

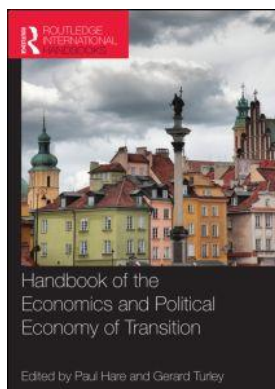
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Paul Hare, Gerard Turley

Theories and Models of Economic Transition

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John Marangos

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11

THEORIES AND MODELS OF
ECONOMIC TRANSITION*John Marangos¹***Introduction**

The collapse of centrally administered socialism in the Soviet Union and Eastern Europe initiated the movement from a centrally administered economy towards a market economy, commonly referred to as the transition process. The word 'transition', the passage from one state to another, might seem appropriate; nevertheless, it did not explicitly capture all the complexities involved. The transition process entailed superseding the essential properties of the centrally administered economy, consequently further destabilizing the former economic system, and replacing it with a market economy.

Any exposition of the transition problem in the economic literature must necessarily be a simplification of the complexities involved. One approach taken in writings on the transition process reduced the issues to an isolated variable of the economic sphere. The various aspects of the transition problem were pigeon-holed in thematic sub-categories, thus avoiding the inter-related nature of economic institutions and behaviour. Others took an alternative approach, and provided a solution to the problem by explicitly or implicitly favouring specific behavioural assumptions and/or economic relationships. Furthermore, others omitted the impact of the political process, ideology, institutions or the initial conditions on the transition process, showing little or no interest in the political, ideological, institutional outcomes of the economic policies implemented and whether the initial conditions influenced those outcomes. Thus, modelling of the transition process was highly subjective and based on value judgements.

The aim of this contribution is to overcome those weaknesses by proposing an alternative conceptualization of the transition process. This involves substituting a more holistic approach for the 'pigeon-hole' methodology adopted by most writers. The elements of the reform programme are interdependent, mutually supportive and interactive. This paper emphasizes the interrelated nature of the reforms which results from the interrelated nature of economic institutions and behaviour. Because of this interrelatedness, there were grave dangers associated with making one or more elements of the reform programme central, while discounting others. But despite the limitations of economic analysis, the transition process itself was never restricted to the economic field. The development of market relations is not independent of other social relations. It would seem that political, ideological, institutional aspects and the initial conditions of the transformation were fundamental. Indeed, economic reforms cannot be understood or assessed solely in narrow economic terms.

The chapter is restricted to the development of theoretical and conceptual models of transition. Each model is a construction based on the values and beliefs, which most economists adopting the particular model, subscribe to. Each model is a stylized version of the view of how the economy operates, with reference to the transition from a centrally administered economy to market economy, suggested by the economic analysis in question.

What follows is structured in the following manner. First, an answer is provided to the question of what the transition process entailed. Next, I argue that a political economy approach is most suitable in analysing the transition process. However, a political economy approach gives rise to alternative theories and models of transition, which are then presented. Non-market alternatives are not considered. Finally, the practicality and usefulness of the political economy approach, as adopted herein, is expounded in the conclusion.

What did the transition process entail?

During the transition process, there is a co-existence of elements of centrally administered socialism and market relations; thus, traditional economic theory based on the presence of market relations was most likely not appropriate. As such, the transition was effectively implemented in the dark. Thus, while not only the collapse and the timing of the collapse of centrally administered economies surprised economists, many aspects of the transition process also did. The transformation was one of the most dramatic non-marginal adjustments in economic systems ever experienced. The complexities involved did not have any historical parallels and people's desire for quick results caught economists unprepared. In the end, economic science responded by developing an appropriate body of economic analysis – transition economics – to facilitate and provide some form of direction to the aforementioned process.

An attempt to solve the transition problem involved several questions, of which the most important were:

- (i) *What should the end state be?*
While most economists agreed on the introduction of market relations in the Russian and Eastern European economies, the market as such is not a homogeneous entity. Experience shows that market capitalist economies are not all identical.
- (ii) *What is the process by which the desirable end state will be achieved?*
This question included reference to the speed and sequencing at which the necessary reforms should be implemented.
- (iii) *What are the means that should be used to induce the reforms?*
This question reflected the choice of policy instruments.
- (iv) *What elements, if any, of the existing structure of the centrally administered economy should remain?*
This question asked whether any aspects of the centrally administered economy were consistent with and desirable in a market economy.

