A Political Economy Approach to the Neoclassical Model of Transition

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ABSTRACT. The neoclassical model of transition from a centrally-administered socialist economic system to a market-based economic system was implemented in Russia and Eastern Europe. The neoclassical process took the form of either shock therapy or gradualism. However, each approach actually involved a combination of shock therapy and gradualist policies, making the distinction between the two approaches unfounded. In addition, both approaches suffered by the innate inadequacies of neoclassical economic analysis as being politically/institutionally naked. Both shock therapy supporters and gradualist neoclassical economists did not provide a specific process of institutional development, favouring a gradual market-driven institutional outcome. With regard to the political structure, democracy was inconsistent with shock therapy, while active state intervention during transition was inconsistent with the ultimate goal of the gradualist neoclassical economists of competitive capitalism.

I

Introduction

THE DOMINANCE OF NEOCLASSICAL ECONOMICS in the economic literature and of economic policies in market economies was the only decisive factor in determining the transition strategy of Russia and Eastern Europe. The neoclassical model of transition from a centrally-administered socialist economy to a capitalist market economy provided a set of liberalisation, stabilisation, and privatisation policies based on the

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neoclassical body of economic analysis. The neoclassical model of transition was also adopted as the only solution to the transition problem by the international financial institutions—International Monetary Fund (IMF) and the World Bank—that provided financial aid upon the implementation of policies recommended by the neoclassical model. Consequently, the debate on transition had nothing to do with the goal, method, or ideology underpinning the transition process. These elements had already been decided and imposed upon transition economies. The goal had to be competitive capitalism, the methodology neoclassical economics, and the ideological foundation of the reform had to be self-interest. Nor were the initial conditions of each country a concern. As a result, the debate on transition was restricted to the speed of the reforms. The only concern was whether transition economies should immediately liberalise, stabilise, and privatise, the shock therapy approach, or implement the neoclassical policies at a slow pace, the gradualist approach.

The aim of this paper is to demonstrate that the debate between shock therapy supporters and the gradualist neoclassical economists[1] was immaterial. Both transition approaches adopted a combination of shock therapy and gradualist strategies. A careful investigation of the reforms recommended and implemented with regard to price liberalisation and stabilisation, privatisation, monetary and fiscal policies, and international trade policies reveals contradictions and inconsistencies in each approach to the point that the distinction is, in fact, invalid. Meanwhile, it is important to recognise that the transition process also depended on developments in the institutional and political structure. Incorporating the institutional and political structure into the transition analysis, which is consistent with a political economy approach, further highlights the contradictions of shock therapy and gradualism, reinforcing the inadequacies of neoclassical economic analysis as being politically/institutionally naked.

II

Economic Reforms in Transition Economies

THE SHOCK THERAPY MODEL derived its name from Poland's stabilisation and liberalisation program, initiated on January 1, 1990. The countries that followed this approach are Czechoslovakia (starting on January 1, 1991), Bulgaria (February 1, 1991), Russia (February 2, 1992), Albania (July 1992), Estonia (September 1992), and Latvia (June 5, 1993). Jeffrey Sachs was an advisor to the Polish government and both he and Anders Aslund advised the Russian government and guided its shock therapy reform process in 1992 to 1993 (Schlack 1996:617). Aslund was, in fact, an economic advisor to the Russian government from November 1991 to January 1994 (Aslund 1995:xi). Sachs and Aslund "shared the belief that the economy [in Russia] was in such a terrible mess that a radical, comprehensive, liberal program would be needed to introduce any kind of rational order" (*ibid.*, p.16).

The shock therapy model highlights the interdependent, mutually supportive, and interactive character of economic relationships, implying that reforms should be introduced simultaneously. Fragmented changes are ineffective. "The idea that there is choice between doing one radical measure or another is simply wrong. There is no trade-off but, on the contrary, complementarity" (Aslund 1997b:187). Thus macroeconomic and microeconomic reforms must be concurrent (Sachs 1990:21). This was why the reform program needed to be sweeping and expedient. Jeffrey Sachs stated, "Poland's goal is to establish the economic, legal and institutional basis for a private-sector market economy in just one year" (1990:19). The program has been described as a "leap to a market economy" (Sachs and Lipton 1990:48) and a "jump to a market economy" (Sachs 1993).

