4+ | 3+ | 3+ | 4+ | 3 | 4 | 3+ |
| Romania | 3- | 4- | 2 | 3 | 4 | 2 | 3- | 2 |
| Slovenia | 3+ | 4+ | 3- | 3 | 4+ | 2 | 3+ | 3 |
| Poland | 3+ | 4+ | 3 | 3+ | 4+ | 3 | 3+ | 3+ |



*Key:*
*1 = little progress; 4+ = standards and performance typical of advanced industrial economies. Source: European Bank for Reconstruction and Development 1999, 24.*

The aim of this essay is to develop a comprehensive neoclassical gradualist model of transition in the tradition of political economy. A political economy approach to the transition process would involve an analysis of what I define as the primary elements of the transition model: (1) economic analysis; (2) definition of a good society; (3) speed; (4) the political structure; (5) the ideological structure; and (6) the initial conditions. After analyzing the primary elements, the next step is to identify the elements of each model with respect to the desirable reforms. This aspect of the developmental process of transition modeling involves an analysis of what I define as the secondary elements of the transition model. A transition model has to answer questions relating to: (1) price liberalization and stabilization; (2) privatization; (3) institutional structure; (4) monetary policy and the financial system; (5) fiscal policy; (6) international trade and foreign aid; and (7) social policy.

## Primary Elements of the Neoclassical Gradualist Model of Transition

### Economic Analysis

The neoclassical gradualist model of transition, as the name suggests, is based on neoclassical marginalist economic analysis. Individuals are characterized by rational maximizing behavior based on self–interested and exogenous preferences, and prices are determined in a perfectly competitive market by supply and demand curves, in equilibrium, without market power. The behavioral assumptions used do not imply that everybody's behavior is consistent with rational choice. However, competitive forces will see that those who behave in a rational manner will survive, and those who do not will fail (North, 1990, 19). As well, neoclassical economists recognized the "unrealistic" assumptions of the perfectly competitive model and as such, an approximation of competitive capitalism is feasible and desirable. Decentralized economic agents are not required to adjust their behavior instantaneously; they do so through a process of trial and error in accordance with rational expectations. In the end, economic agents behave rationally.

Neoclassical economics is based on microeconomic foundations, inquiring into conditions of static equilibrium. The economy can be viewed as being in equilibrium. The macroeconomic variables are the result of adding up microeconomic relationships. Savings determine investment, and equilibrium is achieved at full employment by an adjustment in wages. Consequently, as long as there are no impediments in the operation of the market process, allocative

and productive efficiency is always achieved. The neoclassical dichotomy maintains that nominal variables cannot affect the long run equilibrium, real economic variables (such as real GDP, real income, etc.), which are determined solely by real variables can only affect long run equilibrium. The state should only provide for "truly" public goods (Aslund, 1994b, 181-82).

## Definition of a Good Society

Neoclassical economists view the history of civilized societies as a timeless effort to enhance freedom. This effort is concentrated on structuring all spheres of life and developing institutions that help achieve freedom of the individual. Freedom must be viewed as an overall concept. Anything that reduces freedom in one aspect of life is likely to reduce it in other areas as well. Individual autonomy and sovereignty is of the highest priority for free people. Restrictions on individual behavior by general interests and/or state interests are detested. Neoclassical economists argue that the intrinsic motivation behind human actions is the need to be self–determining and self–reliant. This is expressed by pursuing and accomplishing goals, that are optimal from the individual's point of view.

The market as an economic institution is the expression of economic freedom. The market, in the absence of any form of discretionary power, is an institutional process in which individuals interact with each other in pursuit of their economic objectives. Planning and markets are not compatible coordination mechanisms that can be harmoniously combined in any proportions. Indeed, planning can only lead to coercion (Hayek, 1986, 27). However, economic freedom cannot be absolute. The philosophy underlying economic freedom is not the crude self–interested behavior of getting what is desired by whatever means. Rather, the means must be within defined rules. To facilitate freedom, free societies have developed appropriate laws and institutions, which include defined property rights and procedures guaranteeing the execution of contracts (Sachs, 1995, 52; Aslund, 1997, 20). It is the responsibility of the state to enforce the laws and institutions that are required for an effective market system to exist. This implies a strong but "minimum" and non–market–interventionist state.

Private property is the foundation of economic freedom and an essential ingredient for the efficient operation of the market. "An economy with a predominantly state ownership is unbalanced by definition and is also inflation prone" (Winiecki, 1992, 274). Confidence in private property is based on the incentives that it produces incentives that guarantee the efficient use of resources and eliminate shortages. State involvement should be reduced to a minimum. In the event of market failure, government action is not automatically required.

Priority should be given to private alternatives, with minimal involvement of state property. This is because "government–political failures" are in fact more serious and inevitable than "market failures." In the absence of government and market failure the operation of a competitive market results in efficient scarcity prices, which are indispensable to the operation of the market system (Giersch, 1989, 7–8).

The market, as a means to economic freedom, promotes political freedom because it separates economic power from political power (Friedman, 1980, 88-94). Using the spontaneous forces of society results in using as little coercion as possible. The market is a means by which the organization of economic activity is removed from the control of the political authority. By enabling people to cooperate with one another without coercion, it reduces the scope of political power (Aslund, 1994b, 186). Furthermore, the market serves as a source of potential opposition to the misuse of political power, a form of accountability (Berle, 1954, 66). Hence, neoclassical economists, either as shock therapy supporters or gradualists, were in favor of an economic system based on private property, free market relations, and individual material incentives. Such an approximation to competitive capitalism was feasible and desirable where there were fewer opportunities for corruption and rent–seeking (Aslund, 1994a, 36; Smyth, 1998, 365; Porket, 1998, 163). Thus the reform program could be assessed on whether or not these ultimate goals were achieved.

**Speed**

A market capitalist system did not have to be imposed upon society. As long as restrictions on self–interest and individual action were removed, capitalism would have been a natural outcome, albeit slow (Kornai, 2000, 32). However, the neoclassical gradualist supporters did not rule out the possibility of a "minimum bang" for some aspects of the transition (Kornai, 1986, 1693; McKinnon, 1992a, 33; Smyth, 1998, 384). Whenever immediate changes were needed, immediate action was required (Thomas and Wang, 1997, 218). The choices were fast and costly restructuring or slow but less expensive restructuring (Dewatripont and Roland, 1992a, 299).

The human learning process is complex and does not favor swift change. The revolutionary breakdown of centrally administered socialism in 1989 led to the so–called honeymoon period, when radical policies were implemented in some transition economies. In contrast, an evolutionary process of change cannot include a honeymoon period or radical economic policies. But the revolutionary character of the collapse did not result in an immediate change in individual

behavior. Under the new economic conditions, individuals, to be effective market participants, had to acquire the necessary personal and practical knowledge—that inarticulate knowledge required for the effective performance of any activity. This type of knowledge can only be acquired by direct acquaintance with the activity, and it is inherently specific to particular contexts; thus, knowledge acquired under centrally administered socialism was irrelevant. For the learning process to take place, solving market problems, while important, it is not sufficient; individuals must also look inward. Individuals need to reflect critically on their own behavior, identify the way they often inadvertently contribute to wrong solutions, and then change how they act. In particular, they must learn that the way they go about defining and solving problems can be a source of problems in its own right. If individuals were able to experience an inconsistency in their actions, they would correct it. But if the error is of a magnitude to produce mistrust rather than trust, correcting it is not straightforward. In order to produce trust, individuals must entrust themselves to others. Thus, individuals learning how to reason about their behavior in new and more effective ways break down the defenses that block learning. The transition process results in systemic change (Csaba, 1995, 21) in learning, knowledge, perspective, and motivation.

From the gradualist perspective, people in Russia and Eastern Europe would not have known how to act in a market economy. While small-scale trading could be learned easily, business ethics and legal aspects of economic activity would have taken much longer. The interactive process of learning-by-monitoring, learning-by-doing, and the acquisition of knowledge and new behavior are organic processes that last for several years. As a result, the productivity of small changes would be greater than that of large changes (Kornai and Daniel, 1986, 303; Kornai, 1993a, 198; 1997a, 18; Murrell, 1994, 168; Kolodko, 1999b, 259). History does not move in leaps, but in marginal adjustments—small and gradual steps are easier to correct than sudden and major steps (Kornai, 1997a, 94; Boettke, 1999, 377; Roland, 1994a, 1163). Therefore "capitalism has never been introduced by design: it evolved organically" (Csaba, 1995, 99), similar to the "nurturing of a greenhouse plant" (Svejnar, 1991, 131). Taking into account the social costs, sequencing, learning-by-doing, institution-building, structural adjustment, administrative capacity, behavioral change, informational asymmetry, lack of commitment, political constraints, and the danger of the reversal of the reform, a long, very complex and multifaceted process was favored by neoclassical gradualist economists (Kolodko, 1999b, 253; Samonis and Hunyadi, 1993, 14; Gustafson, 1999, 8; Roland, 1994a, 1163; Van Brabant, 1993, 77, 84; Dewatripont and Roland, 1992a, 297; Murrell, 1994, 170-1; Csaba, 1995, 201; Kornai, 1992a, 16).

Gradualism was optimal, the reforms were not doctrinaire but evolutionary and pragmatic, and the changes were made in tiny, fragmented, concurrent and consecutive stages (Kornai, 1997a, 140; Rana, 1995, 26; Dewatripont and Roland, 1992a, 292; 1992b, 703). Compromises would not derail the reform; indeed, they were critical to success by averting traumatic upheavals and contributing to the relatively calm political atmosphere, providing a foundation for a credible reform of policy (Csaba, 1995, 93; Van Brabant, 1993, 80). While the long-term objective of reform was to reduce the role of government, regulatory intervention could still play an important role. The need for "patience, humanity and tact" (Kornai, 1995b, 13; 1996, 17) again justified a gradual approach.

A gradual process of transition necessitated the sequencing of reforms—transition-by-design rather than transition-by-chance (Kolodko, 1999b, 249). Timing and sequencing of liberalization were imperative (Rana, 1995, 1; McKinnon, 1993, 98, 108); poor timing would have resulted in prolonged stagnation (Csaba, 1995, 87). The shock therapists introduced the reforms in one shot without careful consideration of the ultimate economic consequences (Svejnar, 1991, 128). Under a gradualist neoclassical process, the transition was more complex because reformers paid attention to the order of introducing the necessary reforms and the "painful trade-offs and choices between bad and worse" (Kornai, 1992b, 18). Adopting a suitable reform strategy was not simple (Rana, 1995, 1), and success required "a convincing, detailed, practical program whose implementation must begin at once" (Kornai, 1994, 59) to avoid corruption and crony capitalism (Kolodko, 1999a, 34). As Csaba (1995, 15) stated: "Only the most vulgar or ignorant representatives of the economics profession could seriously be convinced of the feasibility of institutional quick fixes."

