

Alternative models of transition and institutional development

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Abstract: Alternative models of transition are associated with alternative institutional development processes. Alternative models of transition are based on different methods of economic analysis, political structures, views of ‘what is a good society?’ and the speed of implementing the transition policies. As a result, five alternative models of transition are considered: the Shock Therapy model of transition, the Neoclassical Gradualist model of transition, the Post Keynesian model of transition, the Pluralistic Market Socialist model of transition and the Non-Pluralistic Market Socialist model of transition (the Chinese model of transition). The most appropriate method of institutional development depended on how social reality was viewed and what was considered acceptable, desirable and feasible. It depended on assumptions about economic behaviour, the method of analysis and the goals associated with the transition process. Essentially, the choice depended on what was considered to be efficient: a market mechanism providing market-produced institutions, or state intervention providing state-produced market institutions.

Keywords: institutions; transition; global business; economics.

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1 Introduction

The collapse of the centrally administered economies cleared the way for the development of economies based on market relations. The use of market relations was proposed in terms of information and motivation. It was argued that the market was a superior form of organisation, resulting in a superior outcome compared with central administration, and even with the presence of market failure. With the introduction of market relations in Central Eastern Europe and the Former Soviet Union (CEEFSU), issues that were previously deemed irrelevant became extremely important. Concepts such as prices, credit, unemployment, money supply, interest rates and reserve ratios had never been part of long-lasting discussions in centrally administered economies (Aslund, 1995, p.40). Consequently, the hegemony of the market process among economists implied a transformation in the economic system.

Nevertheless, the transition process was not restricted to the economic field, so the debate was not solely about the superiority of market relations over central administration. Market relations are not independent of other social relations. It would seem that the institutional aspects of the transition were fundamental. Indeed, economic reforms cannot be understood or assessed in narrow economic terms. To understand and form an opinion about the transition process, it is essential to view the process in a broader social science context, incorporating institutions. To understand changes in an economic system, it is essential to analyse all the relationships that influence economic choices. In addition to economic relationships, the structure of the institutions that have an influence on economic choices must be examined. This is because the role of economic institutions is to make individuals responsive to the economic environment and make the economic environment responsive to individual actions. Alternative institutional structures give rise to different market-based economic systems.

For this reason, the analysis of the transition process adopted in this paper incorporates within the framework of economic relationships the interaction of institutions. The transition is a holistic, historical, dynamic and comparative process in nature and, as such, an institutional approach would seem appropriate. An institutional approach stresses that making economic sense and understanding economic relationships are not feasible without explicit awareness of institutions. However, an institutional approach eventuates in disagreement and in alternative transition models. Different 'views on social reality' and 'what is a good society?' give rise to alternative models of transition. A radical change such as moving towards a market economy requires reform in the institutional structure consistent with the institutional arrangements that were fundamental to the proper functioning of a market economy. The transition economies, without the heritage of a market economy and democracy, had to provide a hospitable foundation for the establishment of institutions for a market economy. An institutional arrangement can be formal or informal.

The aim of this paper is to consider alternative institutional processes as a result of alternative models of transition, based on three different methods of economic analysis (neoclassical, Post Keynesian and Marxist), two different political structures (pluralism and non-pluralism), four different views of what is a good society (competitive capitalism, social democratic capitalism, market socialism and market socialism with Chinese characteristics) and two different speeds (immediate transition and gradualism) of implementing the transition policies. As a result, five alternative models of transition

are considered: The Shock Therapy model of transition (neoclassical economic analysis, pluralistic political structure, competitive capitalism and immediate transition), the Neoclassical Gradualist model of transition (neoclassical economic analysis, pluralistic political structure, competitive capitalism and gradual transition), the Post Keynesian model of transition (Post Keynesian economic analysis, pluralistic political structure, social democratic capitalism and gradual transition), the Pluralistic Market Socialist model of transition (Marxist economic analysis, pluralistic political structure, market socialism and gradual transition) and the Non-Pluralistic Market Socialist model of transition – the Chinese model of transition (Marxist economic analysis, non-pluralistic political structure, market socialism with Chinese characteristics and gradual transition). The formation of the alternative models of transition is presented in Table 1.