The fundamental basis of the gradualist neoclassical approach to transition was the need to establish economic, institutional, political, and ideological structures before any attempt to liberalise. Without this minimum foundation, radical reforms would have inhibited the transition to a competitive market capitalist system. Moreover, the implementation of the reform program required minimum standards of living; otherwise the social fabric of the whole society would have been at risk. The aim of the gradual neoclassical transition process was to initiate a profound and unique change, a "transformational recession" (Kornai 1993a:182, 189; 1994:41), and to overcome the "shortageflation" syndrome (Kolodko 1993:21) by initiating "preventive therapy" (Kornai 1997:183). This was only possible by taking "the longest road" (Abel and Bonin 1993:230), or by "rebuilding the boat in the open sea" (Elster, Offe, and Preuss 1997). The gradualist neoclassical transition process was implemented in Romania (Poirot 1996), Hungary, which has a tradition of a gradual transformation starting in 1968 with the New Economic Mechanism (Kornai 1993a; Samonis and Hunyadi 1993; Szekely and Newbery 1993; Wolf 1991; Hare 1991), and Slovenia (Kornai 1997).

A. Price Liberalisation and Stabilisation

Price liberalisation and stabilisation were preconditions for a successful reform process (Blanchard and Layard 1993). The shock therapy economists were in favour of an adjustment approach, which involved an immediate jump in the price level. It was better to face a single increase in prices than high and persistent inflation, since there was nothing beneficial associated with high inflation and its resulting corruption (Aslund 1995), and so that investment decisions would not be distorted by transitional prices. In contrast, for the gradualist neoclassical economists, the adjustment to the new price levels needed to be gradual (Kornai 1994). Stable domestic price levels permitted greater domestic financial deepening and higher real deposit rates, reducing risks and greatly simplifying the liberalisation and stabilisation of the real exchange rate (McKinnon 1993). The price controls were not a fruitless exercise; they facilitated the transition and reduced the associated costs to society.

An efficiently functioning labour market was a principal prerequisite to a successful transition process (Frydman, Rapaczynski, and Turkewitz 1997). Strangely enough, while the objective of both approaches was market-determined wages, both approaches argued that it was in the interest of society in the transition phase to maintain some control over wages and to avoid the wage-price spiral. Whereas this is consistent with gradualism, it is inconsistent with shock therapy. Sachs and Lipton (1990) recommended a tax-based wage policy to encourage wage increases below the increases in inflation. For example, the Polish government initiated penalties on wage increases, the so-called *popiwek* (Balcerowicz, Blaszczyzk, and Dabrowski 1997). Enterprises conceding wage increases above the norm were heavily taxed (Sachs and Lipton 1990). The gradual process of reaching equilibrium wages recommended by the shock therapy supporters through a tax-based wage policy was in agreement with gradualist neoclassical economists (Kornai 1996; Fischer and Gelb 1991; Nuti 1991). Progressive taxation above the predetermined norm would act as a disincentive to excessive wage increases (Fisher and Frenkel 1992; Kolodko 1999a), while partial indexation of wages, not automatic indexation, would maintain industrial peace and reduce inflation (Bim 1992; Kornai 1996; Fischer and Gelb 1991).

B. Privatisation

Privatisation and financial restructuring manifested the greatest intellectual and political complexities of the entire transition program (Sachs 1991a; Aslund 1992). This was because privatisation was driven by conflicting objectives (fairness, compensation, restitution, enterprise efficiency, budgetary revenues, and employment) and based on previously unknown methods (vouchers, management acquisitions, and workers buyouts) (Sachs 1996a). It was also fraught with administrative complexity as thousands of small, medium, and large enterprises operated within incomplete markets and a legal vacuum, making corruption highly probable (*ibid.*). For the shock therapy supporters the privatisation process had to be initiated concurrently for all enterprises, using across-the-board mechanisms. Therefore, privatisation should take place through a combination of different methods but, preferably, privatisation of industry should be through free distribution of vouchers (Sachs 1991b).