The belief that the market could be created through shock therapy was "wrong, and in several cases has caused more problems than it has solved" (Kolodko, 1999b, 233). The 100- or even 500-day approaches were not feasible and were disastrous (McKinnon, 1992a, 33; Kolodko, 1999b, 233; Csaba, 1995, 99). It was wrong to presume that a free market would develop overnight, or that the transition economies could jump to a more sophisticated coordination mechanism once the infrastructure of central planning was eliminated by abolishing the old institutional constraints and the market was freed, together with changes in attitudes, expectations, and behavior (Rana, 1995, 25; Csaba, 1995, 52; Van Brabant, 1993, 81). The severity of the unavoidable recession was increased substantially by the errors and mistakes of the transition governments, which mainly stemmed from the adoption of the shock therapy model. Economic performance so far has been even worse than it was under centrally administered

socialism (Olson, 1995, 437). Unfortunately, it was the past failures of gradualism that had driven some of its former supporters to advocate "big bang" type solutions (Rowthorn, 1993, 346).

A gradual process of transition was preferable to shock therapy because it allowed time for adjustment, reduced transition costs, gained political support, and created the conditions for the reform process not to be reversed. The market economy required adequate institutions and massive new legislation and legal codes, which could not be achieved by the shock therapy process. The shock therapy approach resulted in anxiety, uncertainty, fear, despair, and a loss of hope (Berg, 1994, 402; Kornai, 1994, 48).

Gradualism enabled the transition to start with reforms that were likely to have the best outcomes for the majority of the population, while delaying the less attractive changes. This process increased the feasibility of reforms via designing an optimal sequencing from a political economic point of view by building constituencies for further reform (Roland, 1994a, 1163; 1994b, 32-34). For economic and political reasons there was "simply no realistic alternative to gradualism" (Rowthorn, 1993, 346).

## The Political Structure

Kornai (1995e, 64; 1997a, 122), Lipton and Sachs (1992, 215) and Sachs (1993, xiii) agreed that the fundamental transition problem was political and not economic. This was often ignored in economic policy analysis and recommendations, which were characterized by technocratic approaches (Fischer and Gelb, 1991, 104). The failure of partial reforms was associated with the exclusion of the political process (Wolf, 1991, 57). Politics is not an external factor for any economy, but an endogenous variable imposing constraints; ignoring politics is "bad economics," and it is necessary to be "respectful of politics" (Kornai, 1997a, 151, 169; Olson and Kahkonen, 2000, 15; Roland, 1994b, 27; Furubotn, 2000, 120).

Under the neoclassical gradualist approach, maintaining centrally administered elements in the economy would have enabled the bureaucracy to exercise power and appoint people on the basis of political loyalty rather than ability. At this time, reformist governments faced an increasingly broad and aggressive array of interests, some of which strongly opposed the reform program. Under the new politicoeconomic conditions, abuse of power was scrutinized by the mass media and by the voluntary and spontaneous associations that citizens formed to apply political pressure on a variety of issues.

The adoption of democracy should result in the formulation of a "social contract," a "developmental consensus" (Csaba, 1995, 90), among the variety of self-interest groups who were prepared to restrain their demands to help solve the transition problems. Without minimum political cooperation, even well-developed economic programs would fail (Kolodko, 1998, 27). Kornai (1995c, 246) argued that the transition process resembled the prisoners' dilemma. Prisoners have to compromise because they achieve more collectively than they would through noncooperative individualist behavior. In transition economies, the citizens were prisoners of the time, and cooperative behavior was necessary for progress. An essential element in engineering such consensus was the construction of channels for ongoing consultation and negotiation between interest groups (Nelson, 1994, 56). The establishment of a consensus provided credibility for the reform process. For example, in Hungary the elections revealed that a majority of the population preferred parties with a more cautious approach to transition and subsequently gave the governing coalition a mandate to follow the policies of a "calm force" (Andorka, 1994, 29). In Russia, however, no one enjoyed a mandate to launch the shock therapy program (Csaba, 1995, 221; Kornai, 1997a, 127). A democratic political structure was an absolute condition of the gradualist approach to successfully change the economic system.

The process of gradual reform—the priorities and trade-offs, the minimization of social cost and the implementation of "true reforms" (Kolodko, 1999b, 247) that serve the interests of society and not the few in power—could only be decided by the participation of the people through a democratic process. This was essential to achieve social and political stability and avoid confrontation (Thomas and Wang, 1997, 235; Kornai, 1997a, 127). Broadly speaking, political rules in place lead to economic rules, and good economic performance is directly linked with democracy; though the causality runs both ways (North, 1990, 48; Olson, 2000, 132). Kornai (1995d, 150; 1995e, p62, 159, 220; 1993b, 333) elevated the achievement of a democratic political structure to the number one goal of transition; autocratic rule was not worth any price, even efficiency: "If it comes to a conflict between efficiency and the cause of democracy, I am sure that defense of the institutions of democracy is the supreme task" (1997a, 178). Consequently, there was a new role associated with the government (Kolodko, 1999b, 249). Active state participation was required because the public considered it to be the job of the government, consolidated by the political process, to correct the imperfections of the market caused by self-interest lobbies and informal elements such as organized crime (Csaba, 1995, 64; Kolodko, 1999b, 245; Kornai, 1997a, 30).

Political, economic, and financial interests influenced the drafting of economic policy. Political and credit constraints necessitated a gradual restructuring (Roland, 1994a, 1158; Femminis and Ruggerone, 1999, 601). However, there was a danger that leaders would be too focused on short-term problems because the coordination of transition and development policies involved passing between the Scylla of populism and the Charybdis of expansionism (Kolodko, 2000, 273; Kornai, 1995c, 243). These interests bypassed the democratic process and continued to pursue policies even after it was evident that they were wrong: for example, the early liberalization and stabilization policy in Poland in 1989–92; the disregard of corporate governance in the Czech Republic in 1993–96; the Russian privatization of 1994–98; and the deceitful Albanian financial intermediaries in 1995–97 (Kolodko, 1999b, 246). These countries implemented shock therapy, which did not pay attention to democratic institutions.

The absence of any broad political consensus made it extremely difficult to confront the transition problems. Tackling problems such as hyperinflation, restructuring enterprises, and reducing the budget deficit involved dramatic drops in living standards. In addition, shock therapy resulted in great opposition to the reform program, because "the worse the initial shock and the higher the unemployment, the more opposition there is to restructuring" (Blanchard, 1996, 117). Consequently, the neoclassical gradualist economists saw commitment to reforms as counterproductive. Initially the chosen policies would be unsatisfactory and the ability to change extremely important, given that an immense amount of learning had to take place (Murrell, 1992, 88-89).

Implementation of the shock therapy model, which resulted in disillusionment, massive unemployment, inequality of wealth, and corruption, endangered the fledgling institutions of democracy and inhibited meaningful economic reforms (Poirot, 1996, 1058; Olson, 2000, 137). "This economically induced disillusionment provides a fertile breeding ground for demagogy, cheap promises, and desires for iron-handed leadership" (Kornai, 1994, 60). This is consistent with my assessment of the political structure of the shock therapy model. It was in harmony with political pluralism, not democracy with a non-elected government, which did not exercise discretionary power. For neoclassical gradualists, democracy was an essential precondition for a successful reform process, not an obstacle to reform (Dewatripont and Roland, 1992a, 300; 1992b, 705). The shock therapy approach highlighted how speed can constrain a government, whereas the gradualist approach tries to plan the sequence of reforms so as to build, through the democratic process at each stage of transition, constituencies for further reform (Roland, 1994b, 39).

## The Ideological Structure

With respect to the ideological structure, neoclassical economists have developed an ideology that emphasizes political and economic freedom and encourages self-interest and self-help, as presented by Adam Smith (1986, 119). Market power results from the state's use of its discretionary power. Without discretionary power, individuals will behave "as if" they are in competitive capitalism. Hence the state should play a minimal role, and the constitution should allow it to act only where there is market failure. It should also provide a "safety net." Justice does not mean equality of income distribution; it means equal treatment by the state. Everyone is entitled to basic human rights and equality before the law, and privileges based on class, color, religion or gender are rejected.

An ideological foundation for the development of a market system already existed in transition economies, based on the values and the deeply rooted individualism and rationality of the people. The desire for a better economic position, to accumulate wealth, and to compete are inherent in human behavior and may be suppressed but not eliminated. These traits could foster an effective market system as long as all impediments to individual behavior were removed. Consumers in transition economies reacted positively to the market reforms, and their behavior was consistent with that predicted by neoclassical economic theory (Parker, Tritt, and Woo, 1997, 8, Boone and Fedorov, 1997, 187; Berg, 1994, 397). Private enterprises increased dramatically as entrepreneurship was oppressed but not erradicated and self-interest and self-help were replacing paternalism and statism (Mau, 1992, 266). The slogan "Towards the market at the expense of the state, not the citizens" was very popular in Russia (Kosmarskii, 1992, 31). Thus the acquisitive spirit was on the rise in Russia and Eastern Europe.

## The Initial Conditions

The neoclassical gradualist process was inconsistent with rigid thinking and the implementation of the reform program independent of the initial conditions, as in the case of the shock therapy model. "Sensible economics" required the incorporation of the initial conditions in the transition process (Murrell, 1995, 165). Policy instruments and goals had to reflect the specific economic conditions of the time and change as necessary. This required constant reassessment of the specific economic situation and active government participation in economic affairs. The government had to be flexible and responsive to economic changes. Experience revealed that, in economies in

transition, the choice of liberalization strategy correlated with initial conditions. For example, Eastern Europe and China had different sequences of reform (Ickes, 1996, 302; Roland, 1994b, 37) due to different circumstances.

The dynamics of reform differed among transition economies because the starting points were varied. The starting point required clarification. It is not accidental that the states of Central and Eastern Europe and the Baltic region are performing much better than the Commonwealth of Independent States, since centrally administered socialism was established later in these regions. In addition, Hungary was at a relatively advantageous position—gradual reform started in 1968 with the New Economic Mechanism; its ability to avoid hyperinflation may be attributed to the advantageous initial conditions.

In terms of economic development, the socialist experiment was a temporary aberration in the course of historical events (Kornai, 2000, 27). However, the initial conditions in each formerly socialist country determined both the output response during marketization and the speed and sequence of transition policies (Parker, Tritt, and Woo, 1997, 15; Thomas and Wang, 1997, 218; Csaba, 1995, 268; Murrell and Wang, 1993, 387; Murrell, 1991b, 6-7; Wolf, 1991, 45; McKinnon, 1991a, 117; 1992b, 107; Calvo and Frenkel, 1991, 144; Van Brabant, 1993, 85; Furubotn, 2000, 120; Femminis and Ruggerone, 1999, 601). The different initial conditions made each situation unique, and there was "no ready–made recipe" (Kornai, 1995b, 34), "no single detailed road map" (Fischer and Gelb, 1991, 91). Initial conditions aside, the aim of all transition economies was to establish competitive market capitalism, which Slay (2000, 69) defines as a "normal economy."

Incorporating the initial conditions in the transition process justified a gradual approach (Kornai, 1992b, 17). This was because the level of a society's civilization, history, culture, size, efficiency and the degree of social satisfaction were correlated with what actually occurred in the economy (Bim, 1992, 181; Murrell, 1995, 165; Kornai, 1995e, 1; McKinnon, 1995c, 63; Winter, 1993, 325). The starting point required clarification; there could not be a uniform line, and thus governments could not undertake liberalizing measures simultaneously. Instead, there was an "optimal" order of economic liberalization, depending on the initial conditions (McKinnon, 1993, 4; Csaba, 1995, 17). While history and

culture are important, they were not such a binding constraint that a fatalistic approach had to be adopted. Cultural values can mutate and history change (Boettke, 1999, 376).

