A POST-KEYNESIAN APPROACH TO THE TRANSITION PROCESS

John Marangos
Colorado State University

INTRODUCTION

The Post Keynesians argued against rapid, radical, and far-reaching economic reforms in transition economies. They proposed a stabilization package with gradual liberalization and government intervention simultaneously with the establishment of a state-produced institutional structure. This transition model is rendered quite distinct by its incorporation of Post Keynesianism as the body of economic analysis, a “civilized society” based on the principles outlined in Davidson and Davidson [1996] and Marangos [2000/01] as the ultimate goal, and democracy as the preferred political process.

The transition to a market economy required not only the exposition of economic analysis, ultimate goal, and consistent political structure, but also a process by which these elements would be achieved. The aim of this paper is to propose an appropriate mechanism by which the ultimate goal of a civilized market capitalist society, as perceived by most Post Keynesians, would be attained. This necessitates identification of the desired changes with respect to: price liberalization–stabilization; privatization; the institutional structure; monetary policy and the financial system; fiscal policy; international trade and foreign aid and social policy. The approach taken in this paper is a stylized version of the view of most Post Keynesians about the way the economy operates, based on the values and beliefs to which most Post Keynesians subscribe, with reference to the transition from a centrally administered economy to a market economy. In adopting this approach, this paper will selectively incorporate empirical evidence to demonstrate the outcomes of the policies that the Post Keynesians favored.

The Post-Keynesian policies did not receive any consideration because free-market ideology dominated policy discussions worldwide. In addition, the people in transition economies misunderstood the maintenance of government intervention as an element of authoritarian socialism. The transition economies implemented the orthodox transition approach, in either its shock therapy or its gradualist form. Actually, the majority of transition economies implemented the shock therapy approach, because this strategy was in fact forced upon them. Transition economies had to satisfy conditions imposed by the International Monetary Fund (IMF), the World Bank and mature market economies to secure funding for their reform processes. Funding was conditioned upon the implementation of the shock therapy approach.
“there was a single prescription” [Stiglitz, 2002, xiv]. For example, IMF and World Bank loans to Romania were stopped because the privatization strategy that was adopted limited foreign ownership. How, then, can the implementation of a gradualist approach by a few countries be explained? The promises of substantial funding never materialized, as the shock therapy supporters noted. As a result, a few of the transition governments—Hungary, China, Romania, the Slovak Republic, Uzbekistan, Slovenia and Poland (although Poland implemented restrictive fiscal and monetary policy, it opted for a gradual privatization of state enterprises and banks)—ignored the recipe of shock therapy and chose to follow their own gradualist course.

It could be argued that history has rendered the Post-Keynesian transitional strategy a purely academic exercise. Nonetheless, in a period when so many transition economies are searching for alternatives to the Washington consensus, the Post-Keynesian proposal presented in this paper still remains relevant, and there is no reason for it not to be adopted, even today. Independent of the goals of the neoclassical gradualist model, the transition economies that adopted gradualism were able to reduce the cost of transition substantially, and at the same time achieve satisfactory outcomes—even, in some cases, outcomes superior to those obtained under shock therapy. Within the “most advanced” transition economies are Hungary, the Slovak Republic, and Slovenia, together with Poland [Stiglitz, 2002, 151]. I will argue that the gradualist process implemented in these countries contained elements of the Post-Keynesian approach to transition, which contributed to their better performance and reduced transition costs. Surprisingly, the shock therapy model also incorporated active government interventionist policies consistent with the Post-Keynesian perspective. It could also be maintained that Post-Keynesian policies contributed to the overcoming of transitional recession in the economies that implemented either shock therapy or gradualism. Major alterations in institutions and economic policies are not necessarily associated with reductions in output [Olson, 1992a, vii], as the transition orthodoxy insisted, as for example, Ericson [1991, 25].

THE GOAL OF TRANSITION

The Post-Keynesian methodology offers an alternative to the dominant orthodox economic theory, which restricts sensible economic policy, as the Post Keynesians argued. Davidson argues that most likely “orthodox theory will be unable to describe behavior correctly in the real world and economic policy prescriptions will be misleading and possibly disastrous” [1994, 17]. Undoubtedly this was true for the transition process. I will argue that Post-Keynesian policy recommendations would have been more useful to the transition economies than the orthodox prescriptions, because uncertainty was such a characteristic of the process. In addition to the uncertainty associated with the normal functioning of the market, the transition process gave rise to “transitional uncertainty.” Transitional uncertainty was due to institutional and systematic transformation, behavioral inheritance of the past and the political and social changes [Lah and Susjan, 1999, 591]. The traditional notion of rationality (optimal positions are always calculable) was irrelevant. A procedural
The notion of rationality (the limited ability to process information) was relevant for transition economies, because individuals were unable to process information under the unfolding market and transitional uncertainty.

The aim of a transition economy should have been the establishment of a "civilized society" [Davidson and Davidson, 1996; Marangos, 2000/01]. A civilized society, as perceived by Post Keynesians, combines individualism (which requires the dominance of private property and markets in the economic system) with the common good (which requires state property and government intervention) and makes full employment the main goal of economic policy. A civilized society could not prosper on the hardships of its members. Government intervention was essential because the state was responsible for economic performance [Arestis and Sawyer, 1993, 3]. Most Post Keynesians favored state intervention, which ensured full employment and the achievement of social goals, and state property, which avoided market failure. This was in total contrast to the orthodox view, which was the dominant ideology imposed on transition economies: "everyone who tried to talk about the role of the state or industrial policy was branded a conservative or an institutionalist, unaware of basic truths of economic analysis at best" [Yavlinsky and Braguinsky, 1994, 114]. The transition economies had the opportunity to establish the institutional prerequisites for civilized market capitalism as perceived by most Post Keynesians, to provide full employment, economic growth, reducing insecurity and high living standards [Peterson, 1996, 167; Minsky and Whalen, 1996–7, 168; Marangos, 2000/01].