The concerns and reservations that shock therapy economists had about the privatisation process were unfounded. The aim of the shock therapy process was to develop an economy based on market relations without the presence of discretionary power. Whether the privatisation process gave ownership of state enterprises to the workers, management, or general members of society, these owners would only be able to retain their ownership rights if they used their property productively by satisfying market demand at minimum cost. Hence, in a competitive market, which is the ultimate goal of shock therapy supporters, only efficient owners and efficient behaviour would be able to survive, irregardless of how the initial distribution of ownership took place. Consequently, the development of a free market process would derive an efficient ownership structure in due time, making the method of privatisation unimportant. The distribution of private property to the efficient owners through the impersonal market process could only take place after some considerable time.

Kornai (1990) argued that the transformation of state property into private property could only take place by auctioning state enterprises and selling them to the highest bidder. The Hungarian government agreed that privatisation had to result in "real owners" or "strong owners" rather than artificial recipients of state assets (Frydman, Rapaczynski, and Turkewitz 1997; Samonis and Hunyadi 1993; Mihalyi 1993). Ironically, large state enterprises had to be renationalised before they could be privatised, and, even then, the gradual neoclassical approach was not gradual (Stark 1990). Instead of a gradual process of privatisation, enterprises were put up for auction. Hence, the gradualist neoclassical privatisation process was more of a "deferred shock therapy privatisation" process. The only difference between the gradualists and shock therapy supporters was the timing of privatisation, not its speed.

C. Monetary and Fiscal Policies

Shock therapy supporters believed that the independent central bank had to establish credit targets to hold overall money growth to levels consistent with a rapid elimination of inflation (Sachs 1993), implying the elimination of the soft budget constraint. This is because inflation is a monetary phenomenon (Aslund 1993; Rostowski 1993). By establishing an independent central bank with the monetary rule written in its constitution, inflation and the soft budget constraint would be eliminated. But laying the institutional foundations to ensure an independent central bank was a lengthy process.

The gradualist neoclassical economists argued that the imposition of hard budget constraint on enterprises, in the context of macroeconomic stabilisation, was the driving force of adjustment. The soft budget constraint resulted in inefficiency, breakdown of consumer sovereignty, and distorted investment decisions. Thus, reform of the financial system had to be a high priority (Calvo and Frenkel 1991). Meanwhile, the elimination of the soft budget constraint could only evolve gradually, as for example in Hungary (Kornai 1997, 1993b; Csaba 1995). Consequently, an independent central bank was inconsistent with the gradual elimination of the soft budget constraint.

The reduction of large budget deficits was required in order to eliminate hyper-inflation. As the budget deficit was the main source of money creation, and hence inflationary, the reduction of the budget deficit topped the agenda of any economic reform plan (Fedorov 1992). Sachs (1994) argued that while reducing the budget deficit could reduce inflation, altering the way in which the deficit was financed could also reduce inflation. In as much as the budget deficit was financed by foreign financial resources (such as foreign borrowing, grants, and aid) or by domestic borrowing (by the creation of a Treasury bill market), inflation would not result. Consequently, it was possible to have low inflation with a budget deficit. In fact, the shock therapy supporters recognised that the goal of a balanced budget could not be achieved immediately. Sachs (*ibid.*) was critical of the IMF's insistent focus on budget cuts rather than deficit financing and effectively retaining a budget deficit. In actual fact, IMF aid was conditional on reducing the budget deficit (Martinez-Vazquez, Rioja, Skogstad, and Valen 2001).