Murrell (1995, 173) was critical of the shock therapy assumption that market economic systems were the same everywhere, whether in "Russia of 1913 or the OECD of 1994." The top-down reforms that resulted were a sad reminder of the past, although in the transition economies the reforms were designed not by the central authority, but by foreign economists. In the case of Russia, Jeffrey Sachs admitted he felt like a surgeon who had sliced open a patient only to discover nothing that was supposed to be there! Kingston-Mann (1999, 41) added: "The surgeon not only had the wrong diagnosis but mistook the patient for someone else" because the patient's history was so unfamiliar to the surgeon.

## Secondary Elements of the Neoclassical Gradualist Model

### Price Liberalization and Stabilisation

Rational economic planning during the transition was impossible because of the diverse interests of individuals. Therefore, the only possible mechanism for coordinating the market was based on the signals provided by relative prices (Carrington, 1992, 23). However, the adjustment of the quantities to the new prices had to be gradual (Kornai, 1994, 45). Stable domestic price levels permitted greater domestic financial deepening and higher real deposit rates, reducing risks and greatly simplifying the liberalization and stabilization of the real exchange rate (McKinnon, 1993, 30). Meanwhile, the absence of designed price controls and policies resulted in inflationary pressure without eliminating shortages. The price controls were not a fruitless exercise, as the shock therapy supporters insisted; they facilitated the transition and reduced the associated costs to the people. There was a real trade-off between the short-term quantitative antirecessionary gains and the long-term qualitative benefits of economic growth (Csaba, 1995, 95; Kornai, 1993a, 201). The efficiency gains of price liberalization were uncertain (Alexeev, 1991, 390). Prices could not be liberalized immediately; there had to be transitional pricing, in which prices of basic foodstuffs, energy products, and utilities were controlled. For example, an agricultural price support system, similar to the European Union's agricultural policy, could have been introduced temporarily, with tariffs on imported food (Samonis and Hunyadi, 1993, 13; Brooks, et al., 1991, 157).

Prices would have reached their equilibrium values and world levels through a gradual process, because prices and the real exchange rate are endogenous variables (Begg, 1993, 343; Roe, 1991, 10, 11). Also, such controls would have partially substituted for the otherwise underdeveloped social safety net (Fisher and Frenkel, 1992, 38). Foreign aid and the elimination of the black market would have hastened a movement to equilibrium prices. Thomas and Wang (1997, 235) used the experience of successful East Asian reforms to argue that these countries made structural changes incrementally to avoid the need for shock therapy. Market-oriented reforms take years to put into place and usually require even more time before they begin to generate robust investment and growth (Nelson, 1994, 53). For example, prices have been freed gradually in Hungary (Samonis and Hunyadi, 1993, 23; Kornai, 1997a, 15).

The shock therapy argument for total price decontrol was flawed and extremely destructive (McKinnon, 1993, p82, 86; 1995a, 100; Aven, 1997, 60). While central administration had been removed, price signals did not immediately replace the role of directives since individuals were not yet competent to evaluate and utilize this new type of information (Kornai, 1994, 47). As long as state enterprises were bidding for scarce resources with soft budget constraints, no meaningful equilibrium could exist, and their unconstrained bidding caused the price level to increase indefinitely. Indeed, that was a "shock without therapy" (Kolodko, 1999a, 33); thus "prices should not be liberalized on their own" (Csaba, 1995, 71) until the consumer goods market was satiated at the controlled prices (Alexeev, 1991, 381). Thus price liberalization would not be sufficient to develop competitive markets (Fischer and Gelb, 1991, 97).

Based on the gradualist approach, the transition government retained some "relaxed" price controls (Feltenstein, 1994, 218) while permitting the remaining prices to be freely market-determined. Despite the subsequent surpluses and shortages this was a characteristic of every market economy (Kornai, 1983, 158). During the period of price stability, the interest rate had to be controlled to achieve real financial growth without undue risk of major financial panic and collapse (McKinnon, 1993, 31, 41, 91; Fischer and Gelb, 1991, 103). Importantly, while neoclassical economists highlighted the urgent need to reduce inflation, neoclassical gradualist economists were willing to trade off inflation to reduce social hardship, especially in terms of unemployment.

To avoid the massive closure of firms and a substantial rise in unemployment, Kornai (1992b, 10) was prepared to give inefficient enterprises a last opportunity to adjust to the developing market conditions by offering them a one-time, temporary subsidy. In December 1991, consistent implicitly with Kornai, the Romanian Parliament directed the central bank to provide the equivalent of

US$1.35 billion in the form of six-month credits to all enterprises at a nominal interest rate of 28 percent. This did not comply with the IMF, and Romania lost the remaining 58 million SDRs (Poirot, 1996, 1068). In the end, however, Kornai (1992b, 10) was reluctant to recommend the temporary subsidy: "There remains the danger that all the phenomena that emerged in connection with the soft budget constraint may arise here as well."

A negative corollary of gradual liberalization of prices stressed by the shock therapy supporters was that skeptical producers would probably hoard goods in anticipation of higher prices. However, Feltenstein (1994) argued that the gradualist approach would result in higher welfare outcome, if the controlled-price sector had decreasing returns to scale in production. Kornai (1993a, 182; 1994, 45) stressed that the transformational recession process was not a recession in the Keynesian sense because it was not due to inadequate aggregate demand. In some sectors in transition economies, demand for output was reduced substantially, while in others demand for output either remained the same or even increased. Industries for which demand increased included personal computers, electronics, modern information systems, and telecommunications (Kornai, 1994, 45). Under these circumstances, firms had responded by not substantially reducing employment, thus reducing somewhat the negative effects of the reduction in the declining aggregate demand sectors (Blanchard et al., 1992, 19-22). The recession displayed the Schumpetarian characteristics of "creative destruction," dismissing the arguments that aggregate demand decline or excessively tight credit was responsible for the output reduction and promoting an end to unspent purchasing power, the monetary overhang (Berg, 1994, 400; Kornai, 1993a, 189).

The removal of any controls on prices would have resulted in the closure of inefficient firms and production decline whether in Poland, under shock therapy, or in Hungary, where the transition had been gradual (Kornai, 1993a, 182). This was because "reform leads initially to disorganization and that disorganization explains some drop in output" (Blanchard, 1996, 117). Very few economists predicted this large-scale decline in production, because it was "a complex, compound phenomenon that requires a multi-causal explanation" (Kornai, 1993a, 184). However, restructuring of production, technical innovation, and the development of new products was the outcome of the destruction of inefficient enterprises. "This cleansing is essential for the development" of the economy (Kornai, 1992a, 8).

Inflation was "the constant public enemy number one of the transforming countries" (Csaba, 1995, 69). However, in Hungary, due to the gradualist approach, there was no hyperinflation to halt (Csaba, 1995, 195). Kornai (1996,

2; 1995e, 149; 1993b, 323) argued that increasing unemployment could reduce inflation and increase efficiency. Improvement in efficiency required the rejection of full employment and job security and the wearing down of the social security provided freely by the enterprise (Kornai, 1995d, 141, 149). However, it would have been ill-advised "to impose an urgent and radical curb on inflation at the expense of all other tasks" (Kornai, 1997a, 213). Labor is not easily retired or kept idle at low cost. High unemployment imposed serious financial burdens on the state and, indirectly, on the whole economy. Even more important, unemployment created social dissatisfaction, which posed the most immediate threat to the maintenance of the whole reform program (Frydman, Rapaczynski, and Turkewitz, 1997, 63; Csaba, 1995, 7). An extended recession was expected, resulting in several years of high unemployment, which, without state intervention, would only go higher (Kornai, 1997a, 201; 1995e, 216).

While the objective should have been market-determined wages, it was in the interest of society in the transition phase to maintain some control over wages and try to avoid the wage-price spiral (Kornai, 1993a, 211). This was because inflation is a dynamic process; it is generated and sustained by price and wage increases (Kornai and Daniel, 1986, 302). Deregulating wages in an environment of weak profit motive, soft budget constraint, and unemployment would not have helped the transition process (Kornai, 1986, 1714). Also, wage increases should not be fuelled by rises in the price of imports due to devaluation (Kornai, 1995c, 235). The government had to set guidelines for the determination of wages strengthened by tax incentives: a wage and incomes policy (Kornai, 1996, 9; Fischer and Gelb, 1991, 98; Nuti, 1991, 172). Progressive taxation above the predetermined norm would act as a disincentive to excessive wage increases (Fisher and Frenkel, 1992, 38; Kolodko, 1999a, 34); partial indexation of wages, not automatic, would maintain industrial peace and reduce inflation (Bim, 1992, 185; Kornai, 1996, 1; Fischer and Gelb, 1991, 103). It was a transitional measure that could speed up the reform process (Kornai, 1997a, 25). Supporters of shock therapy agreed with these views. The state should ensure minimum wages for workers and a minimum income for those unable to work, combining a hard anti-inflationary policy and social justice. "A more generous approach would signify a lack of understanding of the requirements of a stabilisation policy" (Bim, 1992, 185). The ultimate goal should be economic growth, and "those who preach social sensitivity while neglecting the main problem—growth—are ducking the issue" (Kornai, 1996, 33).

The development of market relations in Russia and Eastern Europe was "path-dependent," like most economic phenomena (Nelson, 1995, 51; Furubotn, 2000, 121). The role of the state in economic policy was among the most debated

theoretical and practical aspects of the transition (Kornai, 1994, 62; Gustafson, 1999, 194). The state sector was too big to be "left alone," while the private sector was growing and was "likely to become a political and economic time bomb that would undermine the whole reform process" (Frydman, Rapaczynski, and Turkewitz, 1997, 83). During the transition period the economy was like "no man's land" (Kornai, 1994, 47), and it was the responsibility of the government to exert some influence by encouraging and promoting growth, creating the macroeconomic, institutional, and legal conditions that favor the growth of output. But, as Kornai (1995b, 26-27) stated, the government does not "start up" growth, it only influences growth.

According to Kornai, "there is no chance of determining theoretically, once and for all, the optimum degree of state activity" (1994, 62). In the transition process the government had shared responsibility in the development of the market economy. "Honeymoons end, and so does the opportunity to blame hard times on the old system" (Nelson, 1994, 54). During the transition recession, managers did not cut costs but increased interenterprise credit, failed to pay taxes or repay loans to state banks, and mobilized their economic power for political purposes. Under the circumstances, they reduced the state's role to a minimum and doing nothing was unacceptable (Kornai, 1995c, 238; 1993a, 224; Bratkowski, 1993, 5). "It does not help much to say that if the government sticks to its guns, the economic agents will have to change their behavior" (Frydman, Rapaczynski and Turkewitz, 1997, 45).

The role of the state in the transition economies was twofold and essential (Kornai, 1993a, 224; 1992a, 16; Krueger, 1992, 220; Csaba, 1995, 299; Olson and Kahkonen, 2000, 4). On the one hand, state activity was determined according to the neoclassical free market concept: developing, implementing, and enforcing the market rule and only acting with regard to market failure. On the other hand, state activity, beyond the traditional notion of the state, was determined by the idiosyncrasies of the transition process. The state had to initiate and actively assist in the development of the new institutions required by a market economy, the establishment of certain new organizations and abolition of others, and the transformation of property relations.