The ultimate political process for a civilized market capitalist society that the Post Keynesians perceived as generating political freedom was democracy. This view is quite the opposite of Walters [1992, 101] who claimed that democracy is neither sufficient, nor even necessary, for a liberal society with a market economy. Post Keynesians recognize that antagonism and conflicting interests exist in society. 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 motivated only by self-interest, the idealized general Post-Keynesian position would be that there was an implicit social agreement in all societies between members of the society—an agreement that promoted tolerance and conveyed disagreement in such a way that it did not destroy civic values [Davidson and Davidson, 1996, 17]. Democracy and civic values are internally linked: each sustains and promotes the other. Political civility, tolerance, compromise, and mutual trust are necessary for an effective democracy. Society’s choice is not simply a matter of adding up individual choices. Self-interest and civic values both contribute to the achievement of a desirable solution, from society’s point of view. In contrast, democracy was inconsistent with the orthodox models of transition, both in the shock therapy model and in the gradual neoclassical model [Marangos, 2002].

The Post-Keynesian approach to the transition process is quite different from both the neoclassical gradualist, which incorporates New Institutionalism and the shock therapy approach (See Table 1). In fact, the neoclassical gradualist approach
emphasizes the institutional structure, since “the neoclassical paradigm [on its own] says little about real-world institutions for dealing with information asymmetry and information acquisition” [Murrell, 1991b, 62]. For the neoclassical gradualists, to secure macroeconomic stabilization in the short run, important pricing, enterprise, banking, interest rate, and international trade policies had to move counter to the ultimate goal of long-run liberalization. Transition governments were encouraged by the neoclassical gradualist economists to seize the financial assets of enterprises, command outputs through state orders, and reinstitute price controls and other such devices. Consequently, as demonstrated in Table 2, the recommendations were for the re-regulation of the financial system, international trade, and state enterprises [Kolodko, 1999, 236; McKinnon, 1995a, 70; 1995b, 106; Stark, 1990, 376]. If competitive capitalism was the ultimate goal of neoclassical gradualist economists, there was an apparent contradiction with the recommended strategy of transition. A competitive capitalist system required a government with no discretion. Re-regulation and re-nationalization occurred, however, during the transition period. The government’s discretionary power was increased in the name of gaining control of economic affairs. The crucial question then was: how could the economy, from a system of increasing government power during the transition period, be transformed into a free market system? The neoclassical gradualist economists failed to demonstrate how this would have been achieved. The Post Keynesians avoid this inconsistency, since in the Post-Keynesian approach, government discretionary power is not only present during transition but is a permanent feature of the economic system.

**THE SPEED OF TRANSITION**

For Post Keynesians, as for the gradualist neoclassical economists, the movement toward a market economy could only be gradual. Institutions, organizations
and patterns of behavior and thinking could not change immediately. There could only be a slow response to the transition process by economic actors within the system. In addition, the transition program had to be flexible enough to be adapted to the changeable character of the socioeconomic conditions. Gradualism allowed for changes and flexibility in the formation and implementation of the transition program. The reforms necessary for each market economy could only be determined country by country, while at the same time developing the principles and objectives of transition. The gradualist procedure enabled elements from the old organization
to be slowly replaced by the new as the process gathered momentum. This required active state intervention.

The market is a social institution, which has been cultivated over time by deliberate human action and comprises a complex network of information. Merely reducing constraints to create markets is not sufficient [Murrell, 1991a, 5]. Market outcomes are influenced by past decisions, current conditions and future expectations. Markets operate within a framework of regulations, interpersonal relations and expectations. Consequently, Post-Keynesian economists argued that the behavior of economic actors could not have changed as rapidly as the orthodox models assumed. The Polish experience revealed that it was a mistake to assume that state enterprises and banks would adjust immediately to market principles [Ellman, 1994, 2]. The hyperinflation caused by the shock therapy approach created an environment that was not conducive to structural, institutional and financial reform. This not only made shock therapy unworkable, but also substantially retarded the development of a civilized society, as perceived by Post Keynesians. In short, “(M)arket economies cannot be shocked into existence” [Poirot, 1997, 237]. Post Keynesians favored a gradual transition, implying an unavoidably long process to allow new market convention to emerge. Also, it would have given economic actors time to adjust their behavior so as to be able to take advantage of the new opportunities. Consequently, the development of market relations was the result of a historical process, which takes time.

In fact, the transition process took place in a specific and dynamic cultural context, characterized by instability and unpredictability. There was no single strategy: “[I]t is extremely naive to expect simple copying to be the shortest way to heaven” [Csaba, 1995, 133]. Ultimate success depended on whether or not sufficient non-economic conditions prevailed, and this included political, ideological and cultural dimensions. The transition economies were characterized by widely different civilizations, history and religion, and by different levels of economic and political development. This strongly influenced the way transition problems were solved, since capitalism comes in many varieties. Economic processes are path-dependent [Arestis and Sawyer, 1993, 9]. “In matters of economic reform, the skills and knowledge more usually associated with the philosopher and the historian must supplement those of the economic theorist and the econometrician” [Murrell, 1991b, 73–4]. Consequently, transition 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. There is consensus now that different initial conditions greatly affected the subsequent performance of transition economies and that countries that experienced partial-piecemeal reforms prior to the 1990s have performed much better [Campos and Coricelli, 2002, 797; Svejnar, 2002, 12; Estrin, 2002, 121; Murrell, 1991a, 6–7; Wolf, 1991, 45; Calvo and Frenkel, 1991, 147]. Recognizing the distinctiveness of each country as well as the limitations of economic analysis makes us aware of the need for a balance between specificity and generalization.
In sum, the Post Keynesian elements of the transition process are contrasted with the shock therapy and neoclassical gradualist approaches in Table 1.

**THE POST-KEYNESIAN PROCESS OF TRANSITION**

The Post-Keynesian approach recommended a set of policies, as presented in Table 2, which are quite distinct from the policies of the neoclassical approach in both its shock therapy and gradualist forms, since they were linked with different goals associated with the transition process. In addition, the adoption of a gradual transition entailed a process, a sequence and a strategy by which the reform program would be implemented stipulating the order of reforms based on the interconnectedness of transition policies. Individual policies introduced at the wrong time or in isolation could only have a negative impact [Rausser, 1992, 312]. Thus, “successful economic programs require extreme care in sequencing—the order in which reforms occur—and pacing” [Stiglitz, 2002, 18]. The shock therapy approach to transition avoided this problem since all the reforms were introduced in one shot, while ignoring the institutional structure. The sequencing of the reforms is presented in Table 3.

