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# Developing a civilised society in transition economies: The Post Keynesian paradigm

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**Abstract**

A Post Keynesian paradigm of transition requires the exposition of what I define as primary elements: economic analysis; definition of a good society; speed; political structure; ideological structure and the role of initial conditions. The next step is to identify secondary elements, the desired changes with respect to: price liberalisation-stabilisation; privatisation; institutional structure; monetary policy and the financial system; fiscal policy; international trade and social policy. It is argued that Post Keynesianism clarifies the reasons why the orthodox model of transition implemented in transition economies was inappropriate and unsuccessful. The Post Keynesian recommendations would have resulted in a more sensible and successful transition.



*JEL classification:* P2; P3

*Keywords:* Political economy; Transition; Post Keynesian economics

## 1. Introduction

The Post Keynesians argued that a stabilisation package with gradual liberalisation and active government intervention would have reduced substantially transition costs compared to the neo-classical paradigm of transition, shock therapy, which was imposed by the IMF, World Bank and mature market economies, and also have developed a civilised society.

While market relations were unimportant under the previous structure, they now had to be elevated to the dominant mode in the economy. This ascent of the market process required, based

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on the Post Keynesian view, a specific composition of political, economic, legal and cultural institutions in society to ensure the dominance of market relations. However, the Post Keynesian propositions were not received positively by international financial institutions, mature market economies or governments in transition economies. The association of extensive government intervention with centrally administered socialism did not allow the implementation of the Post Keynesian policies as transitional measures.

The aim of this paper is to develop a Post Keynesian paradigm of transition in the tradition of political economy. A political economy approach to the transition process would involve an analysis of what I define as the primary elements of the transition paradigm. The primary elements are: (1) Economic Analysis; (2) Definition of a Good Society; (3) Speed; (4) The Political Structure; (5) The Ideological Structure; and (6) The Role of Initial Conditions. After identifying the primary elements, the next step is to identify the elements of the paradigm with respect to the desirable reforms. The following aspect of the developmental process of transition modelling involves an analysis of what I define as the secondary elements of the transition paradigm, the areas of practical application. A transition paradigm has to answer questions relating to: (i) Price Liberalisation-Stabilisation; (ii) Privatisation; (iii) Institutional Structure; (iv) Monetary Policy and Financial System; (v) Fiscal Policy; (vi) International Trade; and (vii) Social Policy.

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

By developing a Post Keynesian paradigm it is possible to demonstrate that Post Keynesian economic analysis provides a better understanding of the complexities involved during the transition process. In addition, Post Keynesian economic analysis clarifies why the neoclassical model of transition applied to the economies of Central, Eastern Europe and the former Soviet Union was inappropriate and ineffective. It is argued that Post Keynesian policy recommendations for transition economies would have resulted in a reasonable and successful transition.

## 2. Primary elements of the Post Keynesian transition paradigm

### 2.1. Economic analysis

Post Keynesianism is based on the writings of John Mayard Keynes, particularly *The General Theory of Employment, Interest and Money*. Keynes (1936, p. 372) argued that the most prominent failure of the market system was its inability to provide full employment. The differences between methods of economic analysis are not only based on varying subject matter but also on different views of economic life. Post Keynesians have a different vision of "what is a good society?", which requires an alternative economic theory.

Post Keynesians reject the three assumptions of orthodox economic theory: the neutrality of money (changes in money cannot influence real economic variables), gross substitution (everything is substitutable for everything else) and that the economic environment is ergodic (the future can be estimated from past statistical information). Post Keynesianism is a more general theory because it is based on fewer assumptions (Davidson, 1996, p. 494). The transition process was a non-ergodic process because neither the result nor the relevant probability distributions could have been deduced from the past. The transition was a unique process.

Post Keynesians are concerned with history, uncertainty, distributional issues and political and economic institutions, all of which, they believe, influence the determination of output and employment. The economic system is defined as an amalgamation of social institutions responsible for satisfying the material needs of the members of the society by producing and distributing the social surplus. Post Keynesians argue that their analysis is concerned with the dynamic behaviour of the economic system and resource allocation. The economic system expands or contracts in time from an irrevocable past to an uncertain and statistically unpredictable future. The neoclassical concept that the economy moves to a unique and exogenously established equilibrium has no relevance for the real world (Davidson, 1994, p. 17). The capitalist economic system lacks any internal self-correcting mechanism for maintaining appropriate levels of aggregate demand, low levels of unemployment and stable prices. Thus, government economic policy is essential in avoiding such market failures. Post Keynesians elevate the role of effective demand in a monetary economy as the engine for economic growth. The goal of economic policies and institutional arrangements is to encourage high levels of aggregate demand, with the aim of achieving and maintaining full employment.

For the Post Keynesians, the economy operates in historical time, which implies that its past is unchangeable and that the future is uncertain. Economic actors make decisions with partial ignorance, due to the fact that information does not exist and cannot be inferred from any existing data. Once uncertainty is recognised as a deep attribute of real-world economies, the traditional concept of equilibrium is undermined and the simplistic propositions of laissez-faire are no longer relevant. This is because uncertainty about the future results in economic instability. In a world of rational expectations, the future is a statistical image of the past, while in a world of uncertainty, the current outcome cannot provide information about the future accurately; thus, free markets are not necessary efficient (Davidson, 1994, p. 72).

In sum, Post Keynesian economic analysis rejects the assumptions of orthodox theory, is concerned with the dynamic development of the economic system and highlights the importance of effective demand and uncertainty. It could be argued that Post Keynesian economic analysis and policy recommendations would have been more relevant to the transition economies than neoclassical economic analysis and policies as the process was characterised by uncertainty. In addition to the uncertainty associated with the normal functioning of the market, the transition process gave rise to 'transition uncertainty' due to institutional and systematic transformation, the behavioural inheritance of the past and political and social changes (Lah and Susjan, 1999, p. 591). The traditional notion of rationality (optimal positions are always calculable) was irrelevant. The procedural notion of rationality (the limited ability to process information) was relevant for transition economies due to the inability of individuals to process information accurately under transition uncertainty.

### *2.2. Definition of a good society*

Post Keynesians are in favour of a social-democratic capitalist system, which implies a variety of property forms and a market with state intervention within a democratic political system. Post Keynesians are seeking only as much freedom as is compatible with a socially desirable outcome. Post Keynesians are therefore prepared to trade freedom for other dimensions such as equality, stability, security and social justice to bring about a novel synthesis. They disagree with the view that all governments can do is to produce oscillations from equilibrium positions and are unable to influence the long-run level of economic activity. The schism between equity and efficiency in the neoclassical paradigm does not appear. Both equity and efficiency can be achieved as long as there is a redefinition of the concepts of freedom and efficiency. Efficiency does not designate maximisation of output at minimum cost but, rather, the maximisation of social welfare. This is due to the extensive nature of the externalities associated with production and consumption. Thus, the aim of economic policy should be the development of an open, democratic, civilised society, which should not be sacrificed for narrow efficiency considerations.