In the meantime, there was government failure as well market failure. The consequences of government failure are often more harmful than what can occur from voluntary interaction in a market, however imperfect the market (Olson and Kahkonen, 2000, 35). However, the transition process involved a protracted and increasing social cost, that could not be reduced without state intervention;

and if the results were disappointing, confidence in the government and in the transition process would erode (Kornai, 1993a, 224; Kolodko, 1993, 8; Nelson, 1994, 54; Bim, 1992, 181; Abel and Bonin, 1993, 340).

In contrast to the shock therapy model, and due to the gradualist nature of reforms, an activist-strong state was extremely important (Gustafson, 1999, 34; Van Brabant, 1993, 79). This activist-strong state was a strong but democratically controlled state. As the experience of Ukraine, Romania, and Russia demonstrated, a weak government was not in a position to bring about stabilization (Csaba, 1995, 83). Meanwhile, it should be remembered that in the public mind, "socialism and serfdom go hand in hand" (Carrington, 1992, 23), and "people are irritated by the state interfering in their private lives and harassing individuals" (Kornai, 1992a, 16); thus a minimal state should be the ultimate goal (Gustafson, 1999, 213). The political authorities and the citizens must ensure, through a democratic process, that attempts to return to centralism and bureaucratic decision-making were neutralized.

Once the transition was completed, state intervention in the economy would not be necessary. As markets developed and the pace of reforms—institutional, structural, and financial—gained momentum, the role of the state would be reduced and with it any remaining discretionary power. Csaba (1995, 89) and Abel and Bonin (1993, 230) found it strange that the state would "wither away" and function as a "minimum state"—implementing only the rules—in the tradition of Hayek and Friedman.

## Privatization

A competitive market capitalist system requires the dominance of private property (Kornai, 2000, 30; Hare, 1991, 197) because "there cannot be capitalism without capitalists" (Gustafson, 1999, 26) and "common property is nobody's property" (Carrington, 1992, 23). However, the efficiency virtues associated with privatization—the main instrument for overcoming the recession and stimulating growth and employment—was "a simplified misconception of the real relationship" (Kornai, 1994, 50), and policies were aimed at artificially accelerating the privatization process (Csaba, 1995, 168). Both privatization and liberalization were simply instruments of economic policy, not targets, and privatization of state enterprises was very painful (Boycko, Shleifer, and Vishny, 1993, 172; Kolodko, 1999b, 245). Politicians would not easily relinquish their control of state enterprises and monopolies used their supernormal profits to retain their status through political pressure and bribery of officials thus threatening the reforms (Vasiliev, 1997, 37). Meanwhile, "state-owned enterprises

have become dependent on the paternalist helping hand of the state and the constant availability of a bail-out, just as many weaker-willed individuals become addicted to the relief of smoking, alcohol, or drugs" (Kornai, 1995d, 148).

Despite the obstacles to privatization imposed by politicians, a new set of problems arose associated with management and workers' control. While management control was preferable to political control, since management and workers would be interested in restructuring the enterprise, there was a need for ownership to be supplemented with outside oversight to ensure that restructuring actually took place. In time, shareholders would have become an important source of financial capital. The real objective of ownership reform of state enterprises was to change the structure of political power of the various interest groups, so that the process of retiring the state sector did not destroy the remaining reforms. Even if the viability of some of the privatized firms was relatively short-lived, the resulting removal of political power would stimulate the development of new private firms (Frydman, Rapaczynski, and Turkewitz, 1997, 85–86).

Based on the gradualist approach, growth would have resulted from the development of new enterprises in the short term (Slay, 2000, 68). In the long run, growth would have resulted from privatization of state enterprises and the enforcement of a hard budget constraint. In contrast, supporters of shock therapy argued that growth in the short run would be the result of privatization. These economists were "stuck on the theme that one is to create the new economy by privatising the old" (Leijonhufvud, 1993, 124). Immediate privatization resulted in a reduction in output, increased unemployment, and a reduction in aggregate demand, and considerations of growth were not given due attention; there was a negative relationship between the speed of privatization and economic performance (Kornai, 1996, 37; Murrell, 1992, 80). By implementing a gradualist approach to privatization, it was the responsibility of the government to ensure that an appropriate balance was achieved between short-term, antirecessionary goals and long-term growth goals (Kornai, 1994, 50). Consequently, the immediate privatization of state enterprises was not necessary, since theoretical and empirical evidence indicated that rapid privatization was clearly utopian and misplaced in the transition process (Csaba, 1995, 92, 135; Berg, 1994, 388-89, 394; McKinnon, 1991, 115; 1992a, 33; 1992b, 105). The gradual process of transition required not only slow privatization, but more importantly, its postponement. The gradualist neoclassical economists favored "deferred privatization," and even though Kornai (1992c, 174) argued that he was a "believer in the process of privatization proceeding as fast as possible," he did not think it could be "accelerated by some artful trick."

Privatization and the establishment of legal institutions cannot be part of shock therapy policies because they cannot be achieved in a short period (Woo, 1994, 277; Kolodko, 1998, 25; Rana, 1995, 18; Anderson, Lee and Murrell, 2000, 527; Litwack, 1991, 84). The speed of privatization is determined by institutional factors (Laki, 1993, 451). "In fact, the simple-minded notion that 'privatization' is all that is required to set faltering and failed economies on the path to growth is a travesty of institutional reasoning that reflects the primitive understanding of most economists about the nature of institutions" (North, 1997, 12). Successful privatization and the development of market infrastructure must be nurtured from small beginnings, in which a sorting process eventually identifies viable enterprises (McKinnon, 1993, 148; 1995c, 60; Vasiliev, 1997, 37). Consequently, "the resulting spontaneous order is best grown from the bottom up" (McKinnon, 1992a, 35).

The interests of society would not have been served by immediate privatization, since the tax agency would not be efficient in collecting tax revenue. Gradualists were in favor of the restructuring and corporatization of state enterprises first and privatization later (Thomas and Wang, 1997, 234; Fischer and Gelb, 1991, 98; Roland, 1994a, 1165). The experience of the transition economies revealed that terminating soft budget constraints and liberalizing prices, foreign trade, and commercial activity encouraged enterprise restructuring independently of ownership (Slay, 2000, 68; Szekely and Newbery, 1993, 7). Thus the "ownership structure and the modus operandi cannot be changed overnight by legislative 'gunpowder'" (McKinnon, 1992a, 35). In fact, privatization of any variety was a political issue, which resulted in renationalization and the deferment of privatization (Kornai, 1992c, 156; Roland, 1994a, 1158). Consequently, in a democratic society neither the sequencing nor the speed of privatization could be planned (Mihalyi, 1993, 109) since it determined "who will eventually get to the sunny or the shady side of this evolving capitalist paradise" (Jarai, 1993, 78).

Privatization should be a pluralistic process and thus analogous to the political process because it is in the interest of society to involve a large number of differently motivated people. There should be open consultation and debate (Nuti, 1991, 170) involving all interested parties: local governments, management, and workers. A gradual, pluralistic privatization process would have facilitated a transformation of public administration through decentralization to strengthen local governments. Reformists had to confront the risk of losing control of the enterprise to management and the risk of increased unemployment, both of which

hinder the privatization and the restructuring of the enterprise. However, independently of the method of privatization, the aim should be to give the strongest incentive to efficient production (Kornai, 1992c, 159).

Kornai (1990, 83) argued that the transformation of state property into private property could only take place by auctioning state enterprises and selling them to the highest bidder; this could help increase state revenue (Kornai, 1992c, 156; Hare, 1991, 199; Roe, 1991, 24). The Hungarian government agreed with Kornai that privatization had to result in "real owners" or "strong owners" rather than artificial recipients of state assets (Frydman, Rapaczynski, and Turkewitz, 1997, 87; Samonis and Hunyadi, 1993, 31; Mihalyi, 1993, 90, 106). Privatization revenues had to fund the budget deficit and reduce the public debt. By 1989, foreign debt was US$1873 per capita and the net interest-to-exports ratio was 26 percent; Hungary had become the country with the highest per capita foreign debt (Oblath, 1993, 193; Abel and Bonin, 1993, 338). By the end of 1995 privatization had yielded substantial revenue, amounting to US$7427 million. This was considered a major advantage of the sales strategy over free distribution of shares (Kornai, 1997a, 157, 159).

Kornai (1992c, 157) did not show any enthusiasm for compensating the original owners of state enterprises. In Hungary, original owners were eligible for compensation vouchers (Samonis and Hunyadi, 1993, 35-36; Mihalyi, 1993, 92). Due to the auctioning of state enterprises, all individuals would have the opportunity to become owners at real market prices. The frequent argument against privatization by sale was that the accumulated public savings were too small to buy the state enterprises. Experience revealed that this was not the real bottleneck in the privatization process (Kornai, 1997a, 159). The deferment of privatization allowed the development of a domestic entrepreneurial class with proved managerial expertise to accumulate sufficient capital to buy state-owned industrial assets (McKinnon, 1992b, 105).

Foreigners would also have the ability to participate so long as some guidelines were imposed to protect the nation's interest. The national policy, however, should not be based on isolationism or xenophobia. The government had to regulate the participation of foreigners. Through the privatization process, property should remain "in national hands, because they are indispensable to sovereignty" (Kornai, 1992c, 174). In other words, "capitalism should strike root primarily in domestic soil" (Kornai, 1992c, 174) so as to foster the development of domestic entrepreneurs (McKinnon, 1991, 115). In Hungary, foreigners dominated the purchase of state assets. In 1991, 85 percent of the 40.1 billion forint in privatization revenue came from foreign investors (Samonis and Hunyadi, 1993, 38; Jarai, 1993, 80).

There was no problem associated with the managers of the state enterprises who were capable of buying the firm—spontaneous privatization—as long as it was done legally (Kornai, 1992c, 163). However, most of the new owners were from the old economic elite of the Communist Party (Kornai, 1997a, 152). Kornai (1999, 166) was not concerned about who owned the newly privatized enterprises. He was more interested in changes in the new owners' behavior associated with the introduction of market relations; he thought the owners would be motivated to earn profits by improving the value of their firms instead of satisfying the requirements of the central committee. Kornai (1999, 166) was satisfied they would be able to facilitate transition provided they behaved in accordance with market decisions. Thus issues of fairness and equality of the privatization program should not have been a concern (Kornai, 1992c, 158). In Hungary, the government initially opposed "spontaneous privatization" but eventually realized that it was the best solution to the problems of privatization. It consequently adopted spontaneous privatization, but under the guise of "enterprise–initiated" privatization or "self–privatization" (Mihalyi, 1993, 104; Laki, 1993, 445).

The neoclassical gradualists had a two-track approach to privatization, with a fast track for small and medium-sized, state-owned enterprises and a slower track for large state enterprises (Woo, 1997, 313; Frydman, Rapaczynski, and Turkewitz, 1997, 96; Anderson, Lee, and Murrell, 2000, 547; Murrell, 1992, 80; Roland, 1994a, 1164). Small and medium-sized enterprises could be privatized immediately; because they were flexible, the exercise would be substantially less time-consuming and did not involve large financial resources. At the same time it would produce favorable externalities to the wider economy; a large number of individuals would be involved and display the pluralistic character of the privatization process. This would help confirm and promote the benefits associated with privatization, that is, improving income and efficiency. Kornai (1992c, 163) advocated credit and tax concessions to support peasants in private farms, private small-scale industry, and trading and small businesses. The development of small- and middle-sized firms would also facilitate the growth of a middle class, essential to the creation of capitalism (Kornai, 1992c, 163; 1995e, 75). "After all, private enterprise, especially on a small scale, needs nurturing and manifold support if it is to become a credible competitor to large firms" (Csaba, 1995, 117).