The time frame adopted was to phase in the reform over ten years [Fischer and Gelb, 1991; Fischer and Sahay, 2000]. The goal was that by the end of Year 10 the aim of a civilized market capitalist society, as defined by the Post Keynesians, would have been achieved. The Post Keynesians would start the reform process by reforming the institutional structure. The institutional structure involved formal institutions and the regulation of the financial system, incorporating a state-controlled central bank and the tax system, all of which would have required two years (Years 0-1 in Table 3). In addition, price liberalization for small and medium enterprises and the free entry of new small and medium enterprises would have been gradually introduced in the start of the transition process (Years 0-1). Once the formal institutional structure was developed, individuals would respond by developing appropriate informal institutions, completed by Year 10 (Years 2-10). After the development of the formal institutional structure, the process of restructuring state enterprises and the privatization of small-to-medium enterprises should have taken place in accordance with the newly established formal institutions under fixed prices for large enterprises, protection and a fixed exchange rate. The privatization of small and medium enterprises would have lasted one year (Years 2-3), while the restructuring of state enterprises would last for four years (Years 2-6). As part of the overall market planning, discretionary monetary and fiscal policies and industry-incomes policies, together with the maintenance of tariffs, should have been initiated throughout the reform process to assist with restructuring of enterprises and the achievement of full employment. To assist individuals with the transition costs, minimum income support, the right to work, and other assistance programs such as retraining, should be initiated in the beginning of the reform process and gradually fine-tuned as the transition gains momentum (Years 0-10). In this way, restructuring of state enterprises could proceed without substantial worker resistance associated with individual transition costs. In addition, the gradual liberalization of prices of the products of
TABLE 3
The Post-Keynesian Approach to the Transition Process

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large enterprises could only take place after enterprises had been restructured (Year 6 in Table 3). The transformation of the Council for Mutual Economic Assistance (COMECON) into a permanent clearing union could be initiated at the beginning of the transition process, and the process would last throughout the transition. Conditional foreign aid is essential throughout the transition program.

THE TRANSITION PROGRAM

Price Liberalization-Stabilization

The Post Keynesians argued that it was not desirable to remove price controls and subsidies immediately. The removal of price controls and subsidies, as recommended by shock therapy, resulted in shortages, black markets, and political pressure to delay the movement towards a market economy. In addition, due to the by-gone industrial structure, price liberalization would not be sufficient to allow competitive markets to emerge [Fischer and Gelb, 1991, 97]. What the orthodox transition models did not recognize was that, due to the highly monopolistic structure of markets, prices would be determined by a mark-up pricing scheme. Enterprises in mature market economies implement pricing based on normal cost and target rate of return. Likewise, enterprises under central administration applied mark-up pricing. Enterprises had no reason to change their pricing policy with the introduction of market relations. Flexibility in prices is achieved by flexibility in mark-ups. The enterprises' response to shock therapy was very different from the orthodox adjustment process. Enterprises were likely to reduce output, but did not improve their efficiency and increased prices based on a mark-up pricing scheme [Kuznetsov, 1992, 475-76]. Due to the gradualist approach, the Slovak Republic, Slovenia, and Poland were the only countries whose output in 1998 was higher than in the last year before their transitions. Hence any removal of controls should coincide with the elimination of imbalances. Price controls would have created the necessary environment for restructuring. With reference to Table 3, price liberalization for large enterprises could only have been initiated after the restructuring of the state enterprises—that is, Year 6—and would last four years (until the end of the transition process at Year 10). Nevertheless, price deregulation for small and medium-sized firms could take place gradually with the initiation of the transition process (Years 0-2).

As a result of introducing market relations, inflation was an immediate problem faced by transition economies. Inflation, especially hyperinflation, disorganized and destabilized the economy, encouraged speculation, and discouraged investment. The shock-therapy approach favored liberalizing prices immediately, under conditions of macroeconomic disequilibrium, while still effectively maintaining soft-budget constraints and a monopolistic structure. The Post Keynesians argued that this could only breed inflation. What orthodox economists did not realize 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 in and of themselves could not control inflation. The supporters of orthodoxy recommended severe fiscal and monetary reduction by reducing the
money supply. This only temporarily reduced inflation. Nevertheless, the social cost was high, with resulting persistent unemployment, reduced capacity utilization, and low economic growth [Davidson, 1994, 154]. In such circumstances it was irrational to initiate immediate price liberalization [Ellman, 1994, 12]. Meanwhile, the Post Keynesians favored 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. An incomes policy is a permanent mechanism for income determination that would have existed throughout the transition process (Years 0-10 in Table 3). Surprisingly, the orthodox models of transition also recommended an incomes policy. For example, the Polish government, which implemented shock therapy, ignored the IMF’s pressure [Stiglitz, 2002, 156] and imposed penalties on wage increases—the so-called popiwek under which wages were to increase by 30 percent of the monthly inflation rate in January 1990, and by 20 percent thereafter. Enterprises conceding wage increases above the norm were heavily taxed. By 1996 most of the transition economies had abandoned incomes policies after achieving inflation rates below 40 percent; the Czech Republic abandoned incomes policies in 1992, Poland in 1993, Slovakia in 1992 and Russia in 1996 [Boeri and Terrell, 2002, 65; European Bank for Reconstruction and Development, 1999, 63]. Boeri [2000, 118] argues, surprisingly, that tax-income policies could be more useful even today to face situations in which bilateral monopoly prevails in wage bargaining. Fischer and Sahay [2000b, 5] argued that the performance of transition economies in reducing inflation has been impressive across the board. Nevertheless, they did not mention or recognize the contribution that income policies had in successfully combating inflation across transition economies, as the Post Keynesians recommended. In addition, even though the Russian labor market has been repeatedly portrayed as a “neoclassical dream” or “the example of a flexible labor market,” its performance in promoting workers’ reallocation is poor [Boeri and Terrell, 2002, 71].