Table 1 Alternative models of transition and institutional development

	<i>Models of transition</i>				
	<i>Shock therapy</i>	<i>Neoclassical gradualism</i>	<i>Post Keynesian</i>	<i>Pluralistic market socialism</i>	<i>Non-pluralistic market socialism (Chinese model)</i>
Economic analysis	Neoclassical		Post Keynesian	Marxism	Marxism Maoism
Political structure		Pluralism-democracy			Non pluralism
What is a good society?	Competitive capitalism		Social democratic capitalism	Market socialism	Market socialism with Chinese characteristics
Speed	Immediate transition		Gradualism		Gradualism Two track system
Institutional structure	Market produced formal and informal institutions		State produced formal institutions and market produced informal institutions		Market produced informal institutions

The paper is restricted to the development of theoretical and conceptual models of transition. Each model is a construction based on the values and beliefs to which most economists of the particular model subscribe. Each model is a stylised version of the view of how the economy operates, with reference to the transition from a centrally administered to a market economy, suggested by the economic analysis in question. As such, empirical evidence will be incorporated selectively. The paper is restricted to the institutional approach of alternative models of transition.

2 The shock therapy approach to institutional development

The development of the appropriate institutional structure in transition economies was one of the most challenging aspects of the transition modelling process (Sachs, 1991, p.30). The development of institutions appropriate to the market process, although essential, was extremely complex and time consuming and, once operative, was very difficult to change. This raised doubts regarding the feasibility of the shock therapy approach. Actually, these doubts were unwarranted, as the shock therapy supporters

argued. Property rights and the institutional structure, like any other good, were the result of consumer sovereignty: consumers determine not only the composition of output but also the composition of institutions.

“Contrary to the common economist’s assumption that a system of property rights is a precondition of a market economy, the development of market institutions is often a prerequisite for a viable private property regime.” (Rapaczynski, 1996, p.102)

The experience of the historical development of capitalist institutions was not that successful economic institutions replace unsuccessful ones, but rather that failed institutions remain, causing unnecessary misery (Sachs, 1995a, p.56). As such there was a choice between the government and the spontaneous market relations creating the necessary market institutions. The shock therapy supporters favoured the latter since it did not involve any coercion. As Woo (1994, p.283) argued, the experience in China ‘shows that a laggard legal system is compatible with a sustained growth rate of more than 8%’. As well, empirical evidence by Svejnar (1996, pp.124–125) revealed that the legal form of the enterprise (form of organisation, registration and commercialisation) was not linked with the level of employment and wages in the Czech Republic, Slovakia and Poland.

Thus the development of market relations did not need to be postponed until an appropriate institutional structure was in place, since the emergence of markets did not require a sophisticated institutional structure. A simple economy did not need an advanced judicially enforced system of property rights. ‘Little economic or legislative sophistication is required’ (Aslund, 1992, p.11). Some simple rules would have been adequate; as the markets evolved, so too would have the legal system and enforcement mechanisms, simultaneously. ‘Thus institutional structure was a necessary but not a sufficient condition for the needed reforms’ (Klaus, 1995, p.46). While government initiation may have developed the necessary institutions, market-produced institutions frequently appeared and were operative beforehand.

Efficient institutions could not have been intentionally designed. Governments and individuals did not have the knowledge-based, because past experiences were inadequate and, in the case of centrally administered socialism, irrelevant. No one was able to predetermine the market outcome; thus there could not have been any prescription to develop market institutions. The development of the institutional structure was path independent, which implied that the development of the necessary institutions was not culturally embedded. Institutional change comes as a result of free market relations, which would have delivered, in due course, the best outcome in response to the need for structural change based on the universal principles of self-interested behaviour. Fundamental changes in relative prices are the most important source of institutional change by altering norms, which subsequently creates incentives to construct more efficient institutions.

Thus institutional change is a derivative. The most important goal was the spontaneous development of market relations through the removal of most restrictions on individual activity. Consequently, institutional structure served to aid the development of the new market relations, and as such new market relations served to aid the development of the institutional structure. ‘Indeed, the legal responses are often only effective against a background of self-enforcing market mechanisms’ (Rapaczynski, 1996, p.102).

Certainly, Aslund (1995, p.274) declared that Russia, for example, featured a high level of economic and political pluralism, which results in the evolution of the necessary market institutions.

The shock therapy process of transition utilised market incentives to internalise the developmental process of institutions, instead of relying on the government, an external actor to the whole process. For example, with respect to environmental policy, harnessing market incentives would be the most efficient method for producers and consumers to be encouraged to internalise any externality. Consequently, a radical reform process did not inhibit the development of the institutional structure. In contrast, the mere fact of the existence of private enterprises and market relations created the need for an appropriate institutional environment. 'The evidence suggests that institutional development is stimulated by early and radical reform' (Aslund *et al.*, 1996, p.249).

The governments of mature market economies and international organisations were responsible to a large degree for the escalation of corruption in the pluralistic transition economies. This was because of the inadequate financial support provided to the transition governments, which, due to the poor economic conditions, had to compromise with the corrupt old guard (Sachs, 1995b, p.22). Only the supply of ample financial resources by mature market economies and international organisations would result in guaranteeing the success of the reform programme and of course the elimination of any corruption.