During the transition process, state-owned enterprises with soft budget constraints would have co-existed with liberalized enterprises with hard budget constraints. State enterprises would have remained subject to price controls and to state material allocations for some inputs and credits. Such enterprises would have been involved in energy-producing and other resource-incentive activities

rather than give enterprises free of charge to workers (Kornai, 1992c, 164). There was no justification for distribution of free gifts beyond the discount price of share purchases by employees and the distribution of property to pension funds and nonprofit organizations (Kornai, 1992c, 173).

In conclusion, the neoclassical gradualist economists did not favor immediate privatization in the transition process. There was a "real economic cost" (Murrell and Wang, 1993, 387) associated with immediate privatization. Ironically, large state enterprises had to be renationalized before they could be privatized, and even then the gradual neoclassical approach was not gradual (Stark, 1990, 366). The democratically elected government had initially to gain control of state enterprises and make managers accountable before privatization. Instead of a gradual process of privatization, enterprises were put up for auction. Hence, the gradualist privatization process was more a "deferred big bang privatization" process. The only difference between the gradualists and shock therapy supporters was the timing of privatization, not the speed.

**Institutional Structure**

A proper institutional structure was "the Achilles heel" (Svejnar, 1991, 134) of transition, because "institutions matter" (Bardhan, 2000, 245). Private property and the building of institutions are fundamental to a free market (Kolodko, 2000, 274; 1999b, 249; Wagener, 2000, 129). While macroeconomic stability was a necessary, not a sufficient, condition for transition to a market economy, institutions were necessary and sufficient (Szekely and Newbery, 1993, 5). A credible transition process can only be achieved by getting the institution "right" in terms of a structure that can direct and channel economic activity to achieve sustainable and equitable long-term growth (Poirot, 1996, 1059, Williamson, 2000, 92). The evolutionary paradigm of institutional development was also used to justify a gradualist approach to reform (Smyth, 1998, 383; Kolodko, 1999b, 234), because "the resulting spontaneous order can indeed spread rapidly" (McKinnon, 1992a, 35). As Coase (1992, 714) advised: "The value of including such institutional factors in the corpus of mainstream economics is made clear by recent events in Eastern Europe. These ex–communist countries are advised to move to a market economy, and their leaders to do so, but without the appropriate institutions no market economy of any significance is possible. If we knew more about our own economy, we would be in a better position to advise them."

or in infrastructure activities such as the construction and maintenance of roads, irrigation, and socially sensitive industries (McKinnon, 1995c, 60-61; 1991, 115). The crucial issue during this period would not have been how to privatize these companies, but how to operate and restructure them while they remained state owned (Rowthorn, 1993, 345). Under the abnormal conditions of transition, Anderson, Lee, and Murrell (2000, 529) found that restructuring of state enterprises in Mongolia, for example, resulted in significantly higher productivity than private ownership. While the privatization of state enterprises was a necessary condition for economic progress it was not sufficient. The number of companies sold could not be a measure of the actual progress of transition (Csaba, 1995, 104).

Inefficient firms that could not be restructured were only valuable in terms of their assets. Creative destruction required a competitive market, not privatization. The average growth rate of the state sector was reduced by removing cheap credit and subsidies, introducing financial discipline, and eliminating inefficient operations. The success of capitalist market economies was based on the introduction of innovative ideas. The advantage of dynamic competition was the incentive to discover and correct earlier entrepreneurial errors (Kirzner, 1998, 44). The economic conditions of the transition economies were quite appropriate for entrepreneurial discovery, which occurs in a world of disequilibrium. In order for firms to play the role associated with creative destruction, in overcoming the transitional depression and stimulating recovery and fast growth, specific systematic and policy conditions had to be satisfied (Kolodko, 2000, 273). However, creative destruction in transition economies remained destruction without enough creation, due to the shock therapy approach (Kolodko, 1999b, 240). "Profits are thereby 'privatized', while losses are 'socialised' in a politically unsustainable process full of negative consequences for the budget and for social policy" (Kolodko, 2000, 290).

The gradualist economists did not favor the privatization of state enterprises through the free distribution of vouchers or through financial intermediaries (Kornai, 1992c, 162; 1995e, 74; Csaba, 1995, 17; Szekely and Newbery, 1993, 8; Murrell, 1992, 92; Hare, 1991, 199). Kornai considered it curious "to turn all citizens into shareholders overnight by a free distribution of shares" (Kornai, 1992c, 172). With shares distributed so widely, the monitoring problem was not solved and hardly influenced actual changes of ownership (Csaba, 1995, 173; Anderson, Lee, and Murrell, 2000, 545). In Hungary, officials contemptuously dismissed free distribution schemes as dangerous experiments, incapable of producing "real owners" (Frydman, Rapaczynski, and Turkewitz, 1997, 95; Samonis and Hunyadi, 1993, 31). It would be wiser to offer shares to employees

Neoclassical gradualist economists interpret institutions as rules: they prescribe, ban, and permit. As such, they direct a feasible set of possible actions, (North, 1997, 1) and help explain choice behavior, including the choice of institutions (Caporaso and Levine, 1992, 156). Effective institutions, consistent with competitive outcomes and the social customs reinforce habits of trust, and people expect compliance as the norm (Gustafson, 1999, 165; Olson and Kahkonen, 2000, 32; Moore, 1994, 818). Neoclassical gradualist economists realized that the overall institutional environment greatly restricted the options available to policymakers.

Neoclassical gradualist economists accepted Coase's theorem that clear property rights, preferably private property rights, were essential for a well-functioning market economy in Russia and Eastern Europe. For market capitalism to consolidate and function efficiently, it was imperative that the institutional structure protect private property, enforce contracts, impose financial discipline, and generally create a stable legal environment (Kornai, 2000, 32; 1995e, 73; Murrell, 1991b, 5; Litwack, 1991, 77; Svejnar, 1991, 128; Hare, 1991, 197; Poirot, 1996, 1057; Kolodko, 1999b, 235). By definition, economic justice means nothing more than respect for private property, and only free market outcomes are just (Caporaso and Levine, 1992, 204). Having market-oriented institutions in place while old institutions were torn down was crucial for reforms to be effective (Thomas and Wang, 1997, 218). Institutional changes would be apparently initiated by the market process, albeit slowly (Vasiliev, 1997, 37).

Neoclassical gradualist economists argued that the transition to a market economy had to be facilitated by an institutional structure, the development of which had to be gradual, natural, organic, and voluntary as opposed to the constructivist, state-directed establishment of institutions (Kolodko, 2000, 274; Kornai, 1992c, 160; 1995e, 62; 1997a, 97; Slay, 1993, 238-39; Csaba, 1995, 101; Gustafson, 1999, 153; Murrell, 1992, 80). A gradual process allowed time to clarify the institutional principles and to test institutional adjustment. Institutional development was a complex evolutionary process, causing ineffective institutions to wither away and choosing as survivors the ones truly fit for the task (Kornai, 1992c, 160; 1995e, 26-27; Nelson, 1995, 78, 82). Market-supporting institutions aimed to make the transition more effective and harder to reverse. Due to the importance of small and medium enterprises in producing the externalities already mentioned, it was essential that the appropriate institutional structure, that is, the legislative and regulatory framework and proper organization, be in place to facilitate their development (Kolodko, 2000, 283, 284).

The development of market institutions takes time, which is one reason why the transition recession in Eastern Europe was persistent. Appropriate government initiatives would have hastened the development and helped reduce the length of the recession. The institution of private property cannot exist without government (Olson, 2000, 131), but recent history has demonstrated that transition governments have "committed many sins of omission in this respect" (Kornai, 1993a, 200; 1994, 49). The collapse of centrally administered socialism did not leave society in an institutional vacuum. Practices and habits, informal arrangements, organizational structures, and social norms were slowly transformed into the basis for the establishment of credible commitments; people would rationally adopt the new conventions as they emerged (Olson and Kahkonen, 2000, 28). The existing institutional structure, even though contradictory and segmented, provided the basis for "rebuilding organizations and institutions not on the ruins but with the ruins of communism as they [economic actors] redeploy available resources in response to their immediate practical dilemmas" (Stark, 1996, 995). Change, even revolutionary change such as the transition process, was the result of adjusting to the new uncertainties by adapting the practised norms to the new economic conditions (Murrell, 1992, 82, 84). This new institutional structure "is not replacement but recombination" (Stark, 1996, 995).

The shock therapy approach to institutional development was vague, inconsistent, and toothless (Anderson, Lee, and Murrell, 2000, 527). "Instant people's capitalism" was not possible and was distinctly "un-Hayekian" since spontaneous markets based on common law best evolved from existing commercial practices (McKinnon, 1992a, 35). The failure of transition economies to stimulate growth after the implementation of shock therapy under the guidance of the IMF, World Bank, and the mature market economies was attributed to neglect of the institutional structure and the destruction of existing arrangements and information processes. While institutions change slowly, they have a strong influence on economic performance and stabilization (Poirot, 1996, 1059; Kolodko, 1999b, 239; Murrell and Wang, 1993, 387; Murrell and Olson, 1991, 244; Blankenagel, 2000, 117).

Governments play an important role in supporting the ever-changing market with the appropriate institutional structure (McKinnon, 1992a, 32; Kolodko, 1999b, 248; Murrell, 1991b, 5). Otherwise "trade relations are destroyed by the absence of market institutions" (Kornai, 1994, 47) and "laissez faire is not optimal" (Thomas and Wang, 1997, 218). Essentially, the success of privatization depended on how quickly the market's legal framework and supervisory institutions developed, how rapidly the bankruptcy proceedings and liquidation

processes were put in place, and how reliable was the free transfer of property rights (Kornai, 1992c, 171; 1995e, 147; McKinnon, 1995c, 69). Institutional change was imperative to divorce tax collection by various levels of government from the ownership of firms (McKinnon, 1995c, 53).

A country's ability in developing market institutions depended not only on its initial endowments and conditions, but also on its way of learning (Thomas and Wang, 1997, 222). There was a need for reeducation and a new public morality (Kornai, 1995e, 73, 76). The transition economies, which relied on the spontaneous appearance of the necessary institutional structure without any government assitance, were unable to manage the transition process adequately (Kolodko, 2000, 289). Nevertheless, governments should not be expected to replace the spontaneous, decentralized, organic growth of institutions, because social arrangements are often more powerful than government in establishing the rules, and fewer rules usually have advantages over more regulations (Williamson, 2000, 107; Kornai, 1992c, 160; Murrell, 1994, 205).

The East Asian crisis demonstrated that even when fundamentals are achieved—such as a balanced budget and current account, low inflation and stable currency, liberalized trade and a vast private sector—growth cannot be sustained without the appropriate institutional structure to safeguard the economic fundamentals (Kolodko, 1999b, 240). Russia suffered the negative experience of liberalization without the existence of an institutional structure whereby instability and free choice created an environment where illegal and criminal activities became acceptable (Kolodko, 2000, 283).