Privatization

The orthodox transition model highlighted the need for privatizing state enterprises. According to the Post Keynesians, however, selling state enterprises to the highest bidder, as recommended by the neoclassical gradualist supporters, violated equity principles. The amount of savings available in the transition economies was not enough to finance a large drive towards privatization. The only people who could purchase firms were those who had benefited under the previous regime through the black-market and illegal activities, or foreigners. McKinnon [1991, 115; 1992, 118] argues that massive sales of state enterprises to foreigners would be likely to inhibit the development of domestic entrepreneurship. Meanwhile, contrary to the orthodox transition model, where culture did not matter, Stark [1992] argued that the privatization strategies pursued had a high degree of national path-dependence. This resulted in “a complex mosaic of national and regional pathways” [Smith, 1996, 135].

Post Keynesians argued that there is a role for state property, especially in cases of market failure. In addition, Post Keynesians claimed that market failure extended beyond just public goods and externalities, encompassing market power and infor-
mation. Their contention, however, was that the majority of property should still
evidence demonstrated that private property had efficiency advantages in competi-
tive conditions, but was not superior when there was market power. Meanwhile,
when state-owned firms were subjected to competition similar to that faced by pri-
vate firms, their performance was efficient [Comiso, 1992, 228]. It was not owner-
ship but environmental factors that determined efficiency. Thus the development of
competitive conditions and a regulatory framework, not ownership, should have been
the goal. Consequently, there were no firm guidelines with respect to the appropri-
ate ownership structure. The experience of mature market economies demonstrated
the variety of ownership structures in market economies and the changing charac-
ter of ownership structure over time. The framework of political and social institu-
tions, traditions, and history and the state of economic growth of the particular coun-
try, therefore, had to be included in the analysis of the development of property
relations. Thus, there was no single ideal strategy with respect to privatization.
Privatization had to be approached case by case, depending on the type of asset, the
internal organizational structure, the level of technology, and the need for capital.
Experience revealed that the slower, case-by-case Polish approach, which had been
consistent with Post-Keynesian recommendations, had been more successful than
the more rapid privatization voucher schemes [Pinto, Belka and Krajewski, 1993].

Whether restructuring should precede privatization was clear for the Post
Keynesians. They believed it was the government’s responsibility to use discretion-
ary measures to ensure the viability of the enterprises before and after privatization.
The government should assist and equip enterprises with the essential internal struc-
ture necessary to survive the competitive market process. “Governments do not kill
state enterprises when they are inefficient” [Frydman, Rapaczynski and Turkewitz,
1997, 85]. Moreover, the maintenance of state enterprises facilitated the develop-
ment of a civilized society as perceived by the Post Keynesians, since the transition
would not necessarily involve a massive increase in unemployment. In addition, the
adoption of a variety of privatization methods would enhance the public’s perception
of fairness [Rausser and Simon, 1992, 252], which is a characteristic of the privatization
methods of Post Keynesians as demonstrated in Table 2.

Some of the fastest growing transition economies (Poland, Slovenia, and China)
were also slow to privatize [Svejnar, 2002, 15]. Strangely enough, Poland and Rus-
sia, which implemented shock therapy, restructured their state enterprises before
privatization quite successfully: Poland restructured its large enterprises and Rus-
sia its small shops [Fischer and Sahay, 2000b, 19]. Although the Polish government,
which implemented shock therapy, initially intended to privatize state enterprises
immediately, in fact, because of bureaucratic and political constraints, privatization
took a gradual form. This postponement of privatization proved extremely produc-
tive, since it gave reformers the opportunity to design an innovative privatization
program, which encouraged restructuring with a minimum of scandal, corruption,
and theft [Goldman, 1999, 390]. State ownership within partially privatized firms is
effective in producing more restructuring than enterprise insiders and non-block
holder outsiders [Djankov and Murrell, 2002, 741]. Evidence is strong that the effect
of privatization in Central and Eastern Europe has been much greater than in the Commonwealth of Independent States (CIS) [Djankov and Murrell, 2002, 753]. The difference in the impact of privatization between CIS and Central and Eastern Europe is due to the different levels of institutional development in each. In view of the fact that the CIS had an ownership portfolio that contained a greater share of labor-managed firms in an inadequate institutional environment, the structure of ownership explains the underperformance of newly-privatized firms in the CIS. Did the private owners of the newly privatized enterprises restructure the firms? Numerous studies concluded that there is no clear evidence that just in the aftermath of privatization, privatized enterprises perform better than the state enterprises. Restructuring and establishment of the regulatory framework, therefore, had to precede privatization. Regarding the fact that “[t]he privatization issue deserves somewhat— and the institutional requirements of a market economy much more—priority than in the past Olson [1992] and Murrell [1992, 46] were in agreement.

With reference to the optimal sequence of reforms in Table 3, small and medium state enterprises could have been privatized immediately after setting up the regulatory–institutional framework at Year 2 in Table 3, and could had been done rapidly, needing only one year to be completed. In addition, free entry of new small and medium enterprises could take place during the setting up of the regulatory–institutional framework (Years 0-2). The contribution of small and medium firms to the development of a market economy in transition economies should not be underestimated [Svejnar, 1991, 133; Fischer, 1992, 233]. The restructuring of large state enterprises would have lasted from Years 2-6. With the completion of the restructuring of large enterprises, gradual price liberalization could have been initiated.

**Institutions**

Contrary to the orthodox transition models, setting up the institutional structure required government action, which “cannot be left to chance or left until later” [Rider, 1994, 8]. A market economy cannot simply be created as a result of “letting capitalism happen” [Olson, 1992a, viii]. Government institutions provide certainty in an uncertain market system. The institutional structure not only facilitates the smooth functioning of the market process [Stiglitz, 2002, 139], but also provides solutions to market failure. Actually, during transition there is an inherent market failure that arises from the destruction of the system-specific organizational capital [Murrell, 1992, 43]. In terms of monopoly power particularly, the aim of the institutional structure should be to restrain market power, and ensure that there is adequate competition [Willing, 1992, 193; Stiglitz, 1994, 135, 256-57]. In the absence of institutions and legality, privatization is impossible [Olson, 1992, ix; Litwack, 1991, 77]. Consequently, “the solution then is for countries in transition to ‘get the institutions right’ (not prices, as orthodox theorists have maintained)” [Grossman, 1997, 251]. “This lack of a market-oriented legal structure appears to have been the Achilles heel of the first dozen years of transition” [Svejnar, 2002, 7].