Market behaviour is consistent with non-self-interested behaviour. In fact, self-interest does not adequately explain economic behaviour. Individuals are motivated not only by self-interest but also by loyalty, love, compassion, responsibility, and the pursuit of excellence; individuals are also motivated by internalised moral values. Market participants require honesty, maturity and civility to finalise transactions. In the meantime, the economy itself requires ethical behaviour by individuals so as to achieve efficiency (Brockway, 1998, p. 165). Hence, the exchange of goods and services in an economy is not simply the result of the aggregation of individuals' maximising behaviour, as assumed by neoclassical economists.

Davidson and Davidson (1996, p. 7) argued that this type of individual motivation is based on 'civic values'. It cannot be assumed that interests are well defined and obvious. Information costs, cognitive processes and ideology are relevant in influencing individual behaviour. Consequently, antagonists may have co-operated to achieve common goals – society's goals – based on civic values. The aim of a transition economy should be to stimulate "capitalism with a human face" (Minsky, 1996, p. 358), "open and humane 'shared-prosperity' capitalism" (Minsky and Whalen, 1996–1997, p. 161), and a 'civilised society' (Davidson and Davidson, 1996). A civilised society cannot prosper on the hardships of its members (Davidson and Davidson, 1996, p. 24). Civic values are the result of a particular historical process, an amalgam of community, social and personal exchanges between members of the society.

Post Keynesians value the primacy of individual values, the principle of private property and the advantages of the market, stressing their importance in conjunction with the common good, state property and planning. The private sector remains the employer of first resort, while the state is the employer of last resort. Full employment is the main goal of economic policy. Discretionary economic management by the state is the means by which economic performance is linked with the community's values, objectives and trade-offs. The use of discretionary power by the central authorities guides individual choices towards social goals. To create the conditions for transition to a civilised society, Post Keynesians stress the importance of an active state in economic affairs. A weak state would be inconsistent with a prospering private sector, due to the fact that capitalism, based on free markets, is inherently cyclical and unstable. A weak state would not be able to hinder the abuse of monopoly power, which undermines the attainment of social goals and economic justice. What the neoclassical economists failed to recognise was that the transition process did not only involve the development of markets but also the development of the state (Fligstein, 1996, p. 1080).

Thus, the Post Keynesian vision of a good society and as such the Post Keynesian vision for transition economies involves a combination of individualism, private property and markets with the common good, state property and market planning.

### *2.3. Speed*

For Post Keynesians, the movement towards a market economy could only have been gradual. Institutions, organisations and patterns of behaviour and thinking could not have been changed immediately. There could only have been a slow response by economic actors to the transition process. In addition, the transition program had to be flexible enough to be adapted to the changeable character of the socio-economic conditions. Gradualism allowed for changes and flexibility in the formation and implementation of the transition program. The reforms necessary for a market economy, and the principles and objectives of the transition, could only have been determined and developed on a country-by-country basis. As the process gained momentum, the gradualist procedure enabled elements from the old way of organising to be slowly replaced by new methods. This required active state intervention.

The market is a social institution, comprising a complex network of information, which has been cultivated over time by deliberate human actions. Market outcomes are influenced by past decisions, current conditions and future expectations. Markets operate within a framework of regulations, interpersonal relations and expectations. The superior performance of the market economies may be attributed to their institutional and behavioural structure. Indeed, creating a system of effective enforcement and of moral constraints on behaviour is a long and slow process. The successful introduction of the market mechanism in a previously centrally planned economy was possible only after a change in attitudes, thinking and culture. In mature market economies, information and learning were important to inform economic actors what was expected and to encourage appropriate responses and behaviour. Consequently, the development of market relations was the result of a historical process, which takes time.

The emergence of entrepreneurs who were able and willing to take risks is an evolutionary process, not simply a result of free prices. However without a capitalist class to adopt the new opportunities for investment there is only 'destruction' without 'creation'. Such destruction would only result in the indefinite postponement of the development of a civilised capitalist class. The collapse of centrally administered socialism and the implementation of the shock therapy paradigm resulted in an uncreative destruction, which encouraged black markets, speculation, unfair trading and illegal activities. As a result, the market system lacked many of the positive attributes, which might have been achievable otherwise.

Post Keynesian economists argued that the behaviour of economic actors could not have changed as rapidly as the neoclassical transition paradigm assumed, since people would have resisted changes that reduced their living standards. The hyperinflation caused by the shock therapy approach created an environment, which was not conducive to structural, institutional and financial change. This not only made shock therapy unworkable, but also retarded substantially the development of a civilised society. Taylor (1994, p. 70) argued that the experience of developing countries had illustrated that it took decades for transitions of this type to materialise. "In short, market economies cannot be shocked into existence" (Poirot, 1997, p. 237).

Hence, the development of a civilised society is a historical process requiring a gradual transition and government intervention, implying an unavoidably long process for the new market conventions to emerge. Also, it would have allowed economic actors the time to adjust their behaviour so as to be able to take advantage of the new opportunities offered.

### 2.4. *Political structure*

The ultimate political process that the Post Keynesians perceived as generating political freedom was democracy. Democracy requires the continuing responsiveness of the ruling authority to the preferences of the members of society, through a structurally defined procedure such as elections. Democracy results in a consensus, which was extremely important for the newly-formed market economies. It would allow reforms to take place in a peaceful manner, rather than in an authoritarian fashion. In this way, the government would have gained popular support (Bigler, 1996, p. 220). As such, governments in transition economies, which did not enjoy popular support, were unable to create effective anti-inflationary policies.

Post Keynesians recognised that antagonism and conflicting interests exist in society due to the diversity of human beings. There is no correct line, no correct perception. Once central control was removed in transition economies, political and economic bargaining among individuals and groups emerged. Developing and implementing economic policies in such an environment was a challenging task. Nevertheless, since individuals were not only motivated by self-interested behaviour, as the Post Keynesians argued, there was an implicit social agreement between members of the society that promoted tolerance and conveyed disagreement in such a way that did not destroy civic values (Davidson and Davidson, 1996, p. 17). Democracy and civic values are internally linked and each sustains and promotes the other. Political civility, tolerance, compromise and mutual trust are necessary for effective democracy. Society's choice is not simply a matter of adding up individual choices. Rather, it reflects participation in the decision-making process by concerned individuals eager to derive the best knowledge available to make the appropriate choices. Self-interest and civic values all contribute to obtaining a desirable solution from society's point of view.