The answers to these questions could not be derived by using mainstream economic analysis alone, but also depended on one's perception of social reality. Given assumptions about economic behaviour, the questions arose of how the economic system functions and responds to changes, and what is a good society? The answers to these questions reflect one's assessment of each economic and non-economic performance dimension, as well as the weights one assigns to these performance dimensions. In addition, alternative economic theories, mostly conflicting, utilize criteria for determining how society and the economy function and how society should distribute responsibilities between the market and the state, with the purpose of solving economic

problems. Thus, different views on social reality and the nature of a good society are associated with distinct methodologies and a particular set of social values which have implications for economic policy formulation. This gives rise to alternative theories and models of transition, based on different assumptions, diverse methods of analysis and different goals.

A political economy approach to transition

The success of the transition reforms depended not only on specifying the necessary economic conditions, but also on whether certain conditions were satisfied with respect to the non-economic elements. In general, reformers are constrained by the lack of sufficient information, the social, legal, cultural and economic institutions, the physical environment and systemic factors. For this reason, the analysis adopted in this paper is in the tradition of political economy, which incorporates the interaction between political institutions, social consciousness and ideas within the framework of economic relationships. The transition process is holistic, historical, dynamic and comparative in nature and, as such, a political economy approach would seem appropriate. Political economy stresses that making economic sense and understanding economic relationships are not feasible without explicit awareness of power, institutions and values. A political economy approach to the transition process contests the belief that economics and politics are interested in distinct terrains within the society and that they employ different methods of analysis. Consequently, the analysis of the transition process was consistent with the tradition of political economy, as economics alone is and was not enough (Murrell, 1991, p. 62). However, a political economy approach generates disagreement and results in alternative transition theories and models. For economists disagree over what defines a good society and thus they disagree about the different weights assigned to economic performance indicators.

A political economy approach to the transition process gives rise to alternative theories and models of transition. The distinguishing features of the different transition theories and models based on each set of unique elements are presented in Table 11.1.

Theories and models of transition

Economic paradigm

This contribution develops five alternative theories and models of transition, based on three distinct views of economic paradigms: the neoclassical, post-Keynesian and market socialism. The neoclassical model of transition encompasses an approximation of competitive capitalism as the desired outcome and uses the neoclassical economic paradigm. The fact that there is disagreement about whether competitive capitalism is an appropriate goal, and whether it is feasible, gives rise to the need to consider alternative theories and models. Consequently, a critique of the neoclassical model which assesses its weaknesses and inadequacies gives rise to an alternative model based on post-Keynesian propositions. The aim here is to develop a model of transition, broadly defined as 'social democratic', which overcomes the weaknesses of the neoclassical model and is also both realistic and feasible, as argued by post-Keynesian economists.

In this context, it would also be appropriate to consider a market socialist model of transition. As the designation of the model implies, it is a combination of a market system and socialist principles. The market socialist model is concerned with the optimal combination of centralization and decentralization, of markets and planning, of individualism and the common good, and of public and private property. The market socialist model incorporates the Marxist economic paradigm and thus takes a different view of the way the economic system functions.

Table 11.1 Alternative theories and models of transition

<i>Models of transition</i>				
<i>Primary elements</i>	<i>Shock therapy</i>	<i>Neoclassical gradualism</i>	<i>Post Keynesian</i>	<i>Market socialism</i>
Economic paradigm	Neoclassical		Post Keynesian	Marxism
What is a good society?	Competitive capitalism		Social democratic capitalism	Market socialism
Speed	Shock therapy	Gradualism		
Political structure	Pluralism			Non Pluralism
Ideological structure	Self-interest		Self-interest Common good	Self-interest Common good Participation through the party
Institutions	Product of market forces		Product of state action	
Initial conditions	Not a concern	Some concern	Important	Extremely important

Source: Adapted from Marangos (2003).

The issue of speed

The movement towards a market economy may take two forms: the shock therapy approach and the gradualist approach. Within the neoclassical model we can distinguish between shock therapy and the gradualist model of transition. The shock therapy approach requires an immediate and rapid transition to the market, while the gradualist model favours an evolutionary process towards a market system. The issue of speed addresses the issue of human consciousness and perceptions when a dramatic change in behaviour is required, such as the transition from central administration to markets. The opposing views, with regard to speed, reflected the different beliefs about individual responses, which can either be rapid or time-consuming. The distinction with regard to speed was relevant only for the neoclassical model, since both post-Keynesians and market socialists were in favour of a gradual approach. They agreed with the neoclassical gradualist economists that change had to be slow since institutions, organizations and patterns of behaviour and thinking could not be changed immediately. In the following, an analysis of the alternative adjustment paths takes place.