Should the institutional structure be developed as a result of free-market transactions? Post Keynesians would absolutely disagree. First, it would be an extremely time-consuming process. Also, the market is incapable of satisfying effective demand
immediately, so it would have been unable to respond to the immediate demand for a complicated institutional structure. Political-economic reforms fail not because market liberalization proceeds too quickly or slowly, but because supportive institutional reforms develop too slowly. The pace of institutional development determines the pace of reforms.

A civilized society in the mold proposed by Post Keynesians requires institutions, developed as a result of purposeful action to satisfy specific needs consistent with the society’s civic values. Market-produced institutions based on self-interest were the product of interests that desire to maintain the status quo or that lobby for self-interest. For example, powerful economic agents such as the Russian oligarchs benefit from the low security of property rights, which facilitated the transformation of state assets into private property [Roland, 2002, 36]. The implementation of orthodox models without the institutional structure in place, and allowing spontaneous market forces to create those institutions, resulted in an institutional structure that was inefficient and difficult to remove because it was linked with vested interests.

Informal constraints, which are culturally embedded, would not change immediately in response to changes in formal rules. Informal constraints have great survival potential because despite changes in formal rules they resolve basic exchange problems among the participants, whether they are social, political, or economic. The overall constraints would have to be restructured to produce a new equilibrium; if they were not, unresolved tension would result in political instability. Simply changing formal institutions is not sufficient. Informal institutions, however, are hard to change and require a gradual process. In Russia, there was no culture or social norm, even before the Bolshevik revolution that made private property acceptable, especially in agriculture. The establishment of laws permitting private property stimulated the development of new firms in manufacturing and services, but it failed to encourage the same in agriculture [Grossman, 1997, 253]. Thus, “deep problems arise when old expectations are still held and when the old patterns of behavior continue” [Murrell, 1992, 47]. The experience of mature market economies demonstrate that securing of property rights and legality depends on a “complex web of social traditions and expectations” [Murrell, 1991a, 5].

In reality, the Post Keynesians, while advocating a gradual transition process, recommended immediate state intervention to develop, implement, and enforce market institutions to create the pre-conditions for a civilized market economy: effectively an institutional shock therapy. The formal institutional framework must be initiated first—Years 0-2 in the Table 3—while the development of the informal institutional structure is a time-consuming process that would last for the whole transition process—Years 2-10. It should be pointed out that many Post Keynesians are influenced by Veblenian-type constructs, which see institutions as mental constructs or habits of thought common to the generality of individuals. Markets are also seen not as exchange mechanisms, but as social institutions. While there is widespread recognition that government must play an important role in building these institutions, surely markets as institutions must evolve not only through state policy but also through their own internal dynamics. Economic actors are most effective in combining learning and monitoring for themselves and for others; local knowl-
edge, local culture and local networks influence the development of new organizational forms [Grabher and Stark, 1997; McDermott, forthcoming].

Empirical evidence confirmed that the immediate development of the necessary institutions by state action must precede liberalization and privatization. Any benefits of liberalization were noticeable only in economies with strong institutional capacities. Popov [2000, 35–36] argues that different performances during transition, after factoring in initial conditions and the external environment, depend mostly on the strength of institutions and not so much on the progress in liberalization in and of itself. This can be demonstrated by the experience of China (with weak formal institutions but strong informal institutions) in pursuing incremental reforms, which managed to avoid the recession. Hungary, following a step-by-step strategy, deregulating prices and the exchange rate, also avoided recession. In addition, Uzbekistan pursued gradual reforms under an authoritarian regime, which showed the best economic performance among former Soviet Union states in the 1990s [Popov, 2000, 10]. The Czech Republic, which implemented shock therapy, is systematically ranked the lowest, in comparison with Central European countries, in terms of the quality of its institutional environment and governance structure, because it grossly neglected the need to establish a functioning legal framework and corporate governance of enterprises [Svejnar, 2002, 10; Lizal and Kocenda, 2001, 157; Verny, 2000, 134]. Romania, which implemented a gradual process of transition, has the highest index of formal judicial power (0.95), while Poland, which implemented shock therapy, has the lowest, at zero! [Ishiyama and Ishiyama, 2000, 169]. Successful privatizations took place in countries where the law and order tradition was well established [Bortolotti, Fantini and Siniscalco, 2001, 131]. Finally, the experience of transition economies seems to indicate that under conditions of weak rule of law, democratization has a marked negative impact on economic performance [Popov, 2000, 42]. Nowadays, there is little doubt that the absence of an institutional framework has hindered economic growth and increased corruption and illegal activities, which is recognized by Fischer and Sahay [2000b, 20] and European Bank for Reconstruction and Development [1999].