In the transition economies, state intervention was necessary to alter the market outcome in a desirable way, but who would have devised the desirable outcomes and how? For example, an incomes policy could not have been imposed by an independent central bank, because independent monetary authorities were inconsistent with the democratic process (Arestis and Bain, 1995, p. 161). Income, financial and exchange rate policies have distributional effects influencing the whole of society. The political process provides a solution, with continuing policy decision-making, policy correcting and policy remaking, based on participatory decision-making. Macroeconomic policies are, in fact, political decisions and, if not accompanied by a democratic process, remain despotic. Democracy in the transitional economies ensured that the process of decision-making reflected the preferences of individuals. Value judgements about economic performance in the name of the people could not have been structured without the same people participating, debating and compromising. So economic planning would have been the crystallisation of a variety of diverse opinions, ideas and interests. Democracy in the transition economies has contributed to highlighting the civic responsibility of the reform process. The shock therapy insistence on the credibility of economic policy was essentially anti-pluralistic and anti-democratic (Grabel, 2000, p. 1). The credibility criterion discredited pluralism, rejected the value of disagreement and obstructed the formation of consensus, which are all features of a civilised democratic society. The implementation of the shock therapy approach, which effectively ignored the political structure, did not allow optimism about the development of the civil political institutions in transition economies.

Therefore, the role of a democratic political structure for the transition process is to ensure popular support for governments and implement a participatory decision-making process to determine the common good.

### *2.5. Ideological structure*

The Post Keynesians have developed an appropriate ideology to encourage an acceptable role for each economic actor based on civic values. Ideology was a means to justify state intervention in the name of society. The neoclassical transition paradigm associated governments with bureaucracy, waste and corruption and markets with individualism. Post Keynesians did not share this concept. Actually, the implementation of the neoclassical transition paradigm resulted in a cultural and ideological vacuum. While individualism, private property and the market were still dominant forces, there was also a need to bring together the goals of individuals and society. Market power was not simply the result of the actions of the government. The market power of enterprises was due to economies of scale. The market power of unions was due to specialisation and industrialisation. However, the use of the discretionary power of the government could have improved the outcome of the economic system by reducing market power. The goals of economic policy would have been derived through the political process. The government should have used economic incentives to encourage individual behaviour appropriate to the social goals. Regulations could have been used where individual motivation was lacking. Individualism should have been combined with the common good, necessitating government intervention.

Thus, the ideological foundation of Post Keynesian economics justifies government intervention during the transition process.

### 2.6. *Initial conditions*

Introducing private property and markets could not have in any way delivered success, since the problems associated with the transition process involved the specific socio-economic conditions of the society in question. The neoclassical transition paradigm "ignore[d] the real environment in which the economy is located" (Rider, 1994a, p. 595). The shock therapy approach did not incorporate the differences between countries, even though they were recognised (Smyth, 1998, pp. 386–387). For the neoclassical transition paradigm, any endeavour to embody the non-economic factors would only have resulted in undermining the operation of the free market process. Although the characteristics of each transition economy differed, the neoclassical transition paradigm did not think this is important enough to justify a change in strategy. This was due to the fact that transition programs were devised by technical experts who were totally ignorant of the economic, political, cultural and history of the country in question. It was not accidental that Central, Eastern Europe and the Baltic states are performing much better than the former Soviet Union, since centrally-administered socialism was established a lot later in these regions (Smyth, 1998, p. 368). Thus, Post Keynesians disagreed with the neoclassical economists because they believed that culture and ideology and, in general, initial conditions were extremely important. Institutions and social practices function and are founded on customs, traditions, and habits which are deeply ingrained and only slowly deserted and replaced by others. Economic processes are generally path-dependent.

Consequently, the transition process, based on the Post Keynesian proposition, was a path-dependent process that relied on the initial conditions, the policies initiated and the external environment. The economy, history, politics and government intervention were inextricably linked in the development of a market system. Reform strategists should not, Post Keynesians argued, have ignored these factors.

## 3. Secondary elements of the Post Keynesian transition paradigm

### 3.1. *Price liberalisation-stabilisation*

The implementation of the neoclassical transition paradigm was based on Say's Law: the level of production was the result of the supply side of the economy. Thus, it was essential to get the prices correct at the beginning of the transition process. The shock therapy approach favoured liberalising prices immediately, under conditions of macroeconomic disequilibrium, while still having effectively soft budget constraints[1] and a monopolistic structure. "Cutting wages and eliminating price distortions are the only means that the mainstream theory has in hand for driving the economy toward high employment" (Taylor, 1994, p. 72). For the development of market relations, according to the neoclassical transition paradigm, it was enough to remove state control and economic planning from the economy and introduce private property. Market relations would only then have been the natural outcome, a necessary and sufficient condition for wealth creation. In addition, the shock therapy supporters recommended severe fiscal and monetary restraint: aggregate demand reduction was essential. However, this only resulted in temporarily reducing inflation, and the social costs were high, with persistent unemployment, reduced capacity utilisation and low economic growth. In such circumstances it was irrational to initiate immediate price liberalisation. The enterprises' response to shock therapy was very different from the neoclassical adjustment process. Enterprises reduced output, but did not improve their efficiency.

What neoclassical economists failed to recognise was that the forces of aggregate demand, and not supply, determined the level of output and thus the level of employment (Davidson, 1994, p. 10). In the labour market, the rigidity of wages was not the cause of unemployment. Wage or price flexibility was neither a necessary nor a sufficient condition for full employment equilibrium. Also, the aggregate supply constraint was neither necessary nor sufficient to explain unemployment. Flexible wages increased uncertainty, without having an influence on employment; planning was made laborious. Decreasing money wages would have resulted in a reduction of profit expectations. The volume of employment depended on aggregate demand factors, not on wage rates. In a non-ergodic world the cause of involuntary unemployment is the existence of non-producible assets, such as money, which are held for liquidity purposes. In contrast to Friedman's point of view, producible goods are not substitutes for money. The explanation of unemployment lies in the money market and not in the labour market. Unemployment is a natural outcome of a money-using laissez-faire economy. Neoclassical economists, by assuming that Say's Law holds, only solve the unemployment problem by assumption and not by economic analysis. In a non-monetary economy there is no rational explanation for the existence of unemployment. Keynes (1936, p. 192) argued that those orthodox economists who relied on rigidities to explain unemployment were "weaker spirits . . . [Whose] . . . common sense cannot help breaking in – with injury to their logical consistency".