The implementation of shock therapy without any institutional fundamentals in place resulted in "bandit capitalism" in the transition economies (Kolodko, 1999b, 249). The rise of criminal activity and Mafia methods of imposing financial discipline was "alarming and intolerable" (Kornai, 1995e, 153; 1993b, 327). It could partly be explained by the harmful side effects of a healthy process, namely the abolition of the police state. It would have taken some time to develop the necessary legal infrastructure for property and contract rights to become secure in the long run (Kornai, 1992a, 6; Sarkozy, 1993, 244; Olson and Kahkonen, 2000, 19; Blankenagel, 2000, 100). At the same time, the establishment of democracy and markets "opened the curtains and made crime more visible." It revealed an unexpected amount of official corruption and Mafia–style crime, which was not compatible with the market economies (Olson, 1995, 438, 457). The increase in crime was the result of weak institutional arrangements (Kolodko, 1999a, 33; Blankenagel, 2000, 115). According to a recent World Bank study, half the Russian economy is now in the hands of the Mafia (Kingston-Mann, 1999, 35).

It is necessary to eliminate restrictions on, and/or harassment of, private enterprise, otherwise this will "only push some people deeper into illegality and discourage others from enterprise altogether" (Kornai, 1992a, 13). Private enterprises would change their behavior and follow the road of legality if the legal structure offered protection for property and guaranteed contracts (Csaba, 1995, 131). All necessary incentives should be used to encourage a law-abiding and tax-paying enterprise, including a carrot-and-stick approach. The faster the institutional development process, the better the environment for doing business and hence for growth (Kolodko, 1999b, 251). "A system where 'only the stupid pay taxes', the contracts are not executed as agreed, or the payments are not made on time, is hardly a market economy. It is rather chaos stemming from institutional disintegration" (Kolodko, 1999b, 249). Mature market economies have demonstrated that individual self-interest based on "buyers beware" and firms with clearly delineated property rights will foster crime prevention, lawful behaviour, and law enforcement, and governments have not had to pour financial resources into combating fraud (Olson, 1995). Consequently, the creation and advancement of a legal framework for the market economy should be much higher on the agenda of international financial organizations. Once in place, it would provide a secure base for growth through liberalization and privatization (Kolodko, 1999b, 257).

In summary, the development of the institutional structure in the shock therapy and gradualist neoclassical processes appear to be quite similar. However, it is my view that while both argued that market institutions can only result from market forces, gradualist neoclassical economists allow institutions to develop concurrently with market relations. In shock therapy, the goal was the development of market relations first with the assumption that the institutions would follow. Both approaches suffered the same flaws. Gradualist neoclassical writings failed to offer a concrete process of institutional development. They simply left the end-state to be determined by the market, assuming that the most efficient institutions would emerge. The gradualist neoclassical break with shock therapy was far less complete than it appeared to be (Smyth, 1998, 387).

**Monetary Policy and the Financial System**

The imposition of hard budget constraints on enterprises, in the context of macroeconomic stabilization, was the driving force of adjustment. Monetary policy was the fundamental lever in achieving monetary stability, a necessary condition for growth (Csaba, 1995, 201; Leijonhufvud and Ruhl, 1997, 344). The soft budget constraint resulted in inefficiency, breakdown of consumer

sovereignty, and distorted investment decisions. Thus reform of the financial system had to be a high priority (Calvo and Frenkel, 1991, 147). The lack of substantial progress in institutional reforms, particularly in privatization and the financial sector, had not prevented major structural adjustment and efficiency gains as a result of hard budget constraints (Berg, 1994, 401; Kornai, 1995d, 140, 1995e, 146; 1993b, 320). Meanwhile, as with all the elements of the transition program, monetary stability could only evolve gradually, as for example in Hungary (Kornai, 1997a, 13; 1993b, 332; Csaba, 1995, 15).

The governments in transition economies should not have been pressured to provide cheap credits and subsidies and to finance investment projects. Firms had to learn that a bank was not an institution for distributing money on orders from above or friendly recommendations from politicians. Firms had to follow the rules of financial discipline strictly (Kornai, 1993a, 203). There had to be credibility with respect to a "no bail-out" commitment (Kornai, 1993b, 324). Kornai (1995e, 156; 1993b, 330) compared the behavior of firms with that of animals and stated that: "Observations of animals provide firm evidence that habits acquired in the initial, particularly sensitive stage of life have an extremely strong influence. They become impressed deeply and almost irreversibly in the memory, and prompt the animal concerned to repeat the experience."

While hard budget constraints would have resulted in unemployment (Berg, 1994, 393), Kornai (1992a, 10) was convinced that it was better to accept this problem openly than to artificially sustain terminally ill firms. The imposition of the hard budget constraint was essentially a political issue, and it required a broad social consensus, public support, and a credible government that would not bend to pressure (Kornai, 1995e, 76, 147; 1993b, 332). This could only be achieved by the establishment of an independent central bank (Varhegyi, 1993, 151; Calvo and Frenkel, 1991, 144: Roe, 1991, 13; Nuti, 1991, 166).

Kornai (1995e, 150; 1993b, 324) used the following analogy to describe political pressure to soften the budget constraint: "Let me recall at this point the story of Ulysses and the Sirens. The bewitching voices of the Sirens would entice sailors towards them into shipwreck and destruction. When Ulysses' ship approached the Sirens island, he blocked his men's ears with wax and told them to tie him to the mast, so that he could not yield to the temptation. The more he begged them to release him, the tighter they were to tie his bonds."

The neoclassical gradualist economists argued that premature attempts to transform the banking system would worsen the overall situation by losing control of monetary policy. In the 1980s, for example, China, Hungary, the Soviet Union, and Poland undertook premature decentralization of the banking system, which resulted in loss of control over credit and increased inflation (McKinnon, 1993,

7). Institution- building must first be sufficiently advanced, and stabilization consolidated. Only then should financial markets be liberalized in a gradual manner (Kolodko, 2000, 292). Consequently, "consolidation of financial discipline is a lengthy process of evolution that extends over several years" (Kornai, 1995d, 150; 1995e, 159). Partial deregulation of interest rates generally comes first, accompanied or followed by development of commercial banking and nonbank institutions. Development of a securities market takes longer, because it requires further institution-building and the establishment of a legal infrastructure (Thomas and Wang, 1997, 234).

In the short run, successful macroeconomic stabilization in the transition economies would have required a major recentralization of the government's control over money and credit and the elimination of "wildcat banks." Prices had to be recentralised as part of the stabilization package. However, this would have presented an unfortunate policy dilemma. In order to secure macroeconomic stabilization in the short run, important banking and commodity pricing policies had to move counter to the ultimate goal for long-term liberalization. It would have been necessary to reregulate the financial system as well as the state enterprises (Kolodko, 1999b, 236; McKinnon, 1995c, 70; 1995a, 106; Stark, 1990, 376). In the initial stages of liberalization, licensing a mass of new domestic or foreign banks to enable entry into the newly opened domestic capital market would have been a mistake (McKinnon, 1993, 53). The governments should not have had to conform to the monetary rule nor introduce restrictive monetary policy (Kornai, 1995c, 240-41).

The banks were burdened with nonperforming loans. One approach, suggested by Blommenstein and Marrese (1991, 103-05), would have been for the government to "purchase" the banks' bad loans with long-term bonds paying an interest rate. The banks' capital would have grown due to the elimination of bad loans and from income accruing from the government bonds. In contrast, Dittus (1994, 338) and Csaba (1995, 111) argued that "bygones should be treated as bygones." The balance sheets of enterprises showed the same negative scenario. Dittus (1994, 347-48) noted that enterprises in transition economies have paid banks more in interest than they have received in new loans.

In response to changes in bank behavior and the elimination of cheap credit due to the lack of financial capital, firms increased interfirm credits excessively. State enterprises effectively borrowed from each other by not repaying their trade credits. Although ostensibly commercial in nature, this credit was not subject to ordinary commercial constraints, and it became a prime cause of softness in enterprise budget constraints (McKinnon, 1993, 87–89). This was an undesirable phenomenon, according to the neoclassical gradualist view, because the

government lost control of the money supply. The distinction between efficient and inefficient and viable and nonviable firms became blurred, and profitable firms were becoming increasingly exposed to the risk of bankruptcy because of the accumulation of large interfirm credits by unprofitable enterprises. The development of a legal framework to enforce credit obligations and establish ownership was necessary to put an end to excessive interfirm credits. Kornai (1995d, 146) suggested that interfirm credit could be converted into bank credit. However, Dittus (1994, 349) argued that interfirm credits would be stabilized as long as the elimination of the soft budget constraint was permanent. In the transition economies reviewed by Dittus (1994, 349), interfirm credits had stabilized or even declined in 1992.

The reduction of enterprise lending was the result of more prudent behavior by the banks and the constraints and incentives under the new economic and legal environment. The reduction was also the result of the inability of banks to evaluate risks and monitor borrowers (McKinnon, 1993, 53). "Building up those skills will take time" (Dittus, 1994, 359), again necessitating a gradual transition process. Another reason for reduced bank lending was the government's budget deficit. To finance their budget deficits, transition governments issued treasury bills with high interest rates, which were very attractive to banks and individuals (Dittus, 1994, 350). Crowding out took place and reduced lending to enterprises. In addition, the level of uncertainty was unusually high for a market economy (Kornai, 1993a, 104, 210). McKinnon (1993, 53, 139; 1995b, 68; 1991, 118; 1992b, 108) noted that, in the initial stages of the transition to a more open capital market, reliance on self–financing was the preferred and simplest technique for imposing financial restraint on liberalized enterprises.

The introduction of a new hard currency, perhaps fully convertible into foreign exchange, was not considered as a means of controlling domestic money and credit; it was unnecessary and disruptive (McKinnon, 1993, 156; Nuti, 1991, 162, 167). Thus, in the optimum order of financial liberalization the development of ordinary commercial banking had to be deferred until monetary and fiscal control were achieved and the price level stabilized (McKinnon, 1993, 6; 1991, 121; 1992b, 110; Boettke, 1999, 378). The gradual imposition of the hard budget constraint, the reliance on self-finance, the establishment of an independent central bank, and the partial control of the interest rates created the preconditions for the development of a market-based financial system and for interest rates to be liberalized.

## Fiscal Policy

Balancing the budget was a long-term concern for the transition governments (Csaba, 1995, 92, 204), but in order to avoid further inflationary explosions, "effective fiscal reforms must come much earlier in their transitions" (McKinnon, 1995a, 96). While every effort had to be made to reduce the budget deficit—or ideally to produce a surplus (Roe, 1991, 14)—reductions were unlikely in the first years of transition (Kornai, 1992a, 6; Csaba, 1995, 204). It would have been dangerous to reduce the deficit too drastically or too quickly. Rapid and severe cuts in government expenditure would have suddenly reduced aggregate demand and caused deeper recession. As a result, the urgency for growth did not require an immediate reduction in the budget deficit (Kornai, 1995b, 28). However, this did not imply a fiscal stimulus, which entailed an inflationary outcome and crowding out (Kornai, 1995b, 9; Csaba, 1995, 141). There was also a need to restructure government expenditure so that the reduced demand from government consumption would be replaced by investment demand (Kornai, 1993a, 214; 1997a, 204; Csaba, 1995, 113; Szekely and Newbery, 1993, 18).