Monetary Policy and the Financial System

With respect to the financial structure, the orthodox transition model examined the problem of transition in the context of a hard budget constraint. A soft budget constraint would violate the concept of relative scarcity—a fundamental aspect of the market process. The recommended hard budget constraint was based on the assumption that savings determines investment, and also that Say’s Law applies [Szego, 1991, 330]. Experience of the transition economies, however, showed that the introduction of a hard liquidity constraint, especially for state-owned enterprises, did not establish a hard budgetary constraint. “This is absolutely unthinkable under the monetarist paradigm but quite natural in other frameworks of economic analysis” [Yavlinsky and Braguinsky, 1994, 100]. This is because orthodox economics does not have a theory of money, so it is not applicable to the real world [Davidson, 1972; Wray, 1996, 141].
The fact that the demand for credit by enterprises is endogenously determined is an important feature that distinguishes the Post Keynesian from the orthodox approach. Banks respond to the demand for loans and not to the independent demand for deposits [Moore, 1997, 427]. While for the individual firm, at the micro level and in the absence of borrowing, the level of savings determines the level of investment, in the context of the whole economy, at the macro level, investment 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 (for example United Airlines) or a centrally administered system. Any move towards a market economy would certainly fail 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, 336]. After the implementation of orthodox stabilization policies in the transition economies, the soft budget constraint persisted as did the output reduction due to uncertainty. Premature efforts to break up the anachronistic banking system failed, resulting in a loss of monetary control and worsening of moral hazard in bank lending [Svenjar, 1991, 129; McKinnon, 1992, 124]. Well functioning capital markets facilitate the distinction between profitable and unprofitable firms [Calvo and Frenkel, 1991, 145], but due to imperfect information, capital markets cannot reach Pareto efficiency; thus government intervention is likely [Stiglitz, 1992, 168–9]. Consequently, Post Keynesians argued, there was a need for government intervention in financial markets: financial markets have inherited weaknesses, which calls for prudential regulation. 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. In addition, governments should use their discretionary power to restructure the banks prior to privatization [Anderson, Berglof and Mizsei, 1996, 79]. The experience of transition economies revealed that financial regulation has not been adequate [Begg, Halpen and Wyploz, 1999, 76].

For the Post Keynesians, the central bank should not be independent, as the orthodox transition model perceived, because this would require the central bank to formulate monetary policy independent 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, 161]. The theoretical and empirical suggestion of a link between the independence of the central bank and price stability is the result of very restrictive assumptions, based on very narrow views of how the economy operates [De Carvalho, 1995/96, 170, 173]. Especially during transition, the actions of an independent central bank would be inadequate [Begg, Halpen, and Wyploz, 1999, 11, 95]. An independent central bank model did not allow governments to use the money supply to fund budget deficits [Arestis and Bain, 1995, 163]. The only option available to transition economies, therefore, was to reduce the budget deficit by reducing government expenditure in an environment of pre-existing high social transition costs. Kornai [1995, 240–41], a supporter of the
neoclassical gradualist paradigm, argued (consistently with the Post-Keynesian perception) that transition governments should not follow the monetary rule nor introduce a restrictive monetary policy. In reality, while the Czech Republic, Poland, Hungary and Slovakia established “independent central banks,” the central banks in Hungary and Poland were supposed to support the governments’ policies as well as attain price stability. The central bank in the Czech Republic—the most “independent” central bank of the four mentioned—implemented monetary policy in close cooperation with the government [Anderson, Berglof and Mizsei, 1996, 73–74]. The “independent central banks” have provided subsidized credit to enable unprofitable, but politically important, enterprises to survive. As such, the monetary, fiscal, and regulatory environment under which financial institutions and markets had to operate, rather than the independence of the central bank, has been the most important element in facilitating financial development [Berglof and Bolton, 2002, 93].

Most Post Keynesians, therefore, have favored government intervention to establish a healthy financial system that facilitated restructuring. This required some banks to be state owned. With references to Table 3, a discretionary monetary policy would have been maintained throughout the transition process (Yers 0-10) initiated by a state-run central bank, while the regulatory financial framework consistent with the institutional shock therapy process should be initiated immediately at the beginning of the transition process and would last two years (Years 0-1).

**Fiscal Policy**

The transition economies have suffered from chronic fiscal problems. Private enterprises have excelled at avoiding tax, especially under the current inadequate institutional structure. Depression has accompanied privatization, inhibiting any increase in tax revenue. Post Keynesians therefore argued that to achieve a successful transformation, transition economies had to take revenue factors into account when considering such policy areas as privatization and foreign trade. Countercyclical fiscal policies were a requirement for the monetary and exchange rate strategies [Anderson, Berglof and Mizsei, 1996, 79].

Aggregate demand is the key policy instrument in influencing the economic activity in a market economy [Peterson, 1996, 163]. The general Post-Keynesian position is that the level of aggregate demand determined by individual actions is insufficient to create full employment at the going real wage. In a decentralized market there are no automatic mechanisms to ensure an appropriate level of aggregate demand [Davidson, 1992, 456; Davidson, 1994, 82; Arestis, Dunn and Sawyer, 1999, 541]. Budget deficits during recessions, as in the transition case, therefore, are essential to maintain full employment. These budget deficits, however, should be the result of productive government expenditure on private–public infrastructure development to stimulate employment, and therefore promote a civilized society as perceived by Post Keynesians. The deficits should not be 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 influences aggregate supply directly and consumption indirectly. Davidson [1994, 79; 1996, 503] characterizes government fiscal policy as a “balancing wheel.”
This recommendation was in contrast to the orthodox-dominated international institutions’ proposal, which imposed the shock therapy approach. The IMF and the World Bank’s conditional loans were based on reducing government expenditure and achieving a balanced budget [Martinez-Vazquez, Rioja, Skogstad and Valen, 2001, 503; Svejnar, 2002, 13]. In spite of this, transition economies continued to maintain relatively high levels of government spending and revenue as a share of GDP [Kostera, 1997, 26]. Even though fiscal balances have generally improved, it is now accepted that there is no clear relationship between the fiscal balance and GDP growth—as the experience of transition economies revealed [Fischer and Sahay, 2000b, 10]. The transition economies that implemented shock therapy displayed a higher ratio of unemployment rates to GDP growth, requiring a greater increase in social security expenditures, than transition economies that implemented gradualism [Coricelli, 1997, 19]. Despite a favorable output performance in 1994 and 1995, unemployment remained high in Poland (around 14.9 percent), in Slovenia (13.5 percent), in the Slovak Republic (13.1 percent) and in Hungary (10.6 percent). Svejnar [1995, 266–7] notes that the unemployed in Central and Eastern Europe form a “stagnant pool,” and resulting in a growing number of long-term unemployed. Surprisingly, the Czech Republic, which implemented shock therapy, registered its highest unemployment rate in 1991, which amounted to only 4.1 percent, with youth unemployment at around 6.5 percent by mid-1996, compared with about 9 percent in Germany, 20 percent in Sweden, and 40 percent in Spain [Kostera, 1997, 32; Boeri, Burda, Kollo, 1998, 82]. The successful reduction of unemployment in the Czech Republic is associated with the implementation of active labor market policies consistent with the Post-Keynesian propositions. These include “carrot and stick” administration of benefits, subsidies targeted toward additional job creation for young, unskilled and long-term unemployment, and a well-organized network of employment offices that actively supervise and assist workers, and provide better screening and placement of vacancies and job seekers [Boeri, Burda, Kollo, 1998, 82]. In contrast, the Slovak Republic suffered a large budget imbalance after the split from the federation in 1993, and as a result did not maintain the active labor market policies inherited by the federation; this resulted in a large increase in unemployment.