It was questionable whether the immediate freeing of prices in transition economies would have stimulated growth. The restructuring of the economy and the reallocation of resources takes some time. It was better to have enterprises operating, even though they were inefficient, and give them the opportunity to become efficient, rather than close them through immediate price liberalisation. Freeing prices encouraged speculation, which did not stimulate increases in output and efficiency. Thus, in the presence of very rapid inflation, flexible prices would have been no better than fixed prices in achieving efficient resource allocation. Restructuring and reallocation of resources stimulated efficiency due to influential non-economic factors, such as expectations and political stability, as well as free price signals.

What the neoclassical transition paradigm did not recognise was that prices are determined in a social market, not just an economic market, by custom, power and competition. In particular,

[1] Firms under centrally administered socialism encountered a soft budget constraint, instead of the hard one faced by capitalist firms. Whenever a socialist firm was in the red, the central authority would bail it out with financial assistance in the form of subsidies, reduced taxation, provision of credit, or increased administered prices (Kornai, 1992a, p. 140, p. 145).

in oligopolistic and monopolistic market environments, prices are based on a mark-up principle. As normal cost is quite constant, mark-ups are established in the short run by custom, convention and reasonableness, and in the long run by competitive pressures and market power. In this environment, firms may maintain prices by reducing profits in the face of the threat of new entrants. Prices are not a means of resource allocation but, rather, a way of generating funds for the expansion of the firm. Enterprises in mature market economies implement pricing procedures based on normal costs and target rates of return. Likewise, enterprises under central administration applied mark-up pricing. There was no reason for enterprises to change their pricing policy with the introduction of market relations. Flexibility in prices is achieved by flexibility in mark-ups. Whenever firms are required to increase investment and lack the internal funds, they increase prices by raising mark-ups. Profit maximisation is not the ultimate goal; rather, firms aim to generate enough internal funds to finance planned investment, subject to some minimum profit constraints. Prices are not linked with current demand, but with future demand, which helps determine investment expenditure sufficient to satisfy such forecasts. All these factors could be summed up as the 'animal spirits' of the entrepreneurs. The institutional environment in which firms make decisions determines these animal spirits. Subjective and psychological elements also influence animal spirits, which are in part endogenous and in part exogenous. In such a world, it is an objective fact that the future is uncertain in a non-predictable way and, as such, it is natural that investment would be volatile.

During the transition process, there should not have been a concern over 'equilibrium' prices, because reforms took place in a state of disequilibrium. The neoclassical transition paradigm was based on an obsession with static efficiency, while the transition process was a dynamic phenomenon, making neoclassical economics irrelevant. Due to uncertainty, investment was reduced in transition economies. This exaggerated reductions in aggregate demand, which, in turn, reduced output and increased inflation and unemployment. There was a 'capital strike' (Taylor, 1994, p. 65). In such circumstances, it was the role of the government to intervene and stimulate the economy with public investment. Public investment would have also crowded in private investment by reducing production costs and creating a favourable investment climate. As a result, wage income would have grown, stimulating non-inflationary growth in consumption.

In the Kaleckian and Keynesian traditions, savings adjust to investment, rather than the reverse, which is assumed in neoclassical theory. Thus, credit has to be created to finance investment ahead of the generation of the corresponding savings. Due to the endogenous nature of money, credit is created by the banking system. High proportions of profits are saved, and such profits form a substantial part of total savings. Hence there is a close link between profits, savings and investment. "The investment market can become congested through a shortage of cash. It can never become congested through a shortage of savings" (Davidson, 1994, p. 132). Almost all corporate investment is financed out of retained corporate profits, while net household saving is close to zero and, in addition, households mainly lend to each other in the aggregate (Palley, 1998a, p. 100). In transition economies, the banking system was not familiar with the new economic conditions and was unable to create the necessary credit. Profits were not adequate to provide savings, due to substantial reductions in output. These profits were also spent on imports or deposited in foreign banks. Savings were not available from the previous generation because there had been no savings incentives under the previous economic structure. As a result, the government had to appropriate and direct savings into productive investment. Such mobilisation of savings could only have taken place via the state-run development functions of the new government (Peterson, 1996, p. 166). This could have been part of an industry policy designed to stimulate demand and encourage access to capital, skill and infrastructure enhancement.

Inflation was an immediate problem faced by transition economies as a result of introducing market relations. What neoclassical economists did not realise was that inflation was not necessarily the result of 'excess demand', but rather arose from a fundamental conflict over the distribution of income. Conventional instruments of fiscal and monetary policy per se could have not controlled inflation (Arestis et al., 1999, p. 541). Post Keynesians favoured an incomes policy together with price controls, increased imports and a buffer stock policy for important resources and agricultural products to ensure adequate supply and price stability in the long-term. A tax-based incomes policy is a 'clever' anti-inflationary policy (Davidson, 1994, p. 149). It is consistent with a civilised society, because it combines self-interest and civic values in the determination of wages. Under a tax-based incomes policy, firms that pay a wage increase above the socially acceptable non-inflationary level, based upon the average labour productivity growth, would be penalised by higher taxes. Davidson (1994, pp. 150–151) compares the tax-based incomes policy to road regulations controlling driving behaviour. While speed limits are set at a socially acceptable level, the magnitude of the limit is based on the driving conditions. A tax-based incomes policy is fundamentally linked with expansionary fiscal and monetary policies. As a result, "planned recessions would be a thing of the past" (Davidson, 1994, p. 151). Surprisingly, both neoclassical approaches, shock therapy and gradualism, also recommended an incomes policy.

Hence, for Post Keynesians, markets do not grow organically; rather they must be created. As Polanyi (1944, p. 139) stated "there is nothing natural about laissez-faire. Free markets could never have existed had things been left to take their course ... laissez-faire was created by the state". The development of market relations could not have been the responsibility of the market; there was a need for government action.

### 3.2. Privatisation

The neoclassical supporters of transition, in either form shock therapy or gradualism, were in favour of immediate privatisation of state enterprise through auctions or free distribution of vouchers. However, the implementation of the neoclassical privatisation process resulted in a cruel deception, in which many individuals colluded, a few profited, and the public at large was the great loser. Privatisation, in an environment of hyperinflation and instability, could only have bred corruption. Instead of the development of an efficient private ownership structure, managers responded to the high level of uncertainty by breaking their firms into numerous joint stock and limited liability companies along divisional, factory, departmental and workshop lines. This gave rise to a new form of ownership, which Stark (1996, p. 1014) named 'recombinant property': "recombinant property is a particular kind of portfolio management. It is an attempt to have a resource that can be justified or assessed by more than one standard". In this way, managers and banks controlled and reaped the benefits of the most profitable parts of the enterprise, while the unprofitable, loss-making and inefficient parts became the responsibility of the state. Recombinant property did not increase efficiency because, firstly, it did not reduce monopoly power, since the same management effectively still controlled the numerous break-ups. In addition, there was a loss of economies of scale. Rather than genuine restructuring, there was a transfer of the responsibility to the state.