Shock therapy

The shock therapy approach was characterized by a rapid implementation of reforms, minimization of time intervals between measures, and fast correction of policy mistakes. 'The main issue is to cross the rising river as fast as possible in order to reach the other shore and establish a firm foundation for the construction of a new economic system based on the market' (Åslund, 1992, p. 87). The shock therapy approach assumed that the transition process did not necessarily

imply a reduction in output as important reforms in economic structures were not necessarily associated with a reduction in living standards. Thus, it was argued that the stabilization programme and the institutional reforms should have taken place at the same time. Lipton and Sachs (1990, p. 100) quoted Gonzalo Sanchez de Losada, Bolivia's former Planning Minister, who in 1986–89 administered the reform process in his country and stated that, 'if you are going to chop off a cat's tail, do it in one stroke, not bit by bit'. Getting the prices right from the beginning would encourage entrepreneurship under hard budget constraints. The underlying assumption was that individuals would always respond quickly to the incentives provided, even when dramatically new behaviour was required. Most importantly, a gradual process would have resulted in the wastage of the precious reserve of political capital developed after the collapse of centrally administered socialism. At the time, people were willing to accept radical solutions to the difficult economic problems they faced, providing a window of opportunity for reforms, that might not last for long.

Gradualism

Neoclassical economists who were in favour of the gradualist approach, along with the post-Keynesians and the market socialists, argued that the changes in the economic system, which were required to complement the introduction of market relations, could not be introduced rapidly: these changes inherently take time. There was need for gradual change, since institutions, organizations and patterns of behaviour and thinking would not change immediately. These elements could only take shape and function after an 'organic historical development' (Kornai, 1990, p. 52). So the process of change had to be slow. It could be speeded up, but nevertheless needed to be gradual. Otherwise 'artificial transplants hastily forced upon these societies will be rejected by their living organisms' (Kornai, 1990, p. 20). Gradualists insist that complementarity between reforms requires gradualism as institutional reforms are slow-moving processes. The gradual approach allows people to adjust their behaviour and thinking with minimum psychological costs; thus reducing their resistance to change. In contrast, the shock therapy supporters argue that the longer the transition process, the more time available for self-interested pressure groups to regroup and use their monopoly and political power to oppose the reforms.

The political structure

The transition process also depended on developments in the political structure. 'In the transition, the liberalization of political markets is often as important as the liberalization of economic markets' (Parish and Michelson, 1996, p. 1043). This is because market reforms initiated 'modern' civil societies, stimulating the emergence of autonomous interest groups, political parties, independent media, and opportunities to participate in political processes. Political legitimacy and cohesion were essential elements of the reform process, which was so extensive and radical.

The political structure determines the decision-making process in society, and this has consequences for the structure and function of the central authorities. It also determines the bureaucratic constraints, that is, formal and informal orders or prohibitions enforced through pressures or threats upon the individual by the bureaucracy. Political decisions would influence market structures. There is a link between economic and political structures. Once a society has chosen its economic structure, this will have consequences for the decision-making processes, and especially for the structures and functioning of the central authorities. In terms of political structure, we can distinguish between two alternatives, namely the pluralistic and non-pluralistic structure. In particular:

Political pluralism

A transitional model with political pluralism introduces fundamental changes with consent, debate and discussion, agreement and compromise. With pluralism there is recognition that antagonism and conflicting interests exist in society, based on the diversity of human beings. There is no single correct line, no sole and invariably correct perception of issues. It means that the common good will not be laid down in an authoritarian or totalitarian manner by the state, but is determined through a plethora of different opinions which are freely discussed. However, the adoption of pluralism would also result in changes in the economic model which reformers strive to introduce. The transition process based on pluralism may influence the model itself. Such changes may be of a minor nature and could be incorporated without altering significantly the basic model. For example, the acceptance of multi-party politics, the concessions for private property and hiring labour were not included in the original Gorbachev market socialist model, but were added at a later stage. However, pluralism exacerbated the difficult situation of transition in the Soviet Union by allowing the people to show their dissatisfaction. The attempt to keep the Union together in a political pluralistic environment resulted in large concessions to the republics, which ultimately resulted in the break-up of the Soviet Union. It was a 'cost' that the reformers had to pay, if pluralism was to be an essential precondition for the implementation of the model. The neoclassical, post-Keynesian and pluralistic market socialists incorporate pluralism in their theory and model of transition.