For the Post Keynesians, the development of a tax system should be based not only on revenue considerations but also the social and cultural background of the society. There is a definite link between tax compliance and civic values [Davidson and Davidson, 1996, 91–92]. In the civilized society envisioned by Post Keynesians, there is a conscious payment of taxes by members of the society. Non-compliance is unacceptable, and is the result of the diminishing role of civic values. The development of the Post-Keynesian civilized society in the transition economies would have encouraged tax-paying norms consistent with civic values, whereby individuals would have to pay their taxes as part of their moral duty [Davidson and Davidson, 1996, 217]. This perception of taxpaying norms was in contrast to the orthodox transition model, in which individuals were motivated not by moral duty but rather by self-interest, and according to which it would have been impossible to increase tax compliance. This was in line with the goal of developing a society based on civic values. Accordingly, it is essential to institute a tax system early in the transition process [Edwards, 1992, 139]. With regard to the optimum sequence in Table 3, discretion-
ary fiscal policy should have been maintained throughout the transition process (Years 0-10), while the tax framework consistent with the institutional shock therapy process should be initiated at the beginning of the transition process, and would last two years (Years 0-1).

**International Trade and Foreign Aid**

Contrary to the orthodox view, Post Keynesians argued that an appropriate level of protection would have been essential for enterprises to survive in an uneven playing field. The experience of mature market economies revealed that their development and industrialization was strongly linked with protectionist measures. Consequently, globalization did not automatically result in trade liberalization. Rather, powerful forces appeared to be supporting the construction of trade barriers. In the Post-Keynesian approach, 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. In the orthodox model, the effect of protection on prices of finished goods is complete, while material tariffs are never significant, and production effects are entirely supply determined. Therefore tariffs produce a demand—not a supply—reaction, and price changes are minor [Norman, 1996, 523, 528]. Consequently, based on the Post-Keynesian approach, transition economies should not expect the removal of tariffs to result in a substantial reduction in prices or inflation. Tariffs and convertibility restrictions were essential in protecting infant industry, to restrict the consumption of foreign products, and allow time for producers to enhance product design and quality. Consequently, the transition economies, while abolishing state monopoly of international trade, should maintain a number of protective measures, with some necessary adjustments.

Post Keynesians argued that a flexible exchange rate system would not reduce short-term movements or produce confidence in stability. It only encouraged financial currency speculation, not production; it discouraged forward contracts, and encouraged stagnation in the domestic and world economy [Wray, 1996, 143; Davidson, 1994, 238–39]. It prompted countries to solve the problems of unemployment and inflation by shifting them to their trading partners, in an uncivilized way [Davidson, 1994, 262]. In addition, the IMF recommended the opening up of the capital account, which was supposed to make transition economies attractive to foreign investors. This, however, facilitated capital outflow instead of capital inflow [Stiglitz, 2002, 145]. The fixed-exchange regime that previously existed, therefore, should be maintained. Sachs [1996, 149], the architect of shock therapy, acknowledged that the transition economies that had a fixed or pegged exchange rate (the Czech Republic, Estonia, Hungary, and Poland) performed much better than the floaters in reducing inflation.

The problems with international trade in the transition economies reflected the problems associated with the current international financial system, in which there is no international lender of last resort willing to stabilize exchange rates. Keynes called for an international central bank under a fixed exchange-rate system that was
a lender of last resort. The international central bank would have the power to create an international currency and its supply would be determined by future growth needs and potential [Moore, 1979, 135]. “Such an institution requires, at the very least, powers greater than those granted to the IMF at the Bretton Woods conference” [Arestis and Bain, 1995, 166]. Keynes insisted on the creation of an International Clearing Union (ICU) based on a bancor unit of account [Wray, 1996, 141–43]. He helped to devise the Bretton Woods Agreement to encourage intervention, fix exchange rates, and control, financial capital [Davidson, 1994, 252]. Post Keynesians recommended an Eastern European Clearing Union similar to the ICU suggested by Keynes for the international financial system [Marangos, 2001], and similar to the earlier Soviet bloc clearing arrangements. In this scheme, creditor nations would share the burden of adjustment of the deficit nations and encourage economic development in the international economy [Davidson, 1996, 503; Wray, 1996, 144]. The collapse of COMECON was inevitable [Svenjar, 1991, 128], but it could easily have been transformed into a clearing union. The idea, however, was rejected [Williamson, 1992, 12]. Without coordination between transition economies market failures induced a very high inflation rate [Begg, Halpern, and Wyplosz, 1999, 53].

The financial assistance provided by the mature market economies has been disappointing. The transition economies had to depend largely on their own resources. Due to the relative scarcity of foreign capital and international aid, transition economies competed only in providing concessions. This may have enabled them to acquire the necessary financial resources, Post Keynesians conceded, but it has had irreversible consequences for the future. It has created heavy reliance on the voluntary movement of capital and handouts from international organizations, which reduces international sovereignty and jeopardizes the development of a civilized society as perceived by Post Keynesians. The transition economies would have been able to stand on their own feet only after an extensive debt-cancellation program, together with the substantial foreign aid. Foreign aid benefited the donor economy as well as the recipient transition economy because it helped to stimulate increased international trade and strengthen relationships in the international community. A prime example is the Marshall Plan’s large military and economic aid programs after the Second World War. The European countries received financial aid to buy American products. This facilitated restructuring in both Europe and the United States [Davidson, 1994, 246]. In addition, decisions in the IMF are based on ideology and politics (its recommendations are closely aligned with the commercial interests of the financial markets in mature market economies) instead of being “a lender of last resort” to stabilize the international financial system: “Keynes would be rolling over in his grave were he to see what has happened to his child” [Stiglitz, 2002, 13].