The timely task of stimulating growth might have been the only way to eliminate the budget deficit (Kornai, 1995b, 9), and it might have required increasing government debt to finance the deficit. Kornai (1995b, 9; 1995c, 243; 1996, 12) did not see this as a problem as long as the loans were used for promoting growth, because they would have created their own resources for repayment. But if they were used unwisely, they would result in deeper recession which taxpayers would have to finance. Surprisingly, Kornai (1996, 36) was willing to stimulate investment projects by providing tax concessions.

A drastic improvement in the transition governments' ability to collect tax revenue was necessary both for macroeconomic stabilization and to support longer-term market-oriented and institutional reforms (McKinnon, 1993, 92; Fischer and Gelb, 1991, 101). While institutions for tracking and collecting personal income taxes in a nondistortionary fashion would have taken some years to put in place, tax reform and systematic changes had to be implemented simultaneously (Koltay, 1993, 268; McKinnon, 1995c, 55). There could not be welfare reform without a profound, considered reform of taxation and vice versa (Kornai, 1997c, 1185). Stabilization required a simple taxation system (Csaba, 1995, 84).

Taxes in transition economies were already high due to the premature welfare state (Kornai, 1996, 16). A broad flat tax or even a poll tax would have been preferable to increasing marginal income tax rates. There would have been no

need for a progressive tax system that penalized those who increased their income and/or savings. With respect to the tax structure neoclassical gradualist economists recommended:

· A linear consumption tax in the form of a value added tax (VAT), which is best suited to enterprise taxation (McKinnon, 1993, 135). There would have had to be some progressive element in differentiated VAT rates to satisfy the requirement of fairness in distribution and meet the criteria for joining the European Union (Koltay, 1993, 262). VAT would be passed on to the consumers, so pressure to exempt loss-making enterprises from the tax would be negligible (McKinnon, 1995c, 56; 1991, 114; 1992b, 105). Successful implementation would require major new administrative bureaucracies to collect the taxes and achieve the necessary political consensus, which was undoubtedly difficult (Csaba, 1995, 103). Nevertheless the reformers had no choice. Such a comprehensive new tax system was simply a necessary condition for reforms to succeed (McKinnon, 1993, 137; Hussain, 1993, 273).

· A single, linear, non-progressive payroll tax.

· A single, linear, non-progressive profits tax. The rate should be the same for all firms.

· If tariffs were needed to cover budget expenditure, they should be kept to a minimum to avoid price distortions. A uniform, linear tariff on all imported goods should be applied.

However, Kornai (1992a, 14) argued that "regrettably, I cannot rule out the possibility of the process being protracted and, thus, plagued with severe fiscal problems caused by loss of budget revenue in the meantime." The transition governments were weak and unable to collect taxes, not because of the legacy from the past, but owing to an ill-advised free market approach and poorly orchestrated deregulation and privatization. It was difficult to bring tax collection under the control of the sovereign state, because of mismanagement of liberalization and the manner in which the institutional redesign took place (Kolodko, 1999b, 250). However, by giving up control of state property, the government in effect gave up its tax base (McKinnon, 1995c, 44; 1991, 110; Hussain, 1993, 273). "Enterprise can no longer so easily serve as cash cows or as vehicles for indirectly taxing households" (McKinnon, 1995c, 44). Privatization should have been postponed until the institutional basis of tax collection had been set up and become operational, bringing government finances under control: "if there is any fiscal gain in privatization, it is in the future rather than immediately" (Csaba, 1995, 115). When tax morality improved and the tax base winded, tax rates could be lowered (Kornai, 1995c, 240).

## International Trade and Foreign Aid

A sustained movement toward free trade was crucial for the successful transition to a market economy, to promote growth of exports, curb the rise in imports, and improve the trade balance and the balance of payments (McKinnon, 1993, 162; Kornai, 1995b, 21). Neoclassical gradualist economists argued that, since the economies in transition had inherited obsolete production methods, participation in international competition was very difficult. While the collapse of COMECON trade had a serious impact, COMECON itself was fraught with problems because it had been influenced by political decisions (Svejnar, 1991, 125; Mizsei, 1993, 44). It was expected that transition economies would have current account deficits, which would have been tolerable temporarily (Kornai, 1993a, 218). There was an argument for maintaining a level of tariffs and transforming quantitative restrictions into tariffs. This would have given firms protection and time to adjust while also providing the government with an income (Kornai, 1997a, 199; Roe, 1991, 15; McKinnon, 1993, 102). Temporary protection for some domestic industries would have had to be determined on the basis of economic rationality, not pressure from lobbies. It would also have had to be in line with the prescriptions of GATT, so that it did not lead to protectionist retaliation by foreign trading partners (Kornai, 1993a, 216; McKinnon, 1993, 184).

Convertibility would have required an appropriate exchange rate, which would have depreciated heavily to adjust to the new economic conditions. The progress toward complete current account convertibility could only be gradual (Abel and Bonin, 1993, 337; Nuti, 1991, 155). A devaluation of the currency would have stimulated exports and reduced imports (Kornai, 1995b, 15). While the positive effects would not have been immediate, gradual devaluation was necessary (Kornai, 1996, 20). Hungary, the prototype of the gradualist strategy, has been successful in its exchange rate policy by avoiding large volatile swings in the real exchange rate (Abel and Bonin, 1993, 339).

International trade would have also contributed to the process of creative destruction (Frydman, Rapaczynski, and Turkewitz, 1997, 61). State enterprises would have required time to adjust to the sudden introduction of foreign trade and prices, otherwise they were likely to collapse. In China, however, state-owned enterprises underwent dramatic changes and are now major international competitors (McKinnon, 1993, 111). It may have been in the interest of transition economies, especially the former republics of the Soviet Union, to have coordinated price liberalization with budgetary and credit reforms.

Williamson (1991, 11–14; 1992, 29–31), Van Brabant (1991b, 63–95), Kregel, Matzner, and Grabher (1992, 102–03), Fisher and Frenkel (1992, 40) and Dornbusch (1993, 107—08) recommended the establishment of a "payments union" between transition economies. An organization similar to the European Payments Union (EPU), which operated from mid-1950 to 1958, was suggested (Eichengreen, Grilli, and Fischer, 1993, 312) because the convertibility of the exchange rate would not otherwise be sustainable due to inelasticity of import and exports demand. Permanent current account deficits would encourage depreciation and detract from international competitiveness due to the inflexibility of wages in the labor market (Eichengreen, Grilli, and Fischer, 1993, 319). During the transition period, most European countries suffered monetary overhangs and repressed inflation. International financial markets were controlled heavily, and currency exchanges were only allowed in exceptional circumstances. If convertibility had been initiated immediately rather than the EPU, European incomes would have been reduced by 1 to 2 percent, which was the same as the contribution made by the United States under the Marshall plan (Eichengreen, Grilli, and Fischer, 1993, 327). This was an all-too-familiar scenario among the transition economies. Through the payments union, transition economies would have been able to establish current account convertibility more rapidly between the member states and with the rest of the world and avoided large depreciation (Williamson, 1992, 30). The payments union would have achieved currency convertibility, intraregional economic collaboration, exploitation of comparative advantage, structural adjustment, and reduction in the social cost of transition, the development of rational trade and prices, and prepared transition economies for participation in international trade. Van Brabant (1991a, 64) argued, "I see such a facility as an indispensable instrument of the reform process."

A payments union is an agreement among the participating trading countries: rather than payment from each other in convertible currency, they accept each others' currencies and credit or debit the trade account imbalances into a clearing account. After a certain period, the clearing account must be settled, and there are usually limits on the level of debit and credit of the account. Through the payments union process, a country that runs a surplus trade account with a transition economy would also provide the funds to finance the deficits of other countries in the form of purchasing exports, foreign investment, or foreign aid. This would enhance export demand as a result of being discriminated in favor of, rather than against (Williamson, 1991, 13). Also, foreign reserves would be available for trade between union members and the rest of the world. Without a payments union the required reserves would be five times higher (Eichengreen, Grilli, and Fischer, 1993, 334; Williamson, 1992, 29–30). The clearing agency

would have the power to enforce the rules when a trade surplus country did not comply. A tax would be imposed by the clearing agency and paid out of the accumulated surplus, forcing the trade surplus country into compliance. In this way, the surplus nations would become responsible for solving persistent current accounts deficits. Once foreign reserves were not in short supply, the payments union would become redundant and the proportion of hard currency in trade would be gradually increased (Williamson, 1992, 30). This would allow current account convertibility to be maintained as well as economizing of hard currency.

The participation of the mature market economies in designing, guaranteeing, and administering the payments union was essential (Kornai, 1992c, 162–63). The European Payments Union required a set of institutions—such as the Organization for European Economic Cooperation and the Bank of International Settlement —with the ability to monitor compliance and impose penalties (Eichengreen, Grilli, and Fischer, 1993, 330). The financial commitment for setting up and maintaining a payments union would have been quite small and would have attracted financial assistance from mature market economies and international organizations. It would not have distorted economic incentives (Van Brabant, 1991a, 91, 94). "It is difficult to think of a more productive form of aid than endowing a capital fund for an Eastern Payments Union that could prevent the collapse of inter-republic trade" (Williamson, 1991, 14). However, the idea was rejected (Williamson, 1991, 12). The international organizations did not permit this idea to flourish, probably because the newly formed republics and Eastern Europe would have depended on trade with Russia for a substantial number of years. Such a union might have provided a mechanism to impose centralization of trade and restrictions on the free movement of financial capital. In addition, the EPU was associated with extended agreements and institutions, which had the short-term goal of economic union, while the long-term goal was political union. Russia and Eastern Europe, encouraged by mature market economies and international organizations, were moving against these links, and the degree of economic and political commonality was rather shallow (Eichengreen, Grilli, and Fischer, 1993, 332; Van Brabant, 1991a, 89; 1993, 96).

The premature elimination of exchange controls on foreign capital flows would have facilitated unwarranted capital flight, increased foreign indebtedness, or both. "Free foreign exchange convertibility on capital account is usually the last stage in the optimal order of economic liberalization as we shall see" (McKinnon, 1993, 10, 117). Without direct government participation, the foreign exchange market was highly illiquid and hopelessly unstable (McKinnon, 1993, 106). There was a lively debate about the advantages and drawbacks of various exchange rate regimes. The regime chosen by Hungary's financial authorities—

the preannounced "crawling peg"—had certain advantages (Kornai, 1995c, 232; Csaba, 1995, 86; Williamson, 1991; Abel and Bonin, 1993, 336; Van Brabant, 1993, 90). It made the intentions of the policymakers clear, maintained commitment, reduced speculation, and also tied the hands of the monetary authorities and reduced their room to manoeuvre.

Kornai (1994, 56; 1993a, 216) was pessimistic about exports as a means of stimulating growth in the short run to assist transition economies out of recession. While in the long run exports were one of the most important sources of growth, especially for small, open economies—export or perish (Kornai, 1993b, 320)—the transition economies had faced unfavorable external conditions, which did not allow them to expand their exports. The mature market economies were affected by recession at the same time the transition process was initiated. The subsequent protectionist measures imposed by mature market economies did not create a favorable environment for international trade (Csaba, 1995, 14; Svejnar, 1991, 128; McKinnon, 1993, 8). WTO membership would have enabled a gradual and feasible liberalization of trade in transition economies and would have contributed to the overall globalization of trade and commerce (Kolodko, 1998, 26).

