A POLITICAL ECONOMY APPROACH TO THE NEOCLASSICAL GRADUALIST MODEL OF TRANSITION

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Abstract. A political economy approach to the neoclassical gradualist model of transition requires the exposition of what I define the primary elements of the model, which are economic analysis, definition of a good society, speed, political structure, ideological structure and whether the initial conditions were incorporated in the model. After the identification of the primary elements of the neoclassical gradualist model the next step is to identify secondary elements, the desired changes with respect to price liberalization-stabilization, privatization, institutional structure, monetary policy and the financial system, fiscal policy, international trade and foreign aid and social policy. The analytical framework developed makes possible to understand the neoclassical gradualist model from a new and more enlightening perspective. We are better able to comprehend the complexities involved and the disagreements about the reform process. The adoption of a gradual process of transition did not only involve specifying the required policies of a successful transition but also entailed a process, a sequence by which the reforms should be introduced. As such, a process of transition consistent with the policies recommended by the neoclassical gradualists economists is developed. The conclusion reveals the inconsistencies in the model.

Keywords. Gradualism; Political economy; Transition

1. Introduction

The fundamental basis of the neoclassical gradualist approach to transition in Central, Eastern Europe and the former Soviet Union (CEEFSU) was to establish economic, institutional, political and ideological structures before any attempt at liberalization. Without this minimum foundation, radical reforms would have inhibited the development of a competitive market capitalist system. This was

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because ‘privatization, marketization and the introduction of competition cannot be contemplated in an economy reduced to barter’ (Carrington, 1992, p. 24). Also, the 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, p. 171) and had to be guided by the principle of voluntariness and free choice (Kornai, 1992b, p. 17).

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

The neoclassical gradualist transition process was implemented in countries such as Romania (Poirot, 1996, p. 1062) and Hungary, which have a tradition of a gradual transformation starting in 1968 with the New Economic Mechanism (Hare, 1991, p. 195; Wolf, 1991, p. 48; Samonis and Hunyadi, 1993, p. 20; Szekely and Newbery, 1993, p. 7; Kornai, 1993a, p. 199) and Slovenia (Kornai, 1997a, p. 122).

The aim of this paper is to develop a comprehensive neoclassical gradualist model of transition in the tradition of political economy and to distinguish the gradualist model from the shock therapy approach. As such, empirical evidence will be incorporated selectively. A political economy approach to the transition process would involve an analysis of what I define as the primary elements of the transition model. The primary elements are (i) economic analysis; (ii) definition of a good society; (iii) speed; (iv) the political structure; (v) the ideological structure; and (6) whether the initial conditions were a concern. The two neoclassical models of transition – shock therapy and gradualism – were similar in terms of economic analysis (neoclassical), definition of a good society (approximation of competitive capitalism) and ideology (self-interest). The goals, methodology and motivating factor of individuals of the gradualist model were quite similar to those of the shock therapy. However, the two models differ in terms of speed, political structure and the relevance of the initial conditions. As such, the paper focuses only on the different elements. After identifying the primary elements, the next step is to identify what I define the secondary elements of the transition model. A transition model has to answer questions relating to (i) price liberalization-stabilization; (ii) privatization; (iii) institutional structure; (iv) monetary policy and financial system; (v) fiscal policy; (vi) international trade and foreign aid (vii) social policy.

2. Primary Elements of the Neoclassical Gradualist Model of Transition

2.1 *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, 2000a, p. 32). However, the neoclassical gradualist supporters did not rule out the possibility of a 'minimum bang' for some aspects of transition process (Kornai, 1986, p. 1693; McKinnon, 1992a, p. 33; Smyth, 1998, p. 384). Whenever immediate changes were needed, immediate action was required (Thomas and Wang, 1997, p. 218). The dilemma was fast and costly restructuring versus slow but less expensive restructuring (Dewatripont and Roland, 1992a, p. 299).

From the gradualist perspective, people in CEEFSU 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 behaviour are organic processes that last for several years. As a result, the productivity of small changes would be greater than that of large changes without discounting the need for large changes to initiate the reform process (Kornai and Daniel, 1986, p. 303; Kornai, 1993a, p. 198; 1997a, p. 18; Murrell, 1994, p. 168; Kolodko, 1999b, p. 259). History does not move in leaps, but in marginal adjustments – small and gradual steps are easier to correct than sudden and major steps (Roland, 1994a, p. 1163; Kornai, 1997a, p. 94; Boettke, 1999, p. 377). Therefore 'capitalism has never been introduced by design: it evolved organically' (Csaba, 1995, p. 99), similar to the 'nurturing of a greenhouse plant' (Svejnar, 1991, p. 131). Taking into account the social costs, sequencing, learning-by-doing, institution-building, structural adjustment, administrative capacity, behavioural 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 favoured (Dewatripont and Roland, 1992a, p. 297; Kornai, 1992a, p. 16; Samonis and Hunyadi, 1993, p. 14; Van Brabant, 1993, pp. 77, 84; Murrell, 1994, pp. 170–171; Roland, 1994a, p. 1163; Csaba, 1995, p. 201; Gustafson, 1999, p. 8; Kolodko, 1999b, p. 253).