Balancing the budget was a long-term concern for the gradualist neoclassical economists (Csaba 1995). However, in order to avoid further inflationary explosions, "effective fiscal reforms must come much earlier in their transitions" (McKinnon 1995a:96). While every effort had to be made to reduce the budget deficit—or ideally to produce a surplus (Roe 1991)—a reduction was seen as unlikely in the first years of transition (Kornai 1992a; Csaba 1995). Reducing the deficit too drastically or too quickly would be dangerous. Rapid and drastic cuts in government expenditure would suddenly reduce aggregate demand and cause deeper recession. As a result, the urgency for growth did not require an immediate reduction in the budget deficit (Kornai 1995a). Instead, privatisation of the state enterprises through auctions increased state revenue, funding the budget deficit (Kornai 1992b; Hare 1991; Roe 1991).

Thus, both approaches were in favour of maintaining the budget deficit and achieving a balanced budget gradually. The disagreement lay in the financing of the deficit. Of course, this was directly linked to the method of privatisation. The shock therapist supporters opted for mainly free distribution of vouchers, which did not provide any revenue; thus, the budget deficit had to be financed by borrowing or grants. The gradualist neoclassical economists supported auctioning of state enterprises, thus giving rise to the necessary revenue to finance the budget deficit.

D. International Trade Policies

The liberalisation of international trade and the establishment of a convertible exchange rate were among the most important prerequisites for successful capitalism (Aslund 1995). Essentially, "convertibility and external liberalisation are natural bedfellows" (Sutela 1992:89). Sachs (1996b, 1997), Aslund (1995), and Sutela (1992) were in favour of a pegged exchange rate at the start of the stabilisation program, changing to a more flexible rate after one or two years. This was because the pegged exchange rate had some advantages in times of high inflation. In the transition economies, the early peggers—Czechoslovakia, Estonia, Hungary, Poland, and Slovakia—performed much better than the floaters, both in terms of the rate and cost of disinflation. The peggers achieved inflation below 100 percent per year by 1994 (Sachs 1996b:149). Meanwhile, the successful short-term implementation of the pegged exchange rate can be interpreted as an argument in favour of a fixed exchange rate system and gradualism.

The gradualist neoclassical economists argued that it was in the interest of transition economies to have coordinated price liberalisation, budgetary, and credit reforms. Williamson (1991, 1992), Van Brabant (1991), Kregel, Matzner, and Grabher (1992), Fischer and Frenkel (1992), and Dornbusch (1993) were all in favour of the establishment of a "payments union" between transition economies. An organisation similar to the European Payments Union (EPU), which operated from mid 1950 to 1958, was suggested (Eichengreen, Grilli, and Fischer 1993), because the convertibility of the exchange rate would not otherwise be sustainable due to the inelasticity of import and export demand. Through the payments union, transition economies would have been able to establish current account convertibility more rapidly between the member states and with the rest of the world and avoid large depreciation of the exchange rate (Williamson 1992). The union would have achieved currency convertibility, intraregional economic collaboration, exploitation of comparative advantage, structural adjustment, reduction in the social cost of transition, and development of rational trade and prices, and would have prepared transition economies for participation in international trade. However, the idea was rejected (Williamson 1991).

III

Institutional Reforms in Transition Economies

THE AIM OF THE TRANSITION PROCESS was not only to eliminate the unreasonable distortions of the central allocation of resources, but also to establish the appropriate institutions in organising the new market mechanism for allocating resources. A proper institutional structure was "the Achilles heel" (Svejnar 1991:134) of transition, because "institutions matter" (Bardhan 2000:245). Private property and the building of institutions are fundamental to a free market (Kolodko 2000, 1999b; Wagener 2000).

The shock therapy process utilised market incentives to internalise the developmental process of institutions instead of relying on the government, an external actor to the whole process: institutional change was a derivative. Consequently, a radical reform process would not inhibit the development of the institutional structure. In contrast, the mere fact of the existence of private enterprises and market relations created the need for an appropriate institutional environment. "The evidence suggests that institutional development is stimulated by early and radical reform" (Aslund, Boone, and Johnson 1996:249).