Hence, while prescribing an immediate transition to a market economy, the shock therapy supporters believed that only the market could have delivered operative institutions. Effectively, and paradoxically, the shock therapy approach recommended the gradual development of market institutions. The imperative of not using government intervention in the market resulted in a contradiction in the shock therapy model. Shock therapy supporters required the immediate destruction of the institutions of central administration, which implied the establishment of market institutions by the government, thus minimising the time necessary to create these institutions. In contrast, the shock therapy economists were willing to sacrifice speed in the context of institutional development, in order to avoid government intervention, which they regarded as totally undesirable.

3 The neoclassical gradualist approach to institutional development

Neoclassical gradualist economists accepted 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. Having market-oriented institutions in place while old institutions were torn down was crucial for reforms to be effective (Thomas and Wang, 1997, p.218). Apparently, institutional changes would have been 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. It was preferable that the development of this structure was gradual, natural, organic and voluntary, as opposed to the constructivist, state-directed establishment of institutions (Kolodko, 2000, p.274;

Kornai, 1992, p.160; 1993a, p.60; 1995, p.62; 1997, p.97; Murrell, 1992, p.80). 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. Market-supporting institutions aimed to make the transition more effective and harder to reverse.

The development of market institutions takes time, which was one reason why the transition recession in CEEFSU 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 Jr., 2000, p.131). However, history has demonstrated that transition governments had 'committed many sins of omission in this respect' (Kornai, 1993c, 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, organisational structures and social norms of society were slowly transformed into the basis for the establishment of credible commitments: people would have rationally adopted the new conventions as they emerged (Olson and Kahkonen, 2000, p.28). The preexistence of an institutional structure, even though contradictory and segmented, provided the basis for 'rebuilding organisations 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 previous norms to the new economic conditions. 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. '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, 1992, p.35). The failure of transition economies to stimulate growth after the implementation of the shock therapy process 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 stabilisation.

Governments had an important role in supporting the ever-changing market with the appropriate institutional structure. 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 privatisation process depended on how rapidly the market legal frameworks and supervisory institutions developed, how promptly the bankruptcy proceedings and liquidation processes were put in place, and on the reliability of the free transfer of property rights. Institutional change was imperative to divorce tax collection by various levels of government from the ownership of firms.

The transition economies that relied on the spontaneous appearance of the necessary institutional structure, without any government initiation, were unable to manage the transition process adequately (Kolodko, 2000, p.289). Nevertheless, governments should not have been expected to replace the spontaneous, decentralised, organic growth processes of institutions, as social arrangements might have been often more powerful

than government in establishing the rules, and fewer rules usually have advantages over more regulation.

The implementation of the shock therapy process without any institutional fundamentals in place resulted in 'bandit capitalism' in the transition economies (Kolodko, 1999, p.249). The rise of criminal activity and Mafia methods of imposing financial discipline were 'alarming and intolerable' (Kornai, 1995, p.153; 1993b, p.327). It could have partly been 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. 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 a market economy. The increase in crime was the result of weak institutional arrangements. According to a World Bank study, half the Russian economy is now in the hands of the Mafia (Kingston-Mann, 1999, p.35).

Private enterprises would have changed their behaviour and followed the road of legality if the legal structure had offered them protection of their property rights and guaranteed contracts. All necessary incentives should have been used to encourage a law-abiding and tax-paying enterprise, with the possible use of a stick-and-carrot approach.

"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, 1999, p.249)

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: these governments have not had to pour financial resources into combating fraud (Olson Jr., 1995). Consequently, the creation and advancement of a legal framework for the market economy should have been much higher on the agenda of international financial organisations. Once in place, it would have provided a secure base for growth through liberalisation and privatisation (Kolodko, 1999, p.257). Thus it was the responsibility of the newly formed governments to initiate a pluralistic process for the development of an appropriate institutional structure consistent with the political, historical and cultural traditions prevailing in the country.

In summary, the development of the institutional structure for the shock therapy and the neoclassical gradualist process approaches appear to be quite similar. However, it is my view that while both argued that market institutions can result only from market forces, the proposals of the neoclassical gradualist economists allowed institutions to develop concurrently with market relations. For shock therapy supporters, the first goal was the development of market relations, on the assumption that the institutions would have followed in due time. Neoclassical gradualist writings, like the shock therapy 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 have emerged. The neoclassical gradualist break with shock therapy was far less complete than it appeared to be.