Large-scale privatisation was not essential to overcome shortages as the neoclassical transition paradigm stipulated. It appears that the soft budget constraint explained inflation rather than shortages. However, according to the Post Keynesians, selling state enterprises to the highest bidder, as recommended by neoclassical gradualist economists, violated equity principles. The amount of savings available in the transition economies was not enough to finance a large privatisation drive. The only people who could have purchased firms were those who had benefited under the previous regime through black-market and illegal activities. The typical answers from neoclassical economists – "the firm is worth whatever someone is willing to pay for it" or "let the market decide" – were problematic when there was not yet a market and where, in fact, the explicit motive for the sales was to create a market (Stark, 1990, p. 359). There were political as well as equity reasons against auctioning firms, because there would have been a lack of support from the majority of the people: the true owners of state assets. Meanwhile, contrary to the neoclassical transition paradigm, where culture did not matter, Stark (1992) argued that the privatisation strategies pursed had a high degree of national path-dependence.

The superiority of private property over state property, as a number of economists argued, should not be interpreted as implying that state property did not have a role. There was a role for state property in areas where private property did not function efficiently, that is, wherever there was market failure. The contentious issue is whether state property should be instituted beyond the areas of market failure. Post Keynesians would argue that there is a role for state property beyond market failure. In addition Post Keynesians claimed that market failure was extensive, encompassing, for example, market power and information. Their main contention, however, was that the majority of property should still remain in private hands.

Vickers and Yarrow (1991, pp. 113–118) argued that empirical evidence demonstrated that private property had efficiency advantages in competitive conditions, but was not superior when there was market power. Meanwhile, when state-owned firms were subjected to competition similar to private firms, their performance was superior (Comiso, 1992, p. 28). It was not ownership that determined efficiency but environmental factors. Thus, the development of competitive conditions and a regulatory framework should have been the goal, not ownership. The case for privatisation in the transition economies became even less clear when the underdeveloped markets for capital, corporate control and managerial labour were considered. The absence of a capital market where take-over could be initiated, the lack of corporate control in the form of institutional norms and the substantial imperfections in the managerial labour market could only have promoted managerial failure. Under these conditions, enterprise managers did not behave in an 'optimal' way, as prescribed by the neoclassical paradigm. This actually facilitated 'spontaneous privatisation' – the transformation of state enterprises into joint-stock companies – whereby the managers became the new owners (Stark, 1990, p. 366).

The Post Keynesians concluded that no form of ownership was perfect. Private firms suffered market failures, a divergence between private and social benefits and costs. Public enterprises experienced government failures, a divergence between political and social benefits and costs. Therefore private ownership with competitive and regulatory markets, while eliminating government failure, still gave rise to market failure. The more desirable ownership structure depended on the magnitude of the imperfections. For this reason Stark (1996, p. 1023) argued that "it is not in finding the right mix of public and private but in finding the right organisation of diversity to yield both adaptability and accountability that post-socialist societies face their greatest challenge". Consequently, there were no firm guidelines with respect to appropriate ownership structure. The experience of mature market economies demonstrated a variety of ownership structures in these economies and the changing character of ownership structure over time. As such, the framework of political and social institutions, traditions and history, and the state of economic growth of the particular country, had to be included in the analysis of the development of property relations. Consequently, there was no single ideal strategy with respect to privatisation. It had to be done on a case-by-case basis, depending on the type of asset, the internal organisational structure, the level of technology and the need for capital.

The initial distribution of private property was paramount for the Post Keynesians, in contrast to the shock therapy approach, since the initial distribution of property would have determined those members of society who would have started from an advantageous position. In an environment in which market power was permanent, due to the nature of technology and industrialisation, the ‘free’ market process would not have been able to alleviate any of the arising inequalities. Rather, these inequalities would have increased in magnitude. In relation to whether restructuring should have preceded privatisation, the answer was clear for the Post Keynesians. They believed it was the responsibility of the government to use discretionary measures to ensure the viability of enterprises before and after privatisation. The government should assist and equip enterprises with the essential internal structures necessary to survive the competitive market process. Moreover, the maintenance of state enterprises facilitated the development of a civilised society, since the transition would not have necessarily involved a massive increase in unemployment.

In summary, for the Post Keynesians, there could have been a transition to a market economy without a substantial change in property ownership. This was because ownership, as such, was less important than competition, the incentive structure and the nature of regulatory policies. There would have been no gain to society if state enterprises were replaced by private monopolies. Thus, restructuring and the establishment of the regulatory framework needed to precede privatisation. However, some critical minimum of property rights reform was necessary.

Post Keynesian methods of privatisation would have incorporated restitution of state property to the rightful owners and liquidation of enterprises, which could not have been revived. In addition, efficiency and equity would have guided the process and this would only have been possible through the distribution of free shares to the people. The government would have needed to retain a percentage of shares as a source of revenue, with the balance going to the workers, to pension funds in order to finance retirement benefits, and the rest to the population. Such an exercise would have attracted political support from the people. In addition, free shares to the workers would have provided them with a financial incentive to restructure their operation into a more efficient one based on their ‘inside’ knowledge. The transfer of state property to financial intermediaries was another alternative to outright privatisation. The advantages were that it was less time consuming and people with specialised skills would have been in charge. Labour-managed firms were viewed favourably by Post Keynesians. Post Keynesians believed worker motivation would have increased to make enterprises efficient and profitable, at the same time mobilising support for the transition process. Labour-managed firms required government financial assistance and an appropriate institutional structure so that they were not disadvantaged. Labour-managed firms could have become a transitional mechanism, allowing people gradually to adjust their behaviour in a participatory environment. It was up to the reformers to exploit and further develop the pre-existing cooperative property structure.

### *3.3. Institutions*

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. The neoclassical transition paradigm, however, ignored the specific elements of culture in the development of the institutional structure. In the neoclassical transition paradigm there was no concern with the efficient design of institutions, the political and cultural consequences and how the existing institutions influenced the transition to a market economy. Shock therapy supporters ignored the importance of implanted social institutions and the role of the state in the market. But the failure by suitable institutional structures to restrain the pursuit of self-interest inhibits the development of a cohesive society (Kregel et al., 1992, p. 1). 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 path (Bucknall, 1997, p. 21).