A gradual process of transition necessitated the sequencing of reforms; a gradual process required transition by design rather than transition by chance (Kolodko, 1999b, p. 249). Timing and sequencing of the liberalization were imperative (McKinnon, 1993, pp. 98, 108; Rana, 1995, p. 1); poor timing would have resulted in prolonged stagnation (Csaba, 1995, p. 87). Under a gradualist neoclassical process, the transition was more complex because of the attention to the order of introducing the necessary reforms and the 'painful trade-offs and choices between bad and worse' (Kornai, 1992b, p. 18). Adopting a suitable reform strategy was not simple (Rana, 1995, p. 1), and success required 'a convincing, detailed, practical program whose implementation must begin at once' (Kornai, 1994, p. 59) to avoid corruption and crony capitalism (Kolodko, 1999a, p. 34). As Csaba (1995, p. 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 initiated through a shock therapy was 'wrong, and in several cases has caused more problems than it has solved'

(Kolodko, 1999b, p. 233). The 100- or even 500-day approaches were not feasible and were disastrous (McKinnon, 1992a, p. 33; Csaba, 1995, p. 99; Kolodko, 1999b, p. 233). 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 outdated institutional constraints (Van Brabant, 1993, p. 81; Csaba, 1995, p. 52; Rana, 1995, p. 25). The severity of the unavoidable recession was increased substantially by 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, p. 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, p. 346). 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, p. 1163; b, pp. 32–34). Because of economic and political reasons, there was 'simply no realistic alternative to gradualism' (Rowthorn, 1993, p. 346).

2.2 *Political Structure*

Lipton and Sachs (1992, p. 215), Sachs (1993, p. xiii) and Kornai (1995e, p. 64; 1997a, p. 122) 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, p. 104). The failure of partial reforms was associated with the exclusion of the political process (Wolf, 1991, p. 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' (Roland, 1994b, p. 27; Kornai, 1997a, p. 151, 169; Furubotn, 2000, p. 120; Olson and Kahkonen, 2000, p. 15).

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. This would have been at a time when reformist governments were faced with an increasingly broad and aggressive array of interests, some of which strongly opposed the reform program. Under the new politico-economic conditions, abuse of power was scrutinized by the mass media and the voluntary and spontaneous associations that citizens have 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, p. 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, p. 27). Kornai (1995c, p. 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 behaviour. In transition economies, the citizens were prisoners of the time, and cooperative behaviour 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, p. 56). The establishment of a consensus provided credibility for the reform process. For example, in Hungary, the elections revealed that the majority of the population preferred parties with the more cautious approach to transition and subsequently gave the governing coalition a mandate to follow the policies of a 'calm force' (Andorka, 1994, p. 29). In Russia, however, no one enjoyed a mandate to launch the shock therapy program (Csaba, 1995, p. 221; Kornai, 1997a, p. 127). A democratic political structure was an absolute condition of the gradualist approach, in contrast to the shock therapy, to successfully change an 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, p. 247), which serve the interests of the 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, p. 235; Kornai, 1997a, p. 127). Broadly speaking, political rules in place lead to economic rules, and good economic performance is directly linked with democracy, although, the causality runs both ways (North, 1990, p. 48; Olson, 2000, p. 132). Kornai (1993b, p. 333; 1995d, p. 150; e, pp. 62, 159, 220; 1997a, p. 178) elevated the achievement of a democratic political structure as the number one goal of transition; autocratic rule was not worth any price, even the price of efficiency: 'If it comes to a conflict between efficiency and the cause of democracy, I am sure that defence of the institutions of democracy is the supreme task'. Consequently, there was a new role associated with the government (Kolodko, 1999b, p. 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, p. 64; Kornai, 1997a, p. 30; Kolodko, 1999b, p. 245). The maintenance of centrally administered elements in the economy and the associated mechanisms of control and influence would ensure that the state would be able to exercise the necessary power to achieve the goals of the gradual process. A weak state was inconsistent with the gradualist process. A weak state was the result of the shock therapy that involved the destruction of all elements of centrally administered socialism.

The 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, p. 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, p. 60). For the neoclassical gradualist supporters, democracy was an essential precondition for a successful reform process. Democracy was not an obstacle to reform, but rather an essential element of the overall transition program (Dewatripont and Roland, 1992a, p. 300; b, p. 705). The shock therapy approach highlighted how speed can constrain a government, whereas the gradualist approach tries to design the sequencing of reforms so as to build, through the democratic process at each stage of transition, constituencies for further reform (Roland, 1994b, p. 39).

2.3 *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, p. 165). Policy instruments and goals required reflecting the specific economic conditions of time and changing accordingly. 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 sequencing of the reforms (Roland, 1994b, p. 37) due to their different circumstances. In addition, the unfolding of the gradual transition process as a result of the evolutionary character of reforms often result in changes, which were accidental and unpredictable in nature, for example, the development of Township and Village Enterprises in China.

The dynamics of reforms differed between transition economies because the starting points were varied. The starting point required clarification. It was not accidental the Central, Eastern Europe and the Baltic states are performing much better than the Commonwealth of Independent States, because centrally administered socialism was established a lot later in these regions. In addition, Hungary was at a relatively advantageous position in the start of the transition process – the gradual reform process started in 1968 with the New economic mechanism – and as such, the ability to avoid hyperinflation should also be contributed to the advantageous initial conditions.

Incorporating the initial conditions in the transition process justified a gradual approach (Kornai, 1992b, p. 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, p. 181; Murrell, 1995, p. 165; McKinnon, 1995c, p. 63; Kornai, 1995e, p. 1). As a result, the dynamics and the speed of reform differed between transition economies because the starting points were different (Kornai, 1992c, p. 168; 1999, p. 164). The starting point required clarification, there could not be a uniform line, thus governments could not undertake liberalizing measures simultaneously. Instead, there was an optimal order of economic liberalization depending on the initial conditions (McKinnon, 1993, p. 4; Csaba, 1995, p. 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, p. 376).