With respect to the sequence of reforms demonstrated in Table 3, the Post Keynesians proposed that tariffs as well as conditional foreign aid should be maintained throughout the transition process (Years 0-10), and called for the establishment of the of the Eastern European Clearing Union through the transformation of COMECON (which could only take place gradually, to minimize transition cost).
Application of the neoclassical transition model resulted in large social costs, massively reduced production, and unemployment. Meanwhile, under the instructions of the IMF and World Bank, dominated by the free market ideology, the transition economies reduced social protection and public investment “probably to levels below those needed to sustain reforms” [Wang, 1996, 22]. Russia’s budget expenditure on health was less than one percent of the GNP [Gustafson, 1999, 186]. The demise of the health care system, together with psychological stress, unemployment, poverty, and alcohol consumption, resulted in the life expectancy of Russian men dropping to 57 years, similar to that in many third-world nations [Campos and Coricelli, 2002, 815; Gustafson 1999, 183–84]. The increase in mortality rates was a monumental embarrassment for the international organizations, such as the World Bank, which had been allocating resources to achieve appropriate health standards [Ellman, 1994, 2]. Russia’s Gini coefficient doubled in the first years of transition, reaching the level of the Philippines, reflecting the corruption and “crony capitalism” that were related to the continuing recession, growing inequality and spreading poverty [Gustafson, 1999, 173]. By 1998, more than 40 percent of the population eared less than $4 a day [Stiglitz, 2002, 153]. Even Aslund [1995, 287], one of the architects of shock therapy, acknowledged these results to be unacceptable. However, due to the ongoing budgetary crises and consolidation efforts—not due to efficiency arguments—transition economies had to tighten eligibility and reduce potential benefit duration [Boeri, Burda, Kollo, 1998, 74]. Consequently, during transition “an efficient and humane market economy” [Clague, 1992, 16] requires a social policy to protect individuals from poverty.

A civilized society in the mold proposed by the Post Keynesians requires a social policy that addresses chronic unemployment. Unemployment causes psychological problems. Hence, social policies were necessary to reduce antisocial behavior due to unemployment. The social policy of Post Keynesians is based on the right to work and the right to a basic income [Jackson, 1999, 639]. Post Keynesians are in favor of the government assuming the role of employer of last resort by 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 is an upper limit for private sector wage increases that are not linked with productivity. This is a desirable way of achieving price stability, instead of living with a “natural rate of unemployment.” Employers would benefit from a pool of trained and work-oriented workers. The program would be funded from the budget and at the same time welfare payments would be reduced. The employer of last resort program was politically feasible—as the partial implementation of the program in Bulgaria revealed—and did not require a substantial amount of financial resources [Mosler, 1997–98; Jackson, 1999, 639]. In addition, basic income was defined as a cash benefit given to all members of the society irrespective of their personal and financial circumstances. It enabled individuals to survive without having to work [Jackson, 1999, 639]. It would allow individuals to express their work preferences, freely taking up jobs that they would prefer and therefore being productive. The Post-Keynesian social welfare ap-
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approach did not involve this large dislocation of human and physical resources, therefore reducing the resources required for a welfare state. The dominance of individualism and of the free-market ideology in transition economies, however, were likely to resist these policies: “arguments for higher benefits, unconditional measures, or a right to work will meet strong political and institutional barriers—the same barriers that have blocked the use of Keynesian policies in recent years” [Jackson, 1999, 661].

With reference to Table 1, therefore, the minimum income and the right to work should be established in the beginning of transition and fine-tuned throughout the process (Years 0-10).

CONCLUSION

The historical experience of the successful postwar reconstruction of Western Europe, which was based upon Keynesian principles, totally contradicts the policies implemented in transition economies. Those countries that opted for price level adjustments during postwar reconstruction faced major hyperinflations [Edwards, 1992, 138]. Although the economic conditions of transition economies could be argued to approximate the postwar reconstruction of Western Europe, during the period of reconstruction of Western Europe, 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 United States 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 cooperation rather than conflict.

Shock therapy has been described by Minsky [1996, xii] as wrong, arrogant and catastrophic. Transition, instead of bringing unprecedented prosperity, brought unprecedented poverty [Stiglitz, 2002, 6]. “Crony capitalism” was increasingly paralleled with “crony research and advice”: more than 30,000 Western “consultants” had visited Moscow since the change of the regime, many of whom were interested in assistance not to ordinary Russians but to themselves [White, 2000, 141]. In such an environment, the Post-Keynesian approach did not have a chance for consideration, even though both the shock therapy and the neoclassical gradualist approaches adopted policies consistent with Post-Keynesian propositions. It appears that the orthodox models of transition in either form could not escape using Keynesian anti-recessionary policies. The transition economies that adopted gradualism and selective Post-Keynesian policies substantially reduced transition costs. Given the research agenda of the IMF and World Bank for the transition economies, “no wonder economics has again become the dismal science” [Davidson, 1992, 462].

NOTES

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2. The Slovak Republic has not really performed as well as the EBRD [1999, 262] reports. High fiscal and current account deficits, infective bankruptcy and corporate transparency and weak financial discipline are characteristics of the transition process.

3. Carlin, Van Reenen and Wolfe [1995, 450] concluded, after a study of 450 newly privatized enterprises in the Czech Republic and Slovakia, Hungary, Poland and Russia between 1990 and 1993, that there was little evidence that privatized enterprises were more likely to restructure than state-owned enterprises. Djankov and Kreacic [1998], by using four case studies and a survey of 92 manufacturing firms in Georgia over the 1991–96 period, found that privatization did not affect restructuring; rather, import competition was associated with improvement in enterprise performance. As well as evidence that a vast proportion of Russian economic activity is carried out through barter, enterprise arrears and tax arrears in a non-cash economy of unrestructured enterprises provides strong evidence against the sufficiency of privatization for restructuring [Gaddy and Ickes, 1998].

4. The support of the EU to Central and Eastern Europe was quite large.

REFERENCES


POST-SHAWAN APPROACH TO TRANSITION