4 The Post Keynesian approach to institutional development

Post Keynesians have been criticised by institutionalists on the grounds that their study of institutions is unsubstantial. Hodgson (1988, p.241) argued that there exists a foundation for the extension of Post Keynesian analysis using the institutional paradigm: “it was with institutionalism as a midwife that Keynesian macroeconomics was born” (Hodgson, 1993, p.260). Actually, Post Keynesians are now realising that the institutional framework can assist their understanding of economic behaviour (Dunn, 1999, p.10). A synergistic synthesis of a Post Keynesian-Institutional approach is attempted in this section with special reference to the transition economies.

Most of the institutional literature on transition perceived that the creation of guaranteed property rights was the only ultimate goal consistent with the neoclassical approach to transition. Consequently, the neoclassical transition model recommended economic policies independent of the present institutional structure because these were supposed to be present in all societies. This presumably reflected their basic assumption of perfect knowledge. In the certain or calculable probabilistic world of neoclassical economics, there is no need for forward contracts since there cannot be any deviation from the foreseeable agreed terms of the contract (Davidson, 1994, p.99). However, equations do not embody institutions. For example, monetary policy can never be independent of institutional structure in the financial sector (Arestis and Howells, 1992, p.135).

For the Post Keynesians, economic policy cannot ignore institutions since the institutional framework of an economic system is a basic element of its economic dynamics. Economic processes, which are the subject of Post Keynesianism, are dynamic, while economic equilibria, the subject of neoclassicism, are static. Post Keynesians emphasised path-dependence, the presence of which results in past states influencing later conditions. Economic action, in times of uncertainty, is part of the economy in real time. The economy cannot be separated from history: ‘institutions matter and history matters’ (Smyth, 1998, p.378). Thus ‘our actions are informed by history and limited by history’ (Brockway, 1998, p.164). Economic action takes place in historical time where past experiences – we are creatures of the past – together with the incremental evolution of institutions, influence present actions that determine the future. The future is different from the past: ‘this means that the system is indeterminate because the future is indeterminate’ (Peterson, 1996, p.156). Economic behaviour is highly influenced by institutions, since individuals are not only atomistic beings, but also, and most importantly, social beings. This is because economic behaviour is positioned in socially constructed institutional structures and not in an impersonal market process. Economic behaviour takes place within a ‘socio-economic context’, with individual constraints ‘which promote and prevent, reward and punish his or her actions’ (Kregel *et al.*, 1992, p.85). Political-economic reforms fail not because market liberalisation proceeds quickly or slowly, but because supportive institutional reforms develop too slowly. The pace of institutional development determines the pace of reforms.

Culture is extremely important in the development of the institutional structure. Culture provided a language-based conceptual framework for encoding, interpreting, processing and utilising information, thus influencing the way informal constraints were specified. Conventions and norms were culture-specific. The future is uncertain and not calculable, so rational expectations in the neoclassical sense were impossible. Most

economic activity is based on accepted conventions. For example, preferences were not exogenous in transition economies. Socially defined conventions about consumption substantially influenced consumer preferences. Because information was difficult to acquire, and limited, individuals depended on socially determined behaviour and conventions. Thus the income available to the consumer in transition economies, combined with socially defined conventions about consumption patterns, determined consumer choice. The neoclassical transition models, however, ignored the specific elements of culture in the development of the institutional structure. In the neoclassical transition models, there was no concern for the efficient design of institutions, the political and cultural consequences and how the existing institutions influenced transition to a market economy. Shock therapy supporters ignored the importance of implanted social institutions and the role of the state in the market. In contrast, Post Keynesians stressed that “actors, ideas, and politics are important to the shape of new institutions” (Fligstein, 1996, p.1080). Institutions develop as a result of local characteristics and a specific cultural framework; that is, social experience and social norms. This is because preexisting institutions influence the shape of what would have been developed. Hence the development of the institutional structure should be conceived as a path-dependent process. This means readjusting existing institutions to the changing economic framework. Institutional change was path-and-culturally-dependent, making ‘the process of transition so difficult and uncertain’ (Grossman, 1997, p.254). Institutions could not have changed at the same pace or developed into a single institutional form and should not, therefore, have been treated as a single variable.

Societies bolster a productive balance between self-interest and civic values through specific institutions. The historical development of markets was associated with preexisting institutions that made possible the development of market societies in such a way as to maintain ‘liberty, prosperity and justice in their societies for many generations’ (Davidson and Davidson, 1996, p.15). Consequently, the aim of market institutions was to encourage self-interest and, at the same time, safeguard the society from any tarnish of civic values by individualism. Institutions control diverse individual interests in an efficient manner. Failure by suitable institutional structures to restrain the pursuit of self-interest inhibits the development of a cohesive society. This, the Post Keynesians argued, was exactly what happened in transition economies. Corruption could not have been reduced in transition economies until the institutions of a market economy were fully established. When the state started to disintegrate, which resulted in an inability to foster a civilised institutional framework, the only path remaining was that of a criminal sociopath. In such circumstances, the Post Keynesians would have been in agreement with the new institutionalists that “neither self-enforcement by parties nor trust can be completely successful...Equally, however, the returns on opportunism, cheating and shirking rise” (North, 1990, p.35) in transition economies. Consequently, a broad variety of institutions of nonmarket coordination were necessary for high-performance market orientation in transition economies.