3. Secondary Elements of the Neoclassical Gradualist Model

3.1 *Price Liberalization and Stabilization*

Rational planning was impossible because of the diverse interests of individuals. Subsequently, the only mechanism for coordination of the market was based on the signals provided by relative prices (Carrington, 1992, p. 23). However, the adjustment of the quantities to the new prices had to be gradual (Kornai, 1994, p. 45). Stable domestic price levels permitted greater domestic financial deepening and higher real-deposit rates, reducing risks and greatly simplifying the liberalization and the stabilization of the real exchange rate (McKinnon, 1993, p. 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. The price controls and policies 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 long-term qualitative benefits of economic growth (Kornai, 1993a, p. 201; Csaba, 1995, p. 95). The efficiency gains of price liberalization were uncertain (Alexeev, 1991, p. 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.

Prices would have reached their equilibrium values and world levels through a gradual process, because prices and the real exchange rate are endogenous variables (Roe, 1991, pp. 10–11). Also, such controls would have partially substituted for the otherwise underdeveloped social safety net (Fischer and Frenkel, 1992, p. 38). Foreign aid and the elimination of the black market would have hastened a movement to equilibrium prices. Thomas and Wang (1997, p. 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-orientated reforms take years to put into place and usually require even more time before they begin to generate robust investment and growth (Nelson, 1994, p. 53). For example, prices have been freed gradually in Hungary (Samonis and Hunyadi, 1993, p. 23; Kornai, 1997a, p. 15).

The shock therapy argument for total price decontrol was flawed and extremely destructive (McKinnon, 1993, pp. 82, 86; 1995a, p. 100). While central administration had been removed, price signals did not immediately replace the role of directives because individuals were not yet competent to evaluate and utilize this new type of information (Kornai, 1994, p. 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,

p. 33), thus 'prices should not be liberalized on their own' (Csaba, 1995, p. 71) until the consumer goods market was satiated at the controlled prices (Alexeev, 1991, p. 381). Thus, price liberalization would not be sufficient to develop competitive markets (Fischer and Gelb, 1991, p. 97).

Based on the gradualist approach, the government retained some 'relaxed' price controls (Feltenstein, 1994, p. 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, p. 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 (Fischer and Gelb, 1991, p. 103; McKinnon, 1993, pp. 31, 41, 91). 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.

The removal of some controls on prices, not all, as the gradualist approach stipulated, 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, p. 182). This was because 'reform leads initially to disorganization and that disorganization explains some drop in output' (Blanchard, 1996, p. 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, p. 184). However, restructuring of production, technical innovation and the development of new products were the outcome of the destruction of inefficient enterprises. 'This cleansing is essential for the development' of the economy (Kornai, 1992a, p. 8).

Inflation was 'the constant public enemy number one of the transforming countries' (Csaba, 1995, p. 69). However, in Hungary, because of the gradualist approach there was no hyperinflation to halt (Csaba, 1995, p. 195). Kornai (1993b, p. 323; 1995e, p. 149; 1996, p. 2) 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, pp. 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, p. 213). Labour 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 importantly, unemployment created social dissatisfaction, which posed the most immediate threat to the maintenance of the whole reform program (Csaba, 1995, p. 7; Frydman *et al.*, 1997, p. 63). An extended recession was expected, resulting in several years of high unemployment, which, without state intervention, would only go higher (Kornai, 1995e, p. 216; 1997a, p. 201).

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, p. 211). This was because inflation is a dynamic process, it is generated and sustained by price and wage increases (Kornai and Daniel, 1986, p. 302). Deregulating wages in an environment of weak profit motive, soft budget constraint and unemployment would not have helped the transition process (Kornai, 1986, p. 1714). Also, wage increases should not be fuelled by rises in the price of imports because of devaluation (Kornai, 1995c, p. 235). The government had to set guidelines for the determination of wages, which were strengthened by tax incentives: a wage and incomes policy (Fischer and Gelb, 1991, p. 98; Nuti, 1991, p. 172; Kornai, 1996, p. 9). Progressive taxation above the predetermined norm would act as a disincentive to excessive wage increases (Fischer and Frenkel, 1992, p. 38; Kolodko, 1999a, p. 34); partial indexation of wages, not automatic, would maintain industrial peace and reduce inflation (Fischer and Gelb, 1991, p. 103; Bim, 1992, p. 185; Kornai, 1996, p. 1). It was a transitional measure that could speed up the reform process (Kornai, 1997a, p. 25). The shock therapy supporters agreed with these views.

The development of market relations in CEEFSU, was 'path-dependent', like most economic phenomena (Nelson, 1995, p. 51; Furubotn, 2000, p. 121). The role of the state in economic policy was among the most debated theoretical and practical aspect of the transition (Kornai, 1994, p. 62; Gustafson, 1999, p. 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 *et al.*, 1997, p. 83). During the transition period the economy was like 'no man's land' (Kornai, 1994, p. 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 favour the growth of output. But, as Kornai (1995b, pp. 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' (Kornai, 1994, p. 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, p. 54). During the transition recession, managers did not cut costs but increased inter-enterprise credit, failed to pay taxes and repay loans to state banks, and mobilized their economic power for political purposes. Under the circumstances, they reduced the state's role to minimum and not doing anything was unacceptable (Bratkowski, 1993, p. 5; Kornai, 1993a, p. 224; 1995c, p. 238): 'it does not help much to say that if the government sticks to its guns, the economic agents will have to change their behaviour' (Frydman *et al.*, 1997, p. 45).