The mature market economies had to provide assistance in the areas of humanitarian, technical, and financial aid and access to international markets. The role of foreign aid was considerable for the transition economies since it would speed and increase the likelihood of success of transition reforms (Fisher and Frenkel, 1992, 41). "Most less developed countries used foreign resources in the period of shifting from recession or stagnation to growth. I could put this more strongly as well: I do not know if there has been a case of a country accomplishing this shift entirely out of its own resources" (Kornai, 1995b, 30–31). This, of course, was in the interest of mature market economies (Fisher and Frenkel, 1992, 41). Partial debt forgiveness was necessary (Kolodko, 1998, 25; Roe, 1991, 22; Fischer and Gelb, 1991, 104), which was anathema to the IMF and World Bank (Nuti, 1991, 171). The World Bank's technical assistance and long-term project support would remain invaluable, as well as the IMF's role as an international crisis manager on a short-term basis. However, they should not "bribe a country into opening its trade accounts since capital injected at the time makes liberalization much harder to sustain" (McKinnon, 1993, 116–19). Unfortunately, Western aid was not forthcoming, and there was excessive optimism and naïve hope placed in the scale of Western economic aid and its helpful stimulating impact on production (Kolodko, 1993, 16; Blankenagel, 2000,

113). Had the transition economies followed the aforementioned optimum order of liberalization, their need for external capital would had been limited (McKinnon, 1993, 116-19).

## Social Policy

The transition process was expected to improve the standard of living of the people, "otherwise, the exercise would not make much sense" (Kolodko, 1999a, 34). However the first taste of the market process was quite bitter for the majority of the population. For example, Russia's population now is older, poorer, and sicker than in 1991 (Gustafson, 1999, 173, 188; Bratkowski, 1993, 5; Van Brabant, 1993, 76). Inattention to the social safety net was not unusual in transition economies; Russia's budget expenditure on health was less than 1 percent of GNP, and price reform was not accompanied by monetary compensation (Murrell, 1995, 166; Gustafson, 1999, 186; Alexeev, 1991, 388). However, improving the health, environment, skills, and mobility of the population were the keys to economic growth and the ultimate popular acceptance of market reforms (Gustafson, 1999, 191). That was why "nobody, not even an economist with rather strong laissez-faire principles, would go so far as to propose that the state abandon all its welfare functions" (Kornai, 1995b, 10; 1996, 14). A major deterioration of economic and social well-being endangered the transition process (Svejnar, 1991, 137).

Unemployment was unfamiliar to the people of transition economies because they had only encountered full employment and labor shortage. They would tolerate some unemployment but only if it was quite minimal (Kosmarskii, 1992, 34). Nonetheless, if firms were forced to shut down, the social safety net—as effective it was—was also shut down (Boettke, 1999, 375). Creating an unemployment insurance system allowed social protection to be lifted off the shoulders of firms, facilitating restructuring (Fischer and Gelb, 1991, 103). In addition, inequality was increasing due to the economic conditions, offering most opportunities to only a segment of the population. Inequality was unavoidable during the initial years of transition. However, beyond a certain limit, income disparities inhibit the expansion of economic activity, stunt economic growth, and delay recovery; the inequities hamper crucial institutional and structural reforms (Kolodko, 2000, 290). Russia's Gini coefficient doubled in the first six years of transition, reaching the level of the Philippines, reflecting the corruption and crony capitalism that were related to the continuing recession, growing inequality, and spreading poverty (Kolodko, 1999a, 34; Gustafson, 1999, 173).

The existing safety net could not halt the decline, presenting one of the gravest of all the transition problems (Kornai, 1992b, 15). There could not be a shock therapy of the welfare system; there could not be a complete "withdrawal" by the state nor the "demolishing" of the welfare state (Kornai, 1995c, 239). As with most elements of the transition process, welfare reform would have to be gradual, the result of evolutionary change and natural selection, necessitating the maintenance of the budget deficit (Kornai, 1995b, 14). There were "no quick fixes" (Csaba, 1995, 204); welfare reforms had to be tactful and humane (Kornai, 1995c, 239; 1995d, 53; 1997a, 97-98, 238; Kingston–Mann, 1999, 41-2) and introduced with "great patience, compassion, and understanding" (Kornai, 1995c, 240). The aim was to establish sophisticated, reassuring, institutional forms of nonstate voluntary insurance (Kornai, 1997a, 232).

The transition economies had to create a safety net from scratch (Kolodko, 1999b, 240). A key task of the transition process was a radical reform of the pension system, health care, provision for children and the aged, and social assistance (Kornai, 1997a, 339). In mature market economies the demand for economic security is the major motivating force of savings; this type of savings had been stalled due to the paternalistic practices of the previous government (Kornai, 1996, 18). This poses the familiar efficiency versus security argument (Kornai, 1993b, 323). "Support is one thing, but paternalism as a substitute for individual action is quite another" (Kornai, 1997a, 231). Kornai (1996, 15; 1997a, 95) defined social policy in Hungary under the Kaidar regime (1956–89) as a "premature welfare state." Although Hungary was much less developed than the Scandinavian countries, the welfare commitments were greater.

The private sector had to be encouraged to provide welfare services in order to minimize a premature welfare state. It was envisaged that there would be a minimal level of state-funded services provided for everyone, in line with contributions, services available through insurance policies (Kornai, 1992b, 17; 1995e, 77). Individuals would have had a choice among welfare service providers, which in turn would have created competition in terms of prices and quality of service and also decentralization. Surveys in Hungary revealed support for welfare reform because it would encourage the market mechanism and private enterprise in the provision of such services, allowing choice (Kornai, 1997a, 340). Voluntary organizations would oversee the private providers and ensure the high quality of services by imposing the rules. Governments would have to play an active part

as initiators of the reform process (Kornai, 1997a, 342). The welfare system, "after decades of spoon-feeding and subservience to political whims, must . . . bestow greater sovereignty on citizens" (Kornai, 1997c, 1186).

## Process of the Transition

The adoption of a gradual process of transition involved specifying not only the required policies but also the sequence in which the reforms should be introduced, based on the interconnectedness of transition policies. Consequently, a gradual process of transition required at least a rough sketch of possible routes, if not a precise map (Roemer, 1994, 126). This would make the transition more complex, because the modeling process involved a judgement not only about the program of reform, but also about the priority of necessary reforms. Supposedly, the shock therapy approach to transition avoided this problem since all the reforms were introduced at once. The time frame for completion of the transition process was a disputed issue. Mihalyi (1993, 90) argued for three to five years; Abel and Bonin (1993, 330) for twenty years; and Csaba (1995, 88) for twenty to twenty–five years. The schedule adopted in this essay is for a ten-year transition, consistent with Fischer and Gelb (1991) and Fischer and Sahay (2000), although a decade is a very short time to turn an economy around (Kolodko, 1999, 253). The sequence is presented in table 2.

According to the neoclassical gradualist approach, the first priority was fiscal control, in conjunction with several other key initiatives. An internal revenue service had to be established to collect taxes from households and firms and replace the traditional tax base of state-owned enterprises, which would disappear. At the same time, the institutional structure would have to be overhauled and an incomes policy introduced, a payments union established, and tariffs for non-payment-union members maintained and only gradually eliminated. A safety net would have to be introduced simultaneously. After the establishment of the formal institutions, informal rules would emerge. Meanwhile, both prices and interest rates would have to be controlled.

Once the initial reforms were in place, budget constraints could be hardened with the imposition of self–financing together with the development of an independent central bank. The privatization of small state enterprises could be initiated, and the restructuring and corporatization of large state enterprises could start. Once the restructuring and corporatization of large state enterprises gained momentum, price liberalization, deregulation of the interest rates and the banking system could begin. With the completion of restructuring and corporatization,

## Table 2: The Neoclassical Gradualist Process of Transition

| | | 0–1 | 1–2 | 2–3 | 3–4 | 4–5 | 5–6 | 6–7 | 7–8 | 8–9 | 9–10 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1. Price Liberalization Stabilization | Price Deregulation | | | | | | | | | | |
| | Incomes Policy | | | | | | | | | | |
| 2. Privatization | Privatization of Small Enterprises | | | | | | | | | | |
| | Restructuring of Large Enterprises | | | | | | | | | | |
| | Privatization of Large Enterprises | | | | | | | | | | |
| 3. Institutional Structure | Formal Institutions | | | | | | | | | | |
| | Informal Institutions | | | | | | | | | | |
| 4. Monetary Policy and the Financial System | Hard Budget Constraint | | | | | | | | | | |
| | Independent Central Bank | | | | | | | | | | |
| 5. Fiscal Policy | Budget Deficit | | | | | | | | | | |
| | Tax Structure | | | | | | | | | | |
| 6. International Trade and Foreign Aid | Payments Union | | | | | | | | | | |
| | Tariffs | | | | | | | | | | |
| | Floating Exchange Rate | | | | | | | | | | |
| | Conditional Foreign Aid | | | | | | | | | | |
| 7. Social Policy | Safety Net | | | | | | | | | | |
| | Private Welfare | | | | | | | | | | |

Years 0 1 2 3 4 5 6 7 8 9 10

large state enterprises could be auctioned. The vacuum in the provision of enterprise welfare services could be filled by the development of private welfare providers.

Before the privatization of large enterprises, the payments union would have become redundant after achieving convertibility, a floating exchange rate, and the elimination of tariffs to establish free trade. The budget deficit would be funded by conditional foreign aid throughout the transition process.

## Conclusion

The aim of the neoclassical gradualist process of transition was a democratic political structure combined with a market economy. In contrast to shock therapy, the policies of the neoclassical gradualist approach had to be approved by the democratic political process in order to facilitate transition; efficiency considerations should not come at the expense of democracy. The gradualist approach thus entailed the maintenance of short-term inefficiencies. However, these priorities presented an unfortunate policy dilemma: in order to secure macroeconomic stabilization in the short run, important pricing, enterprise, banking, interest rates, and international trade policies had to move counter to the ultimate goal of long-run liberalization. Transition governments were encouraged by the neoclassical gradualist economists to seize financial assets of enterprises, command outputs through state orders, reinstitute price controls, and so forth. Consequently they recommended reregulation of the financial system, reregulation of international trade, together with reregulation of state enterprises (Kolodko, 1999b, 236; McKinnon, 1995c, 70; 1995a, 106; Stark, 1990, 376).

If competitive capitalism was the ultimate goal of neoclassical gradualist economists, there was an apparent contradiction. A competitive capitalism system required a government with no discretion. However, reregulation and renationalization occurred during the transition period. The government's discretionary power was increased in the name of gaining control of economic affairs. However, there was a direct link between increased government power and the interests of the bureaucracy and lobby groups. The crucial question was: how could the economy, from a system of increasing government power during the transition period, be transformed into a free market system? The gradualist neoclassical economists failed to reveal how this would be achieved. Strangely enough, the state was expected to "wither away." Stalin advanced a similar argument. For the state to wither away, its power first had to be maximized (Nove, 1989, 63). However, the state would never wither away because it was

linked with the interests and privileges of the bureaucracy, lobby groups, and sectoral interests. These groups would have resisted their own dissolution, and state power and intervention, would have continued. Meanwhile, neoclassical economists, to explain the lack of reform in the Stalinist system, advanced this exact argument. The same argument finds validity in the neoclassical gradualist process of transition.

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