If the members of the society lose their confidence in state institutions to enforce contracts, the monetary system breaks down and the society returns to barter (Davidson, 1994, p.102). The experience of the transition economies reveals exactly this outcome, because it was impossible to attain macroeconomic stability prior to an appropriate institutional development. The shock therapy approach removed, in one shot, the old institutional structure, without replacing it, allowing the free market to set up the appropriate institutional structure. Relying on the market to produce efficient institutions

and concluding that their survival and superiority were the result of efficiency, ignored path-dependence and multiple equilibria. This was the reason for the substantial fall in output, which reinforced the Post Keynesian proposition that economic reforms should not have been initiated before the introduction of institutional reforms. The privatisation of state enterprises should have taken place at a much later stage, once an efficient institutional structure had been established.

Contrary to the neoclassical transition models, the setting up of the institutional structure required government action: 'it cannot be left to chance or left until later' (Rider, 1994, p.8). Government institutions provide certainty in an uncertain market system. The institutional structure not only facilitates the smooth functioning of the market process, but also provides solutions to market failures. There had to be a regulatory framework that internalised any externalities. Particularly in terms of monopoly power, the aim of the institutional structure should have been to restrain market power and ensure that there was adequate competition. Consequently, 'the solution then is for countries in transition to "get the institutions right" (not prices, as neoclassical theorists have maintained)' (Grossman, 1997, p.251). Should the institutional structure have been developed as a result of free market transactions? Post Keynesians would have disagreed absolutely. Firstly, it would have been an extremely time-consuming process. In addition, the market was incapable of satisfying effective demand immediately, so it would have been unable to respond to the immediate demand for a complicated institutional structure. Accordingly, the institutional structure could not have been left entirely to market forces: its development was an active and deliberate process. The 'deficiencies [of the shock therapy model] are associated with the side-stepping of the institutional hysteresis associated with any market or government action' (Yavlinsky and Braguinsky, 1994, p.90).

Institutions embody habits, routines and customs employed by economic actors, including the government and financial institutions. Informal constraints, which were culturally embedded, would not have changed immediately in response to changes in the formal rules. Informal constraints have great survival potential because, in spite of changes in formal rules, they resolve basic exchange problems among the participants, whether they are social, political or economic. The inconsistency between formal market institutions and the informal ones 'will always lead to different interpretations and applications of such laws' (Grossman, 1997, p.252), producing outcomes that could have had significant implications for the effectiveness of the reform programme. The overall constraints would have to have been restructured to produce a new equilibrium, or the unresolved tension would have resulted in political instability. Simply changing formal institutions is not sufficient. However, informal institutions are hard to change and require a gradual process.

The analysis of alternative strategies for institutional development revealed contrasting results for the Post Keynesians and shock therapy supporters. The shock therapy approach, while prescribing an immediate transition to the market economy, argued that it was only through a process of trial and error that the market could deliver efficient operative institutions, thus necessitating a gradual process of institutional development. Meanwhile, the Post Keynesians, while advocating a gradual transition process, recommended immediate state intervention to develop, implement and enforce market institutions to create the preconditions for a civilised market economy: effectively an institutional shock therapy.

5 The pluralist market socialist approach to institutional development

The market socialist model is concerned with the optimal combination of public and private property, centralisation and decentralisation, of markets and planning and of individualism and the social good. Socialism does not, and will never be able to, abolish scarcity. What it offers is a different way of dealing with economic problems: conscious intervention by communal institutions, a 'visible hand', and greater social ownership through the reduction of private ownership of the means of production. Marx emphasised the importance of supporting institutions for accumulation and the fact that institutional choice did not take place in a vacuum (Rider, 1998, p.180). Moreover, given human behaviour, and to ensure socialist outcomes from a market mechanism, the environment had to be altered so that the market outcomes were consistent with the social interests of efficiency, equity, self-management and solidarity. The transition to a socialist market would surely have required the development of new institutions, though possibly no more than those required for the transition to capitalism (Bardhan, 1993, p.154; Bardhan and Roemer, 1992, p.115).