In contrast to the shock therapy model, and because of the gradualist nature of reforms, an activist-strong state was extremely important (Gustafson, 1999, p. 34; Van Brabant, 1993, p. 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, p. 83). Meanwhile, it should be remembered that 'socialism and serfdom go hand in hand' (Carrington, 1992, p. 23), and 'people are irritated by the state interfering in their private lives and harassing individuals' (Kornai, 1992a, p. 16), thus, a minimal state should be the ultimate goal (Gustafson, 1999, p. 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.

3.2 *Privatization*

The neoclassical gradualist economists argued that a competitive market capitalist system required the dominance of private property (Hare, 1991, p. 197; Kornai, 2000a, p. 30) because 'there cannot be capitalism without capitalists' (Gustafson, 1999, p. 26) and 'common property is nobody's property' (Carrington, 1992, p. 23). However, the efficiency virtues associated with privatization – the main instrument of overcoming the recession and stimulating growth and employment – was 'a simplified misconception of the real relationship' (Kornai, 1994, p. 50), and policies were aimed at artificially accelerating the privatization process (Csaba, 1995, p. 168). Both privatization and liberalization were simply instruments of economic policy, not targets, and privatization of state enterprises was very painful (Kolodko, 1999b, p. 245). This was because politicians would not give up so easy their control of state enterprises, and monopolies used their supernormal profits to retain their status through political pressure and bribery of officials, in this way threatening the reforms (Vasiliev, 1997, p. 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, p. 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, because management and workers would be interested in restructuring the enterprise, there was a need for ownership to be supplemented with outside involvement to ensure that restructuring actually took place. In time, shareholders would have become an important source of financial capital. In actual fact, empirical evidence revealed that privatization to outsiders is associated with 50% more restructuring than privatization to insiders; workers' ownership is the least effective than all other ownership types, even state ownership (Djankov and Murrell, 2002, p. 741).

On the basis of the gradualist approach, growth would have resulted from the development of new enterprises in the short term (Slay, 2000, p. 68). In the long run, growth would have resulted from privatization of state enterprises and the enforcement of a hard budget constraint. In contrast, the shock therapy supporters argued that growth in the short run would be the result of privatization. The shock therapy economists were 'stuck on the theme that one is to create the new economy by privatizing the old' (Leijonhufvud, 1993, p. 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 (Murrell, 1992, p. 80; Kornai, 1996, p. 37). 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 by implementing a gradualist approach to privatization (Kornai, 1994, p. 50). Consequently, the immediate privatization of state enterprises was not necessary, since rapid privatization was clearly utopian and misplaced in the transition process (McKinnon, 1991, p. 115; 1992a, p. 33; 1992b, p. 105; Berg, 1994, pp. 388–389, 394; Csaba, 1995, pp. 92, 135). The gradual process of transition required not only a slow process of privatization but also most importantly its postponement. The gradualist neoclassical economists favoured 'deferred privatization', and even though Kornai (1992c, p. 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 (Litwack, 1991, p. 84; Woo, 1994, p. 277; Rana, 1995, p. 18; Kolodko, 1998, p. 25; Anderson *et al.*, 2000, p. 527). The speed of privatization is determined by institutional factors (Laki, 1993, p. 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, p. 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, p. 148; 1995c, p. 60; Vasiliev, 1997, p. 37). Consequently, 'the resulting spontaneous order is best grown from the bottom up' (McKinnon, 1992a, p. 35).

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

Kornai (1990, p. 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. Privatization could help to increase state revenue through the proceeds of selling enterprises (Hare, 1991, p. 199; Roe, 1991, p. 24; Kornai, 1992c, p. 156). The Hungarian government was in agreement with Kornai that privatization had to result in 'real owners' or 'strong owners' rather than artificial recipients of state assets (Mihalyi, 1993, p. 90, 106; Samonis and Hunyadi, 1993, p. 31; Frydman *et al.*, 1997, p. 87). 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%; Hungary had become the country with the highest per capita foreign debt (Abel and Bonin, 1993, p. 338). By the end of 1995, privatization yielded substantial revenue, which amounted to US $7427 million. This was considered a major advantage of the sales strategy over free distribution of shares (Kornai, 1997a, p. 157, 159).

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, p. 174), in other words, 'capitalism should strike root primarily in domestic soil' (Kornai, 1992c, p. 174) so as to foster the development of domestic entrepreneurs (McKinnon, 1991, p. 115). In Hungary, foreigners dominated the purchase of state assets. In 1991, 85% of the 40.1 billion forint in privatization revenue came from foreign investors (Jarai, 1993, p. 80; Samonis and Hunyadi, 1993, p. 38).

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, p. 163). However, most of the new owners were from the old economic elite of the Communist Party (Kornai, 1997a, p. 152). Kornai (1999, p. 166) was not concerned about who owned the newly privatized enterprises. He was more interested in changes in the new owners' behaviour associated with the introduction of market relations. Kornai believed the owners would be motivated to earn profits by improving the value of their firms than in satisfying the requirements of the central committee. Kornai (1999, p. 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, p. 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 guises of 'enterprise-initiated' privatization or 'self-privatization' (Laki, 1993, p. 445; Mihalyi, 1993, p. 104).