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 stabilisation 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 was 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.

Consequently, the neoclassical transition paradigm 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 (Clower, 1999, p. 400). For example, monetary policy can never be independent of the 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 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'. 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 was 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 are impossible. Most economic activity is based on accepted conventions (Robinson, 1974, p. 8). 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. 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 was because pre-existing 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 meant 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 single variables.

Societies bolster a productive balance between self-interest and civic values through specific institutions. The historical development of markets was associated with pre-existing institutions, which 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 the diverse individual interests in an efficient manner. Consequently, a broad variety of institutions of non-market co-ordination were necessary for high-performance market orientation in transition economies.

Contrary to the neoclassical transition paradigm, the setting up of the institutional structure required government action: "it cannot be left to chance or left until later" (Rider, 1994b, 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.

### *3.4. Monetary policy and the financial system*

With respect to the financial structure, the neoclassical transition paradigm examined the problem of transition in the context of a hard budget constraint. A soft budget constraint would have violated the concept of relative scarcity, a fundamental aspect of the market process. The recommended hard budget constraint was based on the assumption that savings determine investment and also that Say's Law applied. Experience, however, showed that the introduction of a hard budget constraint, especially for state-owned enterprises, did not establish a hard budget constraint. "This is absolutely unthinkable under the monetarist paradigm but quite natural in other frameworks of economic analysis" (Yavlinsky and Braguinsky, 1994, p. 100).

In contrast to the neoclassical economists, who consider money to be neutral, the Post Keynesians view money as "a dominant – if not the single most important – institution in systems of market capitalism" (Peterson, 1996, p. 157). Money is not just a medium of exchange and a measure of value but also a store of value which, in a monetary economy, individuals value more than income itself: it is a means of limiting losses in a profit-and-loss economy. The Post Keynesians view non-neutrality of money and endogenous money supply as crucial in inducing changes in the real sector (Davidson, 1994, p. 128). Non-neutrality of money exists under both flexible and sticky wages and prices. As a result, it is not possible to split the capitalist economy into separate real and monetary sectors. Monetary policy is extremely important, since it has implications for income distribution. Post Keynesians propose that monetary policy, money and finance are integral in understanding the economy.

Post Keynesian monetary theory begins with production for the market is always monetary production under uncertainty, and money can never be neutral in an economy that operates in historical time. Consequently, Post Keynesians require an active domestic and international monetary policy. In the Keynes-Kalecki-Kaldor tradition, investment is an autonomous factor. It cannot be represented as a stable, downward-sloping function of the interest rate. The autonomy of investment is possible because of the credit system from which firms can borrow. Investment determines how much credit firms seek from outside sources. Credit often comes from the banking system, which leads to the creation of money. Furthermore, a supplier of investment goods may grant credit, for example, to the purchaser. Thus, the level of credit taken on by the firm is determined by, rather than being the determinant of, the level of investment. Essentially, the stock of money, in contrast to the monetarist view, is endogenous. It is determined by the level of investment, which also implies that investment takes place independently of the level of current savings. However, banks and financial institutions may be short of liquidity as a result of monetary tightening initiated by the central bank, or may be unwilling to lend due to excessive risk, or firms may be constrained by a low level of corporate cash flow (Palley, 1998a, p. 100). The endogeneity of money, as a result of credit provided by financial institutions, is central to the Post Keynesian view of the economic world. Money responds to the needs of production through the credit provided by the banks. The central bank determines the rediscount rate and the banks provide loans to creditworthy customers at the rediscount rate, plus a risk-related mark-up. New loans create new deposits.

The development of a modern banking system in the transition economies was essential, the Post Keynesians argued, because it established the relations between debtors and creditors, which were the foundation of capitalism. A financial system, which has the ability to create money as a result of market transactions, was essential in the operation of a market economy. However, the financial system is "a necessary but not sufficient condition for lifting an economy out of an unemployment morass" (Davidson and Davidson, 1996, p. 150). Liquidity is essential for economic activity in a market economy where the future is uncertain and full of surprises. "Liquidity is freedom" (Davidson, 1994, p. 225). However, any time individuals wanted to increase their liquidity this comes at a cost to consumption resulting in a reduction in output and employment. It is the responsibility of the government to increase government expenditure, effectively acting as a lender of last resort when there is a deficiency of private spending, to ensure full employment in a civilised economy. The expansion of government expenditure results in an increase in the demand for money and the banking system responds by endogenously expanding the money supply. This endogenous money supply increase will take place pari passu with additional orders for purchases of goods and inputs, which is correlated with an income-generated finance process (Davidson, 1994, pp. 135–136).

The fact that demand for credit by enterprises is endogenously determined is an important feature distinguishing the Post Keynesian from the neoclassical approach. Banks respond to the demand for loans and not to the independent demand for deposits (Moore, 1979, p. 427). For the individual firm, at the micro level and in the absence of borrowing, the level of savings determines the level of investment. Conversely, in the context of the whole economy, at the macro level, it is investment that determines savings. What holds for one enterprise does not hold for all enterprises. Hard budget constraints do not really exist because, given the cost of obtaining credit, firms have a soft budget constraint whether they operate in a market or a centrally administered system. Any move towards a market economy would certainly have failed if reformers ignored the existence of the soft budget constraint. Thus, "the problem of shortage can in no way be solved by reducing the role of planning and state control in the economy as suggested by Kornai" (Szego, 1991, p. 336). After the implementation of neoclassical stabilisation policies in the transition economies, the soft-budget constraint persisted and so too did the output reduction due to uncertainty. Consequently, Post Keynesians argued, there was a need for government intervention in financial markets. The government's role was to increase confidence in the financial system by providing the appropriate incentives and regulation for the development of a healthy financial system.

The new economic conditions required the development of a two-tiered banking system comprising the central bank, which prints money and controls the stock of money, and the private banking sector, which accepts deposits and provides credit. For the Post Keynesians, the central bank should not have been independent, as the neoclassical transition paradigm claimed, because this would have required the central bank to formulate monetary policy independently of civic values, which required full employment. "The tendency toward independent central banking (both at national and international levels) can be seen as a rejection of the spirit of Keynes since it has become associated with the idea that the control of inflation must dominate other macroeconomic policy objectives" (Arestis and Bain, 1995, p. 161). An independent central bank paradigm did not allow governments to use the money supply to fund budget deficits. Thus, the only option available to transition economies was to reduce the budget deficit by reducing government expenditure in an environment of high pre-existing social transition costs. The theoretical and empirical suggestion of the link between the independence of the central bank and price stability is the result of very restrictive assumptions, based on very strong and narrow views of how the economy operates (Grabel, 2000, p. 6). Additionally, banking innovations have undermined monetary targeting.