Under market socialism there would indeed have been markets, but there would also have been a wide range of other social, political and legal institutions that would constrain them. Institutional norms would have fostered participation in self-management and the establishment of information disclosure laws and the implementation of periodic 'social audits' to monitor infringements of ecological and egalitarian standards. In this context, collusive behaviour and cartels would have been illegal. Such institutions could only have been the result of targeted societal and state action. Market exchange also requires an informal system of institutions, similar to those that have evolved painstakingly over time, and in a variety of ways, in various market economies. The development of informal relationships in transition economies required positive encouragement, the importance of which was often underestimated. Roemer (1996, p.35) stated that "I remain agnostic on the question of the birth of the so-called socialist person, and prefer to put my faith in the design of institutions that will engender good result with ordinary people".

In CEEFSU, institutions of private property did not exist. There was no independent judiciary and no bourgeois state to enforce private property rights. Yet, without these guarantees, most capitalists remain reluctant to put money into productive investments. Hence, there has been little productive investment and little development, and the economy continues to sink even after privatisation. The result was widespread corruption in which the new bourgeois was developed in a process of 'kleptocracy' (Eyal *et al.*, 1997, p.62). What shock therapy economists did not recognise was that the institutions of capitalism, including the legal, political and economic infrastructure, were not easy to replicate. As a result, trust in such institutions was seriously undermined and slowly disappeared.

Given shock therapy's insistence on the need for speed, there was no time for a native capitalist class of small private entrepreneurs to mature over decades or centuries into large corporations. For the shock therapy approach to be able to set up the basis for 'normal' capitalist accumulation, capitalists had to be created as soon as possible. 'There was no feasible way his (Sachs's) privatisation could be done legally, legitimately or morally' (Holmstrom and Smith, 2000, p.9). This class had to be 'hothoused', virtually overnight. In the end, a combination of elements was essentially drafted to privatise the economy, using criminal methods: the underground Mafia, the nomenclatura and

segments of the intelligentsia. Thus ‘spontaneous privatisation’ was a deliberate strategy by the nomenclatura and criminal elements to transform itself into a capitalist class. Indeed, economic advisors – the highly paid missionaries and the Harvard Institute for International Development (HIID) – bear much of the responsibility for the creation of CEEFSU’s criminal capitalists. Currently, there is an investigation into whether, and to what extent, the HIID broke US laws. It has been claimed that they channelled hundreds of millions of dollars from the US Agency for International Development into the hands of corrupt privatisers. Also, it is being ascertained to what extent Harvard academic advisors personally profited in the process (Holmstrom and Smith, 2000, p.9).

The transition economies lacked private capitalists with the necessary financial capital to purchase enterprises, making foreign ownership the only alternative. It was not by coincidence that foreign capital came to the rescue of transition economies. This was an act of purposeful action by the mature market economies, ensuring that foreign ownership was the only permissible medium of privatisation. A process like shock therapy implicitly has the goal of initiating the destruction of any institutional barrier inhibiting the penetration, influence and power of foreign capital. The International Monetary Fund and the World Bank were responsible for creating the depression in transition economies through the collapse of domestic markets and Council for Mutual Economic Assistance (COMECON), the development of the hard budget constraint, and the provision of foreign aid conditional on satisfying specific ‘shock therapy’ targets. In such an environment, the only interested buyers come from abroad at a price ‘for next to nothing’ (Gowan, 1995, p.45). There was ‘a brutal struggle to steal everything they could get their hands on’ (Holmstrom and Smith, 2000, p.7). Equally important was the pressure exerted on governments of transition economies to sell state assets and public utilities to multinational companies (the only possible buyers) to reduce fiscal deficits, lower inflation and discipline the labour market by inducing high unemployment. Effectively, multinationals practiced ‘cherry-picking’ in the name of global integration and national disintegration (Radice, 1993, p.10). Packages of incentives and legal regulations were often negotiated on a case-to-case basis, making the process appear arbitrary and even corrupt (Smyth, 1998, p.366). As Bucknall (1997, p.8) stated, “it must be great fun remaking nations, a chance few ever get, and it must be even better when it is personally profitable”. Nevertheless, “this does not so much suggest a new era on the globe as something rather old fashioned which, in the days of communism, used to be called imperialism” (Gowan, 1995, p.60).

6 The Chinese approach to institutional development

The Chinese experience demonstrated that the development of institutional arrangements required specific knowledge of the historic time, region, culture and government, since institutions are public goods. While the development of market institutions is tremendously important, they take time to actually materialise. Owing to the fact that China’s reform effort was experimental, based on improving performance rather than establishing a Western-style market system, it is not surprising that institutional change has also been gradual, uneven and unfinished. Maintaining, instead of destroying, existing institutions avoided the time-consuming process of individuals having to reconstruct their knowledge about the workings of the economy. In fact, the

dual-track approach used minimal additional information, compared with other possible liberalisation schemes. The dual-track approach utilised the existing information contained in the original plan and enforced the plan through existing institutions. No new information or institutions were required.