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 (Murrell, 1992, p. 80; Woo, 1994, p. 313; Roland, 1994a, p. 1164; Frydman *et al.*, 1997, p. 96; Anderson *et al.*, 2000, p. 547).

Small- and medium-sized enterprises could be privatized immediately, because they are flexible the exercise would be substantially less time-consuming and would not involve large amounts of financial resources. At the same time, it would produce favourable externalities to the wider economy, because a large number of individuals would be involved and would 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, p. 163) advocated credit and tax concessions to support peasants in private farms, private small scale industry and trading and small businesses. The development of the small- and middle-sized firms would also facilitate the development of a middle class, essential in the creation of capitalism (Kornai, 1992c, p. 163; 1995e, p. 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, p. 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 or in infrastructure activities such as the construction and maintenance of roads, irrigation and socially sensitive industries (McKinnon, 1991, p. 115; 1995c, pp. 60–61). 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, p. 345). Under the abnormal conditions of transition, Anderson *et al.* (2000, p. 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, p. 104).

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

3.3 *Institutional Structure*

A proper institutional structure was 'the Achilles heel' (Svejnar, 1991, p. 134) of transition, because institutions matter (Bardhan, 2000, p. 245). Private property and the building of institutions are fundamental to a free market (Kolodko, 1999b, p. 249; 2000, p. 274). 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, p. 5). A credible transition process can only be achieved by getting the institution right in terms of an institutional structure that can direct and channel economic activity to achieve sustainable and equitable long-term growth (Poirot, 1996, p. 1059; Williamson, 2000, p. 92). The evolutionary paradigm of institutional development was also used to justify a gradualist approach to reform (Smyth, 1998, p. 383; Kolodko, 1999b, p. 234), as 'the resulting spontaneous order can indeed spread rapidly' (McKinnon, 1992a, p. 35).

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

Neoclassical gradualist economists accept Coase's theorem that clear property rights, preferably private property rights, were essential for a well-functioning market economy in CEEFSU. For market capitalism to consolidate and function efficiently, it was imperative that the institutional structure protected private property, enforced contracts, imposed financial discipline and generally created a stable legal environment (Hare, 1991, p. 197; Litwack, 1991, p. 77; Murrell, 1991, p. 5; Svejnar, 1991, p. 128; Kornai, 1995e, Poirot, 1996, p. 1057, p. 73; Kolodko, 1999b, p. 235; 2000a, p. 32). By definition, economic justice meant nothing more than respect for private property and only free market outcomes were just (Caporaso and Levine, 1992, p. 204). Having market-orientated institutions in place while old institutions were torn down was crucial for reforms to be effective (Thomas and Wang, 1997, p. 218). Institutional changes would be apparently initiated by the market process, albeit slowly (Vasiliev, 1997, p. 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 (Kornai, 1992c, p. 160; 1995e, p. 62; 1997a, p. 97; Murrell, 1992, p. 80; Csaba, 1995, p. 101; Gustafson, 1999, p. 153; Kolodko, 2000, p. 274; Slay, 2000, pp. 238–239). A gradual process allowed time to clarify the institutional principles and to test institutional adjustment. Institutional development was a complex evolutionary process, causing the ineffective institutions to wither away and choosing as survivors the ones truly fit for the task (Kornai, 1992c, p. 160; 1995e, p. 26–27; Nelson, 1995, pp. 78, 82). Market-supporting institutions aimed to make the transition more effective and harder to reverse. Because of the importance associated with small and medium enterprises to produce the externalities already mentioned, it was essential that the appropriate institutional structure, that is legislative and regulatory framework and proper organization, be in place to facilitate their development (Kolodko, 2000, pp. 283–284).

The development of market institutions takes time, which is one reason why the transition recession in CEEFSU was persistent. Appropriate government initiatives would have hastened the development and helped reduce the time of the recession. The institution of private property cannot exist without government (Olson, 2000, p. 131), but experience has demonstrated that transition governments have 'committed many sins of omission in this respect' (Kornai, 1993a, p. 200; 1994, p. 49). The collapse of centrally administered socialism did not leave the society in an institutional vacuum. Accordingly the 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, p. 28). The pre-existence of an 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, p. 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, pp. 82, 84). This new institutional structure 'is not replacement but recombination' (Stark, 1996, p. 995).

The shock therapy approach to institutional development was vague, inconsistent and toothless (Anderson *et al.*, 2000, p. 527). 'Instant people's capitalism' was not possible and was distinctly 'un-Hayekian' because spontaneous markets based on common law best evolved from existing commercial practices (McKinnon, 1992a, p. 35). The failure of transition economies to stimulate growth after the implementation of the shock therapy process under the guidance of the IMF, World Bank and the mature market economies was attributed to the 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 (Murrell and Olson, 1991, p. 244; Murrell and Wang, 1993, p. 387; Poirot, 1996, p. 1059; Kolodko, 1999b, p. 239; Blankenagel, 2000, p. 117).

Governments had an important role to support the ever-changing market with the appropriate institutional structure (Murrell, 1991, p. 5; McKinnon, 1992a, p. 32; Kolodko, 1999b, p. 248). Otherwise, 'trade relations are destroyed by the absence of market institutions' (Kornai, 1994, p. 47) and '*laissez faire* is not optimal' (Thomas and Wang, 1997, p. 218). Essentially, the success of the privatization process depended on how speedy the market legal frameworks and supervisory institutions developed, how rapid the bankruptcy proceedings and liquidation processes were in place and how reliable was the free transfer of property rights (Kornai, 1992c, p. 171; 1995e, p. 147; McKinnon, 1995c, p. 69). Institutional change was imperative to divorce the tax collection by various levels of government from the ownership of firms (McKinnon, 1995c, p. 53).