Non-pluralism

This is where the transition to a market economy is characterized by a non-pluralistic process, based on a political party which is a leading role party (with a monopoly of power), which adopts a leading position (its views determine most decisions) and a correct line (the party scientifically derives the correct understanding of things). Those in favour of a non-pluralistic process argued that the implementation of such radical reforms required a politically stable and powerful government that had enough authority to implement the reforms, independent of public opinion and vested interests. In this way, the government would be able to concentrate on the reform process and avoid any problems associated with the political process, thus formulating unconstrained economic policy. Authoritarian rule may likewise be capable of achieving a dynamic improvement in the standards of living. A transition process based on non-pluralism would have avoided the problems that Gorbachev had to face, according to non-pluralistic socialists. In broad terms, the Chinese transition process uses a non-pluralistic process; the Chinese transition process, however, is also multi-level, characterized by competition between districts, provinces, etc.

The choice between pluralism and non-pluralism effectively had to do with the nature of economic and political power and whether the central authority was willing to relinquish some of its power in favour of participation by the people through pluralism. Accordingly, it depended on whether the reformers were willing to accept the input of the people in the development of the transition programme, at the cost of altering the model significantly.

Ideology

Ideology refers to a cohesive set of values and beliefs about others, the world, and ourselves. It embodies a distinct 'world view' as to how society and, thus, the economic system functions. 'Ideas and ideologies shape the subjective mental constructs that individuals use to interpret the world around them and make choices' (North, 1990, p. 111). The introduction of market

relations in the former centrally administered economies unavoidably eventuated in a change in the dominant ideology. This was because human behaviour takes place within a given ideological framework, with its specific values, beliefs and worldview. Ideology is a set of directives for activity as well as the means for rationalizing human behaviour assisting in overcoming the free-rider problem.

Ideology advocates a particular pattern of social relationships and arrangements, and determines the goals of human activities and the moral standards of human behaviour. Ideology determines and creates human personality, which influences the identity of a society. Thus, we should regard ideology as a set of directives for activity, as well as the means for rationalizing human behaviour. It is used to justify a specific economic structure, which its supporters seek to promote, realize, pursue or maintain. The economic, political, legal, moral and religious institutions are what they are because they facilitate and uphold the ideological framework of the society. Ideology can encourage within a market system:

- a *Self-interest*. With respect to the ideological structure, market economies have developed an ideology that emphasizes and encourages self-interest and self-help based on Adam Smith's famous arguments. Neoclassical economists stress that in order to be able to understand social phenomena we need to understand individual actions. Individuals are allowed, within defined limits, to follow their own values and convictions rather than somebody else's, and individuals should not be subject to coercion. The neoclassical model would be in favour of stimulating a self-interest ideology.
- b *Common good*. The question arose whether there was a need to bring together the goals of the individual and society. Should there be any restriction on individual behaviour in a market system in the name of the common good? If the answer were 'yes', then how would the common good be determined? Perhaps by an open pluralistic process where individuals come together to plan for the common good, or through a leading-role, leading-position and correct-line party? The answer needs to be incorporated in each transition model. The post-Keynesian model combines a self-interest ideology with the common good within a pluralistic political environment.
- c *Participation*. The decision-making process does not only involve the formulation of the common good, but may also involve the breakdown of hierarchical relations within the enterprise and society. The question then arises whether the transition theory and model will allow the effective participation of the workforce in the decision-making process of the enterprise. The market socialist theory and model integrates self-interest, common good, and participation. While the pluralistic market socialist model would encourage participation in all aspects of decision-making, the non-pluralistic Chinese model encourages participation only through the party mechanism.

The role of institutions

A radical change such as moving towards a market economy required a reform in the institutional structure consistent with the institutional arrangements fundamental for the proper functioning of a market economy. This was because any 'attempt to account for the diverse historical experience of economies or the current differential performance of advanced, centrally planned economies and less-developed economies without making the incentive structure derived from institutions an essential ingredient appears to me a sterile exercise' (North, 1990, p. 134).

The role of economic institutions is to make individuals responsive to the economic environment and make the economic environment responsive to individual actions. The institutional structure determines the rules of the game in a society, which are human-devised restrictions

that mould human interaction (North, 1990, p. 3). It identifies the constraints in that rational economic actors comprehend, plan and endeavour to achieve their goals. Institutions encourage competitive or co-operative behaviour, reduce or increase transaction costs and provide the organizational foundation for production and exchange. In addition, society's interests are embedded in the institutional structure and change as institutions change in accordance with customs, regulation, ideology and *ad hoc* decisions by those who hold power. Hence, under the new economic conditions of emerging markets, economic actors struggle to establish institutions to facilitate competition and to serve their interests through both informal arrangements and formal institutions.