Hence the shock therapy advocates, while prescribing an immediate transition to a market economy, argued that the market could only deliver operative institutions. Effectively and paradoxically, the shock therapy approach recommended a gradual development of market institutions. The imperative of not using government intervention in the market resulted in a contradiction in the shock therapy model. In theory, shock therapists required the immediate destruction of the institutions of central administration, which implied the establishment of market institutions by the government, thus minimising the time necessary to create institutions. In reality, the shock therapy economists were willing to sacrifice speed in this context so as to avoid government intervention, which they regarded as completely undesirable.

The gradualist neoclassical economists used the evolutionary paradigm of institutional development to justify their approach to reform (Smyth 1998; Kolodko 1999b). Gradualist economists argued that the transition to a market economy needed to be facilitated by an institutional structure, the development of which had to be gradual, natural, organic, and voluntary, as opposed to the constructivist, state-directed establishment of institutions (Kolodko 2000; Kornai 1992b, 1995b, 1997; Csaba 1995; Gustafson 1999; Murrell 1992). A gradual process allowed time to clarify the institutional principles and to test institutional adjustment. Institutional development was a complex evolutionary process, causing the ineffective institutions to wither away and facilitating the survival of those institutions that truly were fit for the task (Kornai 1992b, 1995b; Nelson 1995).

In summary, the development of the institutional structure of the shock therapy and the gradualist neoclassical processes appeared to be quite similar. However, while both approaches argued that market institutions can only result from market forces, gradualist neoclassical economists allowed institutions to develop concurrently with market relations. For shock therapy supporters, the goal was first the development of market relations, with the assumption that the institutions will follow in due time. The gradualist neoclassical argument suffered from the same flaws as shock therapy. Gradualist neoclassical writings failed to offer a concrete process of institutional development, simply leaving the end-state to be determined by the market, and assuming that the most efficient institutions would emerge. The gradualist neoclassical break with shock therapy was far less complete than it appeared to be.

IV

Political Reforms in Transition Economies

SHOCK THERAPY SUPPORTERS FAVOURED a democratic process of decision making (Aslund 1995, 1994, 1997a). Thus, "the market revolution has gone hand in hand with a democratic revolution" (Sachs 1995:50). However, was democracy consistent with the shock therapy process? Actually, a democratic political process was inconsistent with the shock therapy process of transition because democracy requires the continuous responsiveness of the government to the preferences of the members of society. Policy making reflects the variety of preferences and interests of society.

But the shock therapy supporters argued that there had to be no political interference. The shock therapy process had to be implemented independently of the political process and consistently, in spite of criticism. It could not favour anyone; everybody had to follow the basic rules. This could only take place by stripping the government of its discretionary power and assigning it the responsibility of maintaining the rules written in the constitution in the tradition of Hayek (1944) and Friedman (1980). Consequently, the shock therapy model was only consistent with a non-elected government that did not exercise discretionary power, rather than a government that was democratic but intervened in the market, distorting and thus withholding the attainment of a free market. When Intriligator stated that "democracy is neither necessary nor sufficient for good economic performance" (Intriligator 1998:241), this was an implicit agreement with Walters's reference to the transition economies that "we should not claim democracy as either sufficient or even necessary for a liberal society with a market economy" (1992:101).

The implementation of the shock therapy model was short-lived. Despite the substantial initial support for governments initiating the process in transition economies, considerable undesirable outcomes resulted, such as unemployment and inflation. This led to the governments' unpopularity. High inflation and unemployment caused social and political instability, threatening the fragile democratic governments. Intrinsically, these governments did not have the power to pursue the policies required by the shock therapy platform. In a democratic environment, the substantial reduction in output and employment associated with the shock therapy process of transition resulted in the ultimate downfall of these governments through the electoral process. The shift to gradualism took place in Poland on September 19, 1993; in Russia on December 12, 1993; in Bulgaria on December 18, 1994; in Estonia on March 5, 1995; in the Czech Republic on June 1, 1996; and in Latvia on July 25, 1997. In all cases, these shifts occurred after unfavourable election results for the shock therapy governments (Marangos forthcoming).