The implementation of the shock therapy process without any institutional fundamentals in place resulted in 'bandit capitalism' in the transition economies (Kolodko, 1999b, p. 249). The rise of criminal activity and Mafia methods – the term Mafia lost its exclusive Italian connotation – of imposing financial discipline was 'alarming and intolerable' (Kornai, 1993b, p. 327; 1995e, p. 153). 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, p. 6; Blankenagel, 2000, p. 100; Olson and Kahkonen, 2000, p. 19). 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 home grown Mafia-style crime, which was not compatible with the mature market economies (Olson, 1995, pp. 438, 457). The increase in crime was the result of weak institutional arrangements (Kolodko, 1999a, p. 33; Blankenagel, 2000, p. 115). According to a recent World Bank study, half the Russian economy is now in the hands of the home grown Mafia (Kingston-Mann, 1999, p. 35).

It is necessary to eliminate restrictions on and/or harassment of private enterprise, otherwise, they will 'only push some people deeper into illegality and discourage others from enterprise altogether' (Kornai, 1992a, p. 13). Private enterprises would change their behaviour and follow the road of legality if the legal structure offered them protection of their property and guaranteed contracts (Csaba, 1995, p. 131). All necessary incentives should be used to encourage a law-abiding and tax-paying enterprise, with the possible use of a stick-and-carrot approach. As the mature market economies have demonstrated that individual self-interest based on 'buyers beware' and firms with clearly delineated property rights, foster crime prevention, lawful behaviour and law enforcement, and governments have not had to pour financial resources into combating fraud (Olson, 1995).

In summary, the development of the institutional structure of the shock therapy and the gradualist neoclassical process 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. For shock therapy supporters, the goal was the development of market relations first with the assumption that the institutions would follow in due time. Thus, while the gradualist supporters argue that institutions can be created by market forces, they often require active state intervention through legal state processes. After all, institutions are social coordination mechanisms that establish the framework within which markets function. Given the numerous externalities, the market left to itself would be unable to create the appropriate institutions to function effectively, as the experience of mature market economies demonstrate. Thus, a combination of the market mechanism with state intervention would result in the development of the right set of institutions, consistent with the gradualist approach.

3.4 *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, p. 201; Leijonhufvud and Ruhl, 1997, p. 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, p. 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 (Kornai, 1993b, p. 320, 1995d, p. 140, e, p. 146; Berg, 1994, p. 401). Meanwhile, as with all the elements of the transition program, monetary stability could only evolve gradually, for example in Hungary (Kornai, 1993b, p. 332; 1997a, p. 13; Csaba, 1995, p. 15).

The governments in transition economies should not have been pressured to provide cheap credits, 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, p. 203). There had to be credibility with respect to a 'no bail-out' commitment (Kornai, 1993b, p. 324). Kornai (1993b, p. 330; 1995e, p. 156) compared the behaviour 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, p. 393), Kornai (1992a, p. 10) was convinced that it was better to accept the serious problem of unemployment 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, 1993b, p. 332; 1995e, pp. 76, 147). This could only be achieved by the establishment of an independent central bank (Calvo and Frenkel, 1991, p. 144; Nuti, 1991, p. 166; Roe, 1991, p. 13). The role of the central bank had to be redefined. It had to become an effective monetary authority: it could not have been the provider of a soft budget constraint. An independent central bank had to establish credit targets to hold overall money growth to levels consistent with the rapid elimination of inflation. This was because inflation is a monetary phenomenon. The quantity theory of money states that the monthly rate of inflation is equal to the rate of growth of the money supply minus the rate of growth in output. Therefore, monetary policy should have followed a specific rule, that is, increasing the money supply in line with the increase in real output. In this way, the danger of inflation would have been reduced. This was possible only by establishing an independent central bank, with the aforementioned rule stated in its constitution, ensuring in this way the elimination of the soft budget constraint. In addition to the establishment of an independent central bank, the new states of the ex-Soviet Union and for a few countries of Eastern Europe (i.e. Slovakia, Slovenia, etc.) had to establish a new currency.

The neoclassical gradualist economists argued that premature attempts to transform the banking system would worsen the overall situation by losing control of monetary policy. For example, in the 1980s, 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, p. 7). Institution building must first be sufficiently advanced, and stabilization ought to be consolidated into stability. Only then should financial markets be liberalized in a gradual manner (Kolodko, 2000, p. 292). Consequently, ‘consolidation of financial discipline is a lengthy process of evolution that extends over several years’ (Kornai, 1995d, p. 150; 1993b, p. 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, p. 234).

In the short run, successful macroeconomic stabilization in the transition economies would have required a major re-centralization of the government’s control over money and credit and the elimination of ‘wildcat banks’. Prices had to be re-centralized 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 re-regulate the financial system as well as the state enterprises (Stark, 1990, p. 376; McKinnon, 1995a, p. 106; Bim, 1992, p. 70; Kolodko, 1999b, p. 236). 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, p. 53).

McKinnon (1991, p. 118; 1992b, p. 108; 1993, pp. 53, 139; 1995b, p. 68) 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 (Nuti, 1991, pp. 162, 167; McKinnon, 1993, p. 156).