The question that had to be answered by the transition theories and models was how would an appropriate institutional structure be developed in transition economies. Does it involve government action, as Kregel *et al.* (1992, p. 28) argued that institutions 'often emerge spontaneously and through repeated social interaction but in many cases they have to be made by conscious action', a statement with which the post-Keynesians and the market socialists would agree. However, Rapaczynski (1996, p. 87) differs, stressing that institutions are '... largely the product of market forces, rather than government fiat'. Neoclassical economists, following Hayek, interpret the presence of institutions as an outcome of 'human action' rather than 'human design'. As such, the likelihood of designing institutions, as post-Keynesians and market socialists argue, is regarded as utopian, an immaterial exercise, that not only will not work but will be counterproductive.

Initial conditions

While the Russian and Eastern European economies were structured on the basis of a central administration, this did not mean that these economies were identical. The need for change was recognized long ago and the political authorities in these countries had experimented, to varying degrees, with reform. In addition to each country's initial economic structures and economic conditions, there was a need to incorporate their own political, cultural, ideological, and institutional elements, power relationships and the role of the state. All these elements were unique to each country. Therefore, the question arose: 'What is the impact of strategy and policy, and sequencing, as opposed to country-specific initial conditions such as politics, pattern of industrialisation, or institutional structure?' (Parker *et al.*, 1997, p. 3).

The shock therapy supporters argued that the transition programme they proposed had general application across economies with immensely different initial conditions and political environments. The basic elements of a market economy could have been adapted to different historical and cultural environments. For the remaining theories and models, to varying degrees, the efficiency and feasibility of any transition strategy depended on the specific conditions prevailing in the individual countries. The neoclassical gradualist economists showed some concern for the initial conditions, since they shaped the gradual transformation of the society. However, they argued that this should not have been used as a pretext to substantially delay the reforms and distort the achievement of a free market. The post-Keynesians considered the initial factors important, while for the market socialists they were extremely important in shaping socialism, because of the hostile capitalist world the transition countries would be surrounded by if they chose the socialist path.

Conclusion

A political economy approach to the transition process gives rise to alternative theories and models of transition. The development of each theory and model is based on a set of ideas, to

most of which individual economists who subscribe to the particular body of analysis would conform. The shock therapy theory and model is based on neoclassical economic analysis, has a goal of competitive capitalism, it uses a shock therapy approach towards speed, the political structure is pluralistic, the ideology encourages self-interest, the necessary institutions will be the result of market forces and the initial conditions were not a concern (Marangos, 2002).

The neoclassical gradualist model is based on neoclassical theory, has a goal of competitive capitalism, it uses a gradual approach to reforms, the political structure is pluralistic, the ideology encourages self-interest, the necessary institutions will be the result of market forces, and there was some concern for the initial conditions (Marangos, 2005).

The post-Keynesian model uses post-Keynesian theory and has social-democratic capitalism as a goal; it adopts a gradualist approach towards speed, the political structure is pluralistic, the ideology encourages self-interest and the common good, the necessary institutions will be the result of state action and the initial conditions were important (Marangos, 2004).

The pluralistic market socialist model uses Marxist economic analysis and has market socialism as a goal; it uses a gradualist approach towards speed, the political structure is pluralistic, the ideology encourages self-interest, the common good and participation, the necessary institutions will be the result of state action and the initial conditions were extremely important.

Finally, the non-pluralistic market socialist model uses Marxist economic analysis and has market socialism as a goal; it uses a gradualist approach towards speed, the political structure is non-pluralistic, the ideology encourages self-interest, the common good and participation through the party, the necessary institutions will be the result of state action and the initial conditions were extremely important.

In this way, a political economy approach makes it possible to understand the transition process from a new and more enlightened perspective. With this approach, we are better able to comprehend the complexities involved and the disagreements between social scientists about the transition process.

Note

- 1 Part of this chapter is based on John Marangos (2003), 'Alternative Politico-Economic Models of Transition', *Journal of Economic and Social Policy*, vol. 8(1), pp. 52–71; see journal website, epubs.scu.edu.au/jesp. I would like to thank the Managing Editor of JESP, Associate Professor Jeremy Buultjens, for allowing me to use elements of the published paper.

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