Hence the Post Keynesians recommended government intervention to establish a healthy financial system, which facilitated restructuring. This required some banks to be state-owned to counterbalance the market power of private commercial banks.

### *3.5. Fiscal policy*

The recommendation for transition economies by neoclassical economists and the neoclassical-dominated international financial institutions, the International Monetary Fund (IMF) and World Bank, was to achieve a balanced budget. The conditional loans by the IMF and World Bank were based on reducing government expenditure and achieving a balanced budget at any cost. Meanwhile, the transition economies have suffered from chronic fiscal problems. Private enterprises have excelled at avoiding tax under the current inadequate institutional structure. Depression has accompanied privatisation, inhibiting any increase in tax revenue. Therefore, Post Keynesians argued that transition economies, to achieve a successful transformation, had to take into account the revenue factors when considering such policy areas as privatisation and international trade. Aggregate demand is the key policy instrument in influencing the economic activity in a market economy. Post Keynesians argue that the level of aggregate demand, determined by individual actions, is insufficient to create full employment at the going real wage. It is the responsibility of the government to adjust aggregate demand to the level of full employment since, in a decentralised market; there are no automatic mechanisms to ensure an appropriate level of aggregate demand. Thus, budget deficits during recessions, as in the transition case, were essential to maintain full employment. However, these budget deficits should have been the result of productive government expenditure on private-public infrastructure development in order to stimulate employment and, thus, promote a civilised society. The deficits should not have been due to reductions in taxes, such as the Reagan supply-side deficits. Increasing investment is much more effective than increasing consumption; this is because investment directly influences aggregate supply and consumption indirectly. As such government fiscal policy plays the 'balancing wheel' in an economy (Davidson, 1994, p. 79, 1996, p. 503).

### *3.6. International trade*

The neoclassical transition paradigm was in favour of immediate liberalisation of international trade. In the neoclassical paradigm, the effect of protection on prices of finished goods is complete, while materials tariffs are never significant and production effects are entirely determined by supply. But the free trade initiated by the shock therapy approach was "overshooting in the sense that it is causing deindustrialisation" (Yavlinsky and Braguinsky, 1994, p. 103). The emphasis of the shock therapy approach on comparative advantage, as a means by which international trade would take place, ignored the role of economies of scale, which might have been more important than comparative advantage (Yavlinsky and Braguinsky, 1994, p. 104). In such circumstances, the substantial reduction in output initiated by the implementation of the shock therapy transition paradigm had a negative impact on international trade because firms were unable to exploit economies of scale, which proved to be far more important than was assumed by neoclassical analysis.

The comparative advantage theory of international trade was developed in a specific historical period where natural resource endowments and capital-labour ratios determined economic location. Today, this has been replaced by an era of knowledge-intensive industries where comparative advantage is human made rather than created by Mother Nature and history (Thurow, 1996, p. 214). Natural resources have ceased to dominate economic activity. Long-run economic growth is the result not only of the country's resource endowments but also, most importantly, of its capacity to satisfy both domestic and foreign knowledge-intensive production processes. Differences in production opportunity costs are due to what each society believes to be civilised working conditions (Davidson, 1994, p. 242). The presence of high and persistent unemployment and of very large transaction costs contradicts the assumptions of comparative advantage. Hence that Post Keynesians argue comparative advantage is irrelevant. Industry policy should facilitate strategic economic advantage.

Post Keynesians argued that a flexible exchange rate system encouraged only financial currency speculation and not production, discouraged forward contracts, and encouraged stagnation in the domestic and world economy (Davidson, 1994, pp. 238–239). It prompted countries to solve the problems of unemployment and inflation by shifting them onto their trading partners in an uncivilised way (Davidson, 1994, p. 262). Post Keynesians note that *The Financial Times* and the *Economist*, which supported the freely floating exchange rate and pressured the international community to adopt it, have changed their view. They have admitted it was a failure and that the advantages were grossly overestimated (Davidson, 1994, p. 264; Davidson and Davidson, 1996, p. 182).

Under a flexible exchange system expansionary monetary and fiscal policy result in exchange rate depreciation, a reduction in aggregate demand, inflation and capital flight, leading to both budget and trade deficits (Palley, 1998b, pp. 345–346). This is because it is not possible to achieve full employment and balanced trade at the same time by maintaining purchasing power parity. Thus, it "is a barbaric conservative policy that can improve one's own job position only by exporting unemployment. The ultimate effect of these policies is to reduce the standard of living of both deficit and surplus nations" (Davidson and Davidson, 1996, p. 184). The resulting trade wars, for example during the 1930s, created instability and were to the detriment of the whole international community. In a world of imperfect competition and market power, domestic firms forced consumers to pay higher prices to make their products effectively cheaper overseas, cross-subsidising export growth.

Post Keynesians recognised the positive benefits associated with international trade. Meanwhile, because open economies are more complex than closed economies, the market outcome would have been even less likely to be a socially desirable outcome (Davidson, 1994, pp. 198–199). Active government intervention was essential from the start to restructure external trade and payments appropriate to a civilised market economy. Contrary to the neoclassical view, Post Keynesians argued that an appropriate level of protection would have been essential for enterprises to survive on an uneven playing field. The experience of mature market economies revealed that their development and industrialisation were strongly linked with protectionist measures. Consequently, globalisation did not automatically result in trade liberalisation; rather, there seemed to be powerful forces, which supported the construction of trade barriers. In the Post Keynesian paradigm the effect of protection on the prices of finished products is quite small and due mainly to tariffs on inputs, while the effect on production depends on demand. Thus, tariffs produce a demand and not a supply reaction, and price changes are minor (Norman, 1996, p. 523, p. 528). Consequently, based on the Post Keynesian paradigm, transition economies should not have expected a substantial reduction in prices or inflation by the removal of tariffs.

Post Keynesians viewed the recommendation for establishment of a payments union by neoclassical gradualist economists as a positive element in the transition process. However, they were very critical of the temporary nature of the payments union in establishing only convertibility, after which it would have ceased to exist since no other goal justified its existence. A Post Keynesian approach would have favoured a permanent mechanism for international trade between transition economies, which offered stability and the development of a civilised society. The Payments Union would have evolved, if it were established – and there is no reason not to establish it today – to an Eastern European Clearing Union similar to the International Clearing Union suggested by Keynes for the international financial system. Through the clearing union, a fixed exchange system would have eliminated the instability and negative outcomes caused by the flexible exchange rate system. There would have been no advantage in engaging in export-led growth and importing inflation. In this international system, fiscal and monetary policies would still remain the responsibility of the sovereign state. Through the clearing union "as in all civilised games, all participants are winners who reap benefits" (Davidson and Davidson, 1996, p. 206).