Thus, in the optimum order of financial liberalization the development of ordinary commercial banking had to be deferred until monetary and fiscal control was achieved and the price level stabilized (McKinnon, 1991, p. 121; 1992b, p. 110; 1993, p. 6; Boettke, 1999, p. 378). Thus 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.

3.5 *Fiscal Policy*

Balancing the budget was a long-term concern (Csaba, 1995, pp. 92, 204) but in order to avoid further inflationary explosions, 'effective fiscal reforms must come mush earlier in their transitions' (McKinnon, 1995a, p. 96). While every effort had to be made to reduce the budget deficit – or ideally to produce a surplus (Roe, 1991, p. 14) – reductions were unlikely in the first years of transition (Kornai, 1992a, p. 6; Csaba, 1995, p. 204). It would have been dangerous to reduce the deficit too drastically or too quickly. Rapid and drastic 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, p. 28). However, this did not imply a fiscal stimulus, which entailed an inflationary outcome and crowding out (Csaba, 1995, p. 141; Kornai, 1995b, p. 9). There was also a need to restructure government expenditure so that the reduced demand from government consumption was replaced by investment demand (Szekely and Newbery, 1993, p. 18; Kornai, 1993a, p. 214; Csaba, 1995, p. 113; 1997a, p. 204). Nevertheless, the initial conditions of each transition economy had consequences for the fiscal policy implemented. As such, most CIS countries were subsidized heavily by Russia up to 1992, after which the subsidies stopped forthcoming. These countries effectively inherited a huge budget deficit that had to be financed.

A drastic improvement in the transition governments' ability to collect tax revenue was necessary both for macroeconomic stabilization and to support longer-term market-orientated and institutional reforms (Fischer and Gelb, 1991, p. 101; McKinnon, 1993, p. 92). 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 (McKinnon, 1995c, p. 55). Taxes in transition economies were already high due to the premature welfare state (Kornai, 1996, p. 16). There could not be welfare reform without a profound, considered reform of taxation and vice versa (Kornai, 1997c, p. 1185). Stabilization required a simple taxation system (Csaba, 1995, p. 84).

However, Kornai (1992a, p. 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, p. 250). However, by giving up control of state property, the government in effect gave up its tax base (McKinnon, 1991, p. 110; 1995c, p. 44). 'Enterprise can no longer so easily serve as cash cows or as vehicles for indirectly taxing households' (McKinnon, 1995c, p. 44). Privatization should have been postponed until the institutional basis of tax collection had been set up and had 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, p. 115). When tax morality improved and the tax base winded, tax rates could be lowered (Kornai, 1995c, p. 240).

3.6 *International Trade and Foreign Aid*

A sustained movement towards 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, p. 162; Kornai, 1995b, p. 21). Neoclassical gradualist economists argued that, because 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, p. 125). It was expected that transition economies would have current account deficits, which would have been tolerable temporarily (Kornai, 1993a, p. 218). There was an argument for maintaining a level of tariffs and transforming quantitative restrictions into tariffs. This would have provided protection and time for the firms to adjust while also providing the government with an income (Roe, 1991, p. 15; McKinnon, 1993, p. 102; Kornai, 1997a, p. 199). 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 WTO, so that it did not lead to protectionist retaliation by foreign trading partners (McKinnon, 1993, p. 184; Kornai, 1993a, p. 216).

Convertibility would have required an appropriate exchange rate, which would have depreciated heavily to adjust to the new economic conditions. The progress towards complete current account convertibility could only be gradual (Nuti, 1991, p. 155; Abel and Bonin, 1993, p. 337). A devaluation of the currency would have stimulated exports and reduced imports (Kornai, 1995b, p. 15). While the positive effects would not have been immediate, gradual devaluation was necessary (Kornai, 1996, p. 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, p. 339).

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, pp. 10, 117). Without direct government participation, the foreign exchange market was highly illiquid and unstable (McKinnon, 1993, p. 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 pre-announced 'crawling peg' – had certain advantages (Williamson, 1991; Abel and Bonin, 1993, p. 336; Van Brabant, 1993, p. 90; Csaba, 1995, p. 86; Kornai, 1995c, p. 232). It made the intentions of the policy-makers clear, maintained commitment, reduced speculation and also tied the hands of the monetary authorities and reduced their room to manoeuvre.

Because of international integration, a substantial increase in exports would have taken place with the mature market economies, removing the previous reliance of transition economies on the Soviet Union. The arguments that the CEEFSU should not have opened their borders to free international trade nor introduced a convertible currency because enterprises were inefficient and could not have survived fierce international competition, were false. Ricardo argued that international trade was the product of comparative – not absolute – advantage. Any country could have engaged in free trade. As such, export expansion as a means of stimulating growth was imperative for transition economies.

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 because it would speed and increase the likelihood of success of transition reforms (Fischer and Frenkel, 1992, p. 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, p. 30–31). This, of course, was in the interest of mature market economies (Fischer and Frenkel, 1992, p. 41). Partial debt forgiveness was necessary (Fischer and Gelb, 1991, p. 104; Roe, 1991, p. 22; Kolodko, 1998, p. 25), which was anathema to the IMF and World Bank (Nuti, 1991, p. 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. The provision of foreign aid should be differentiated on the basis of the initial conditions of the transition economy and the outcomes of the unfolding reform process.

3.7 *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, p. 34). Most importantly, social policy played a political, as well as social welfare role, by helping to protect large numbers of unemployed people from major declines in their standards of living and, at the same time, maintain support for the reform program. Thus, the transition and social program required transparency and participation from the disadvantaged, so that this group was not marginalized.