The goal of the gradualist neoclassical process of transition was a democratic political structure combined with a market economy. In contrast to the shock therapist approach, the policies of the gradualist neoclassical approach had to be approved by the democratic political process in order to facilitate the transition. However, the policy prescriptions presented an unfortunate policy dilemma for the gradualist neoclassical economists. In order to secure macroeconomic stabilisation in the short run, important pricing, enterprise, banking, and international trade policies had to move counter to the ultimate goal of long-term liberalisation. Transition governments were encouraged by the gradualist neoclassical economists to seize financial assets of enterprises, command outputs through state orders, reinstitute price controls, restructure enterprises, and coordinate international trade policies. Consequently, the recommendation was for reregulation of the financial system and reregulation of international trade, together with the reregulation of state enterprises (Kolodko 1999b; McKinnon 1995b, 1995a; Stark 1990). The gradualist neoclassical economists implied that, once the transition was completed, state intervention in the economy would be unnecessary. As markets developed and the pace of reforms gained momentum, the role of the state would be reduced and with it any remaining discretionary power.

As competitive capitalism was the ultimate goal of gradualist neoclassical economists, there was an apparent contradiction with the transition strategy recommended. A competitive capitalist system required a government with no discretion. However, reregulation and renationalisation occurred during the transition period: the government's discretionary power was thus increased in the name of gaining control of economic affairs to guide the gradual process of transition. There was a direct link between increased government power and the interests of the bureaucracy and lobby groups. The crucial question was how could an economy, from a system of increasing government power during the transition period, be transformed into a free market system with no government discretion? The gradualist neoclassical economists failed to reveal how this would be achieved. Strangely enough, the state was expected to "wither away" and function as a "minimum state"—implementing only the rules—consistent with the tradition of Hayek and Friedman (Csaba 1995; Abel and Bonin 1993). Notwithstanding, Stalin advanced a similar argument during the 1930s. For the state to wither away, its power first had to be maximised (Nove 1989). However, the state would never wither away because it was linked with the interests and privileges of the bureaucracy, lobby groups, and sectoral interests. These groups would have resisted their own dissolution and state power and intervention would have continued. Gradualist neoclassical economists advanced a similar argument to explain the lack of reform in the Stalinist system. The same argument finds validity in the gradualist neoclassical process of transition.

V

Conclusion

A POLITICAL ECONOMY EXAMINATION of the neoclassical model of transition in either the shock therapy or gradualist approach reveals the internal inconsistencies of each. The shock therapy approach recommended a gradualist process of implementation of the neoclassical policies with regard to wages (wage-tax policy), privatisation (efficient ownership structure as only market-determined), monetary policy (establishment of an independent central bank), fiscal policy (maintaining the budget deficit), and the foreign exchange (pegged exchange rate). The gradualist neoclassical process, while advocating gradualism in transition, opted for a shock therapy privatisation process by auctioning off state enterprises. Both approaches favoured gradual market-driven institutional development. However, an institutional structure as a result of the market process was a very time-consuming method, resulting in corruption and illegal activities. A democratic political structure was inconsistent with shock therapy, while active state intervention during transition was inconsistent with the ultimate goal of the gradualist neoclassical economists of competitive capitalism.

The implementation of the neoclassical model of transition in Russia and Eastern Europe in either form, shock therapy or gradualism, had to varying degrees common outcomes. These were inflation, reduced output, unemployment, external imbalances, the destruction of the welfare system, and corruption. The neoclassical economists presented these outcomes as "short-term necessary adjustments." Actually, these outcomes were the result of the innate inadequacies of neoclassical economics associated not only with inconsistent policy prescriptions but also with the effective exclusion of the institutional and political elements of the transition.

Note

1. A gradualist transition model could also take the form of a post-Keynesian transition process or a market socialist approach, such as in China. The analysis in this paper is restricted to the neoclassical model.

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