The Post Keynesian paradigm recommended an adaptive strategy that combined open but managed trade with government expenditure adjustment programs. "A fixed exchange rate regime operating in tandem with intelligent internal demand and incomes management policies will create an environment where all nations simultaneously can be winners and economic growth increases globally without any nation necessarily running into a balance of payments constraint" (Davidson, 1994, p. 256). Economic policy co-ordination has, therefore, become a necessary condition for achieving sustained economic prosperity in the new globalised economic environment. A concurrent generalised expansion of income across countries, through a co-ordinated approach, might have helped to mitigate the problems of trade deficits and capital flight driven by international differences in inflation and interest rates. This would have enabled countries to stay on an expansionary course. In the absence of such co-ordination, the adverse policy incentives that promoted the macroeconomics of austerity and the lowering of the wage floor would have inevitably asserted themselves (Palley, 1998b, p. 352).

### *3.7. Social policy*

Transition economies failed to estimate the dangers associated with the inadequate provision of social services. Such policies were necessary for the reform process. The substantial reduction in government expenditure, as it was recommended by the shock therapy approach, and the establishment of the "safety net" proved to be totally insufficient. The demise of the health care system resulted in the life expectancy of Russian men dropping to 57 years, similar to that in many Third World nations (Intriligator, 1998, p. 243; Gustafson, 1999, pp. 183–184). The increase in mortality and morbidity rates was a momentous embarrassment for the international organisations, such as the World Bank, which had been allocating resources to achieve appropriate health standards (Ellman, 1994, p. 2). Even Aslund (1995, p. 287), one of the architects of shock therapy, recognised this unacceptable result.

Post Keynesians argue that social provisioning in the transition economies was necessary due to the high social cost involved. Supplementation of income and the provision of social services were society's responsibility, and the legal right of each disadvantaged individual. Society recognises those who need assistance by using civic values as the yardstick. People need financial support and essential social services as well as time to become familiar with the new economy; hence, it must be a gradual process. It was recognised by Post Keynesians that people were unable to use their potential resource capacity to provide a decent standard of living. Under the abnormal economic conditions of transition, "income distribution is too important to be left solely to the capricious forces of the market" (Davidson and Davidson, 1996, p. 177).

A civilised society, in the mould proposed by the Post Keynesians, required a social policy that addressed chronic unemployment. Unemployment causes psychological problems. Hence social policies were necessary to reduce anti-social behaviour due to unemployment. The social policy of Post Keynesians is based on the right to work and to a basic income (Jackson, 1999, p. 639). Post Keynesians are in favour of the government assuming the role of employer of last resort, offering public service jobs to anybody who wants to work at a low fixed wage. This eliminates involuntary unemployment and achieves full employment. This wage becomes a constraint upon private sector wage increases that are not linked with productivity. This is a desirable way of achieving price stability, instead of creating the 'natural rate of unemployment'. Employers would have benefited from a pool of trained and work-oriented workers. The program would have been funded from the budget and, at the same time, there would have been a reduction in welfare payments. The employer of last resort program was politically feasible and did not require a substantial amount of financial resources (Jackson, 1999, p. 639). In addition, basic income is defined as a cash benefit given to all members of the society irrespective of their personal and financial circumstances. It enables individuals to survive without having to work (Jackson, 1999, p. 639). It would allow individuals to express their work preferences, freely taking up jobs that they would prefer, thus increasing their productivity. "In sum, neither the claim that social security distorts competitive labour markets, nor that it reduces net national saving stand up to close inspection. The empirical evidence is that households view social security wealth as compensation" (Palley, 1998a, p. 108).

## 4. Conclusion

The Post Keynesians propose that the market outcomes should be desirable from a societal point of view that, in turn, requires discretionary government policies. Consequently, institutional and non-economic factors become relevant in the paradigm, not as imperfections but as important elements of the transition process. Limiting the growth of aggregate demand through restrictive fiscal and monetary policy does not reduce inflation. It reduces output and increases interest rates and unemployment. That is exactly what happened in transition economies. Thus, laissez-faire was and is not optimal.

The implementation of the shock therapy approach took place in an environment where "most practical economists in Russia know very little about mainstream economics, but mainstream economists know very little about the Russian economy. As could easily be expected, one area of knowledge is really no substitute for the other" (Yavlinsky and Braguinsky, 1994, p. 103). If the historical experience of the successful post-war reconstruction of Western Europe approximated the economic conditions of transition economies – which is questionable – the successful policies adopted then totally contradict those implemented in Central, Eastern Europe and the former Soviet Union. During the period of reconstruction, price ceilings and subsidies were maintained and economic planning was implemented. Monetary and fiscal reforms and policies were adopted and the European Payments Union was established, with the aim of restoring trade among countries. Exchange rates were controlled and capital flows restricted, and the USA provided financial and technical support under the Marshall Plan. Lastly, markets were influenced and guided by an active state, with the aim of supporting the initiatives of firms. The state was able to implement these policies only under a consensus process, which encouraged co-operation rather than conflict. The successful post-war reconstruction of Western Europe reveals, "there is no single policy that can restore high-wage full employment. Instead, a successful program will have to be multidimensional and comprise structural reform, monetary policy, fiscal policy, international economic policy" (Palley, 1998b, pp. 349–350). Therefore, Post Keynesians rejected any idea that there could have been a completely 'free market' economy in the transition economies.

In terms of today's global economic problems, including those of the transition economies, Keynes would have argued that aggregate demand policies, together with policies to reduce inflation, were necessary for transition economies. The political leaders of the transition economies and the public were misled by the prevailing ideology of the free market in relation to the role of the government and budget deficits. Government discretionary policies were not the problem, but part of the solution. The policies implemented, based on orthodox economic analysis, failed to reduce unemployment and develop a civilised society, making it even more difficult to attain the Post Keynesian goals. A different program was required, consistent with the Post Keynesian propositions to initiate recovery. Thus, a hands-off approach is totally inappropriate because it is socially undesirable.

For the Post Keynesians the advice of shock therapy was wrong, arrogant and catastrophic. Yavlinsky and Braguinsky (1994, p. 115) suggested "in the old days, engineers who constructed a railway bridge in Russia had to stand under it when the first train crossed. One should either stake one's life in this transformation or do something else . . . and ask all those advisors who care so little about the countries they try to help that they are unable even to theorise properly to stay at home".

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