To a Western-trained economist, the centrality to any transformation process of establishing well-defined private property seemed so self-evident as to hardly merit discussion. Actually, one of the major problems with the CEEFSU transitions concerned the inability to establish well-defined private property rights. In China, the process of institutional development avoided any collapse in output. Actually, the unusual institutional arrangements in China challenge many popular notions about economic reform. In contrast to property rights theory, the Chinese 'ownership maze' demonstrated that while ownership claims are tacitly recognised, property rights in the formal sense are vague, ill-defined and fuzzy. In the Chinese economy, transparent, legally protected individual property rights were the exception, not the rule. Public ownership characterised by confused property rights was the norm. Most importantly, China's reforms have been successful in stimulating economic growth in spite of their failure to clarify property rights.

In China, institutional development was viewed as a product of simply removing controls. Consequently, the emphasis placed on informal institutions, rather than formal contracts, seemed to be a response to deficiencies in the explicit institutional structure. Therefore, once the integrity of the traditional economic system was cracked by the introduction of enterprise autonomy, institutional changes occurred in a way that was self-propelling. China's path-dependent institutional reforms have followed a path that can be explained by induced rather than designed institutional innovation. Basically, the absence of a well-defined legal framework encouraged implicit interfirm arrangements. In addition, the absence of well-developed capital markets contributed to the growth of informal rural credit cooperatives. It is clear that informal arrangements are preferable to none at all.

The experience of other transition economies suggested that there had to be a significant period of conversion to market tradition before a strong set of formal institutions could evolve. That it would have taken time for a market tradition to be developed is pertinent. Thus, introducing formal institutions might not be possible, at least in the shorter term. In a period of transition, such implicit and uncodified property rights and informal institutions have several advantages, depending on the degree of market imperfection and the pattern of market demand. Indeed, the need for an explicit legal framework was reduced, because implicit contracts were self-enforcing (Smyth, 1997, p.243). The Town and Village Enterprises (TVEs) enter into informal contracts based on its reputation, which is considered a core asset common to all TVEs. It is the effects of reputation and custom that underpin the functioning of informal institutions. Although obscure, property rights may lead to short-sightedness in investment decisions. Ownership incentives and risk sharing have, so far, outweighed this short-sightedness in investment decisions (Yusuf, 1994, p.76).

The property rights of TVEs can only be exercised collectively through the representatives of the community. There is no residual claimant in the traditional sense. In fact, 60% or more of the after-tax profits of TVEs cannot legally be distributed directly to the residents, but must be reserved for the TVEs. Most of this reserve fund is reinvested, with the remainder used as a collective welfare fund, since it is intended for social purposes. A transformation strategy centred on custom and vaguely defined

cooperatives, even with a hard budget constraint, would seem the farthest thing imaginable from the conventional wisdom of property rights theory. However, owing to this bizarre institutional structure, the dynamism of the economy came mainly from the swift entry of new, small, nonstate enterprises. Implicitly, the Chinese reformers followed Hayek (1944/1986), who argued that efficient institutional arrangements could emerge only through a spontaneous process, as the unintended consequence of interactions between self-interested actors. Consequently, informal institutions might be more efficient than formal institutions.

Nevertheless, so far two questions have not been addressed: under what circumstances might informal institutions be more efficient than formal institutions? Why are vaguely defined cooperative TVEs as efficient as private firms? It seems fair to say that standard property rights theory aspires to be universal or culture-free. The theory assumes, explicitly or implicitly, that all people are indiscriminately noncooperative, regardless of their cultural background. Weitzman and Xu (1994, pp.136–137,139) argued that conventional property rights theory might be inadequate because it missed a critical dimension: cooperative culture, the capability or desire to be cooperative. Meanwhile, governance arrangements have a high correlation with historical background and the social, cultural and commercial environment. Corporate governance operates at both the formal and informal regulatory levels, where customs, business culture, ethics, historical background, and social and commercial environments have an important role.

Let the outcome to a repeated noncooperative prisoner's dilemma game be quantified by the parameter λ (lambda), which has a value between zero and one. A high value of λ , close to one, means a noncooperative solution that resembles the outcome of cooperative collusion. A low value of λ , close to zero, means a noncooperative solution that differs from the outcome of cooperative collusion. The parameter λ represents the ability of a group of people to resolve the prisoner's dilemma and free-riding problems internally, without the imposition of explicit rules of behaviour. With a value one of λ , people in a group would be able to solve the free rider problems internally. With a λ equal to zero, people in a group would not be able to solve the free rider problems. With a λ between zero and one, people in the group would be able to cooperate effectively, the more so the larger the value of λ .