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 (Bratkowski, 1993, p. 5; Van Brabant, 1993, p. 76; Gustafson, 1999, p. 173, 188). Inattention to the social safety net was not unusual in transition economies; Russia's budget expenditure on health was less than 1% of GNP, and price reform was not accompanied with monetary compensation (Alexeev, 1991, p. 388; Murrell, 1995, p. 166; Gustafson, 1999, p. 186). 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, p. 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, p. 10; 1996, p. 14). A major deterioration of economic and social well being endangered the transition process (Svejnar, 1991, p. 137).

Unemployment was unfamiliar to the people of transition economies because they had only encountered full employment and labour shortage. The people would tolerate some unemployment but only if it was quite minimal (Kosmarskii, 1992, p. 34). Nonetheless, if firms were forced to shut down then the social safety net – as effective it was – was also shut down. This was because welfare provision took the form of enterprise-funded welfare programs. As such, employment in a state enterprise provided accommodation, health care, childcare, schools even meals.

The transition economies had to create a safety net from scratch (Kolodko, 1999b, p. 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, p. 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, p. 18). This poses the familiar efficiency versus security argument (Kornai, 1993b, p. 323). 'Support is one thing, but paternalism as a substitute for individual action is quite another' (Kornai, 1997a, p. 231). Kornai (1996, p. 15; 1997a, p. 95) defined social policy in Hungary under the Kaidar regime (1956–1989) 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 and services available through insurance policies (Kornai, 1992b, p. 17; 1995e, p. 77). Individuals would have had a choice between 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, p. 340). Voluntary organizations would oversee the private providers and ensure the high quality of services by imposing the rules. The government would have to play an active part as initiators of the reform process (Kornai, 1997a, p. 342). The welfare system, 'after decades of spoonfeeding and subservience to political whims, must be to bestow greater sovereignty on citizens' (Kornai, 1997c, p. 1186).

4. Process of the Transition

Under the assumption that an effective political structure is in place that is conducive to the reform process, 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, 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, the 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 the corporatization of large state enterprises could start. Once the restructuring and the corporatization of large state enterprises gained momentum, price liberalization, deregulation of the interest rates and the banking system could be initiated. With the completion of restructuring and corporatization, 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 introduction of a floating exchange rate and the elimination of tariffs would establish free trade. The budget deficit would be funded by internal resources, foreign borrowing and conditional foreign aid. The sequencing of the reforms is summarized in Table 1. Assuming that the transition would last 10 years, the shaded cells demonstrate the timing and sequence of each reform.

5. Empirical Evidence: The Performance of Gradualist Transition Economies

Gradualist transition supporters interpret the transition indicators (Table 2) as that the process clearly outperformed the shock therapist approach, rather than merely avoiding some of the obvious flaws. In hindsight, Kornai (2000b) argues that his recommendations at the time concerning ownership reform were correct,

Table 1. The neoclassical gradualist process of transition.

		Years										
		0	1	2	3	4	5	6	7	8	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 stricture	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	Foreign borrowing											
	Tariffs											
	Floating exchange rate											
	Conditional foreign aid											
7. Social policy	Safety net											
	Private welfare											

Table 2. Transition indicators for Hungary, Romania, Slovenia, Slovakia and Poland.

Country	Type of transition	Large scale privatization	Small scale privatization	Governance and enterprise restructuring	Price liberalization	Trade and foreign exchange system	Competition policy	Banking reform and interest rate liberalization	Securities market and nonbank financial institutions
Hungary	Gradual	4	4+	3+	3+	4+	3	4	3+
Romania	Gradual	3–	4–	2	3	4	2	3–	2
Slovenia	Gradual	3+	4+	3–	3	4+	2	3+	3
Slovakia	Initially shock therapy as Czechoslovakia then gradualism	4	4+	3	3	4 + 3	3–	2+	
Poland	Shock therapy	3+	4+	3	3+	4+	3	3+	3+

Source: European bank of reconstruction and development (1999), *Transition Report 1999*, London, p. 24.
1, little progress.
4+, standards and performance typical of advanced industrial economies.

while concerning macroeconomic stabilization he was partly right and partly wrong. Today, Kornai (2000a) argues that the question shock therapy versus gradualism was badly put. He recognizes that each element of the process has its own appropriate speed. Some processes required one-stoke intervention while other processes required incremental changes. As well, Svejnar (2002) nowadays argues that the initial conditions and the nature of reform are not adequate enough 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.

Conclusion

The aim of the neoclassical gradualist process of transition was a democratic political structure combined with a market economy. In contrast to the shock therapists, the policies of the neoclassical gradualist approach had to be approved by the democratic political process in order to facilitate transition. However, efficiency considerations should not be at the expense of democracy. Meanwhile, a gradualist approach entailed the maintenance of short-term inefficiencies. However, these priorities presented an unfortunate policy dilemma for the neoclassical gradualist economists. 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 other such devices. Consequently, the recommendation was for re-regulation of the financial system, re-regulation of international trade together with the re-regulation of state enterprises (Stark, 1990, p. 376; McKinnon, 1995a, p. 106; 1995c, p. 70; Kolodko, 1999b, p. 236).

If competitive capitalism was the ultimate goal of neoclassical gradualist economists, there was an apparent contradiction. On the basis of neoclassical gradualist approach, re-regulation and re-nationalization 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, p. 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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