A lot of anecdotal evidence could be cited to justify the general proposition that East Asia is a high-lambda society relative to Europe, which by comparison is more of a low-lambda society (Weitzman and Xu, 1994, pp.139–141). Well-defined property rights may not be so crucial in a high-lambda society; an implicit contract may be more efficient than an explicit contract. High-lambda individuals prefer implicit to explicit contracts because there is a saving of time and energy in negotiating, formulating and enforcing the contract and there might be an incentive effect for the implicit contract.

Li (1996) explained the usage of informal institutions in China by the fact that the market environment can be characterised as a grey market. A grey market is one in which transactions may be blocked due to government regulations. However, a government bureaucrat can work around the obstacles and make the transaction possible. Thus, the grey market gets its name owing to the uncertainty regarding whether the transaction will be 'white' or 'black', *i.e.*, legal or illegal. Facing a grey market, the entrepreneur has an incentive to include the government as an ambiguous owner. Ambiguous property rights arise when the owner's rights are not guaranteed beforehand. Instead, owners have to fight for actual control *ex post*. Strangely enough, the otherwise private firm is optimally

chosen to have an ambiguous owner and property rights. The benefit of ambiguous property rights is that, when the transaction is black, the firm can get help from bureaucrats. In other words, the arrangement of ambiguous property rights is a response to the greyness of the market, which is a form of market imperfection. Hence, by choosing to register the firm as a collective, entrepreneurs intentionally invite the local government to share the rights of control. Once the local government is involved in the operation of the firm, it is difficult to preassign control rights and the division of control becomes blurred: control rights are ambiguous (Li, 1996, p.5).

It has been widely recognised that the reform process in China has resulted in an unacceptable level of corruption and rampant, unregulated and often illicit speculation. Such official corruption reduces the effectiveness of the dual-track system and undermines political support for the reform (Li, 1999, p.133). Corruption was due to the fact that the maintenance of political stability was an obsession for the reforming government. Political stability required continued commitment to the old political institutions. The maintenance of political stability enabled the state to remain comparatively effective in maintaining reasonably predictable rules. However, corruption effectively diminishes the relative power and advantages of the administrative elite.

It has been suggested that the solution to these unprecedented levels of corruption is the institutionalisation of private property rights, which are secure and transferable (Perkins, 1994, p.28). In addition, the informal institutional arrangements in the economic system have become internally inconsistent. Informal institutions entail costs, which become more manifest as the nonstate sector grows in size and informal avenues are no longer sufficient, requiring the excessive use of direct administrative means (Smyth, 1997, pp.248–249; World Bank, 1996, p.51). Subsequently, in this context, the reform of property rights in China is more important than immediate privatisation. Increasingly, economic actors can coordinate their interests through market institutions and social networks, bypassing the local party organisation to some extent. The question is whether a communist government, accustomed to political monopoly and unfettered control over economic resources, can create a legal and regulatory framework within which enterprises can further broaden their autonomy and establish institutional guarantees of private property. This would effectively ‘get rid of the communists and install a bourgeois state’ (Smith, 1993, p.97).

7 Conclusion

Alternative models of transition are associated with alternative institutional development processes. It was demonstrated that both neoclassical models, the shock therapy and the gradualist, utilised the market process as a means of developing formal and informal institutions. The distinguishing feature between the two approaches was that the neoclassical gradualist approach encouraged the development of institutions concurrently with the development of market relations, while the shock therapy approach prioritised the development of market relations believed and the institutions would follow suit.

Both the Post Keynesians and the pluralistic market socialists recommended the immediate formulation and completion of the necessary market institutions and the establishment of the necessary enforcement mechanisms as a result of state action. So while both the Post Keynesians and pluralistic market socialists recommended a gradual transition process, with respect to the institutional structure, they effectively argued for an

institutional shock therapy. In addition, the pluralistic market socialists argued that the necessary institutions for the establishment of a socialist market would probably be no more than those required for the establishment of a capitalist market. The Chinese process of transition did not show any concern with regard to the establishment of formal rules; the transition process was based only on informal rules. The link between alternative models of transition and the institutional structure is presented in Table 1.

The most appropriate method of institutional development depended on how social reality was viewed and what was considered acceptable, desirable and feasible. It depended on assumptions about economic behaviour, the method of analysis and the goals associated with the transition process. Comparisons between alternative institutional processes are meaningless after taking into account the aforementioned elements, effectively making the choice a normative one. Essentially, the choice depended on what was considered to be efficient: a market mechanism providing market-produced institutions, or state intervention providing state-produced market institutions.

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