
Was there an optimum model of transition?

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Abstract: The aim of this paper is to develop and compare alternative models of transition using a political economy approach. As a result, five alternative models of transition are developed: the Shock Therapy, the Neoclassical Gradualist, the Post-Keynesian, the Pluralistic Market Socialist and the Non-pluralistic Market Socialist models of transition. An attempt is made to identify whether, from the models developed, an optimal model of transition existed. The optimality criterion tilts towards the neoclassical gradualist model. It can be argued that the neoclassical gradualist model maximised social welfare under the given internal and external constraints.

Keywords: transition; political economy; social welfare.

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1 Introduction

The movement from a centrally administered to a market-based economy is commonly referred to as the 'transition problem'. While the word 'transition' – the passage from one state to another, in this case from a centrally administered to a market-based economy – might seem appropriate, it did not explicitly capture all the complexities involved. The word 'transition' or 'reform' was a misnomer for what was occurring; "revolution

is more fitting” (Murrell, 1991b, pp.3–4). The transition process entailed superseding the essential properties of the centrally administered economy, consequently destabilising the economic system and replacing it with a market economy.¹ Thus, in order to solve the transition problem, several key issues had to be addressed: What was the goal of transition? What process should be used to achieve the goal? What policy instruments were appropriate? What elements of the existing economic structure should be maintained?

The answers to these questions could not have been derived by using economic analysis alone, but also depended on the perception of social reality and ethical issues. Based on assumptions about economic behaviour, the following questions arose: How does the economic system function and respond to change? Also, what is a good society? The answers inevitably reflected the observer’s personal assessment of each economic and non-economic performance dimension, as well as the significance assigned to those performance dimensions. In addition, alternative and often conflicting economic theories used different criteria for determining how society and the economy functioned, and how society should distribute responsibilities between the market and the state. Thus, different views on ‘social reality’ and ‘what is a good society?’ were associated with distinct methodologies and a particular set of social values, which have implications for economic policy formulae. This gives rise to alternative models of transition, based on different assumptions, different methods of analysis and different goals.

The aim of this paper is to consider and compare alternative models of transition, based on different methods of economic analysis, different views of ‘what is a good society?’ and different speeds of implementing the transition policies. As a result, five alternative models of transition are developed: the Shock Therapy model of transition, the Neoclassical Gradualist model of transition, the Post-Keynesian model of transition, the Pluralistic Market Socialist model of transition and the Non-Pluralistic Market Socialist model of transition (the Chinese model of transition).

Each model is a construction based on the values and beliefs to which most economists of the particular model subscribe. Each model is a stylised version of the view of how the economy operates, with reference to the transition from a centrally administered to a market economy, suggested by the economic theory in question. Differences between economic models result from differences in political, philosophical, cultural and moral arguments and values. All models have their own ideologies and sets of values, based on which the models are defined.

To my knowledge, there have been no attempts to develop and compare alternative models of transition. In addition, there is very little literature available on the transition process based on the tradition of political economy. An exception is Radice (1993, p.13), who distinguished between three alternative transformation paths: the neoliberal (which aims to achieve a rapid and comprehensive commodification of economic life), the protectionist (which aims to develop a viable national economy) and the state-development path (which aims to develop a national strategy to compete effectively in international markets). His analysis was limited, and focused on government strategies and practices relating to foreign capital investment. As a result, his analysis did not encompass all the elements of the transition in the tradition of political economy.

2 A social science perspective of the transition process

The transition process was not restricted to the economic field, so the debate was not solely about the superiority of market relations over central administration. Market relations are not independent of other social relations. It would seem that the political and ideological aspects of the transition were fundamental. Indeed, economic reforms cannot be understood or assessed in narrow economic terms. To understand and form an opinion about the transition, it was essential to view the process in a broader social science context, incorporating political and economic relations as well as ideology. To understand changes in an economic system, it is essential to analyse all the relationships which influence economic choices. In addition to economic relationships, the structure of the political authorities and the state, and the prevailing ideology must be examined, as well as the external environment, which all have an influence on economic choices. This is because the state has a monopoly over the legitimate use of force as a means of imposing restrictions on individual behaviour. The prevailing ideology releases the appropriate directives, moral standards and values to motivate people to behave in a certain predictable way. All these elements give rise to different market-based economic systems and this diversity cannot be adequately conceptualised as simply mixtures of capitalism and socialism (Stark, 1996,p.1017). That is why Horne (1995,p.391) wrongly concluded that “perhaps the main lesson learnt from the experiences of transition economies is how little is understood of the process of systemic economic transformation and the factors that explain apparent success or failure”. I strongly believe that such confusion and supposed ignorance can be avoided only when economic analysis and policy are viewed from the broad perspective of social science.

A social science perspective involves recognition that state, class, gender, race, and ideology, as well as the market, are key elements in shaping the social order of modern market economics. Within this framework economic relationships are perceived as interconnected and interdependent with noneconomic structures. Consequently, the development of a strategy for the transition process reminds us of the statement by Hirshleifer (1996,p.91) that “ultimately, good economics (in our case, good transition economics) will also have to be good anthropology and sociology and political science and psychology”. Hence, the success of the transition process depends not only on specifying the necessary economic conditions, but also on whether certain conditions are satisfied with respect to noneconomic elements. Differences in historical background, national culture, economic and political structures and international aspirations can affect growth patterns. For this reason, the analysis adopted in this paper is in the tradition of ‘political economy’, which incorporates within the framework of economic relationships the interaction between political institutions, social consciousness and ideas. The analysis of the transition process was consistent with the tradition of political economy (Kornai, 1992,p.6; Murrell, 1991a,p.62). The transition was a holistic, historical, dynamic and comparative process in nature and, as such, a political economy approach would seem appropriate. “Political economy is necessarily procedural, human, institutional and environmental in its scope” (O’Hara, 1999,p.128). Political economy stresses that making economic sense and understanding economic relationships is not feasible without explicit awareness of power, institutions and values. In particular, political economy maintains that politics and economics are not reducible to one another. Aslund (1995,p.12), one of the architects of the shock therapy approach, argued, ‘to a

considerable extent, therefore, my interest focuses on political economy'.² However, a political economy approach eventuates in disagreement and in alternative transition models. Different 'views on social reality' and 'what is a good society?' give rise to alternative models of transition.

3 Alternative models of transition

3.1 Primary elements of the transition models

After recognising the existence of alternative models of transition, the next question that is required to be addressed concerns the basis on which different models are distinguished from each other. The aim is to detect what I call the 'primary elements' that differentiate transition models. The primary elements of each model are distinct for, and characteristic of, a specific model. The primary elements are: a) economic analysis; b) What is a good society?; c) speed; d) political structure; e) ideological structure; and f) initial conditions. The primary elements of each transition model are analysed below:

3.1.1 Economic analysis

Economic analysis involves the application of a social scientific method to the making, and consequences, of economic choices. Using economic analysis, economic reality is described by abstracting and generalising its basic characteristics. On the basis of economic analysis three alternative bodies of methodologies can be distinguished:³

1 Neoclassical economic analysis

This employs marginalist economics, in which individuals are characterised by rational maximising behaviour. Prices are determined in a perfectly competitive economy by supply and demand curves in equilibrium, without market or government discretionary power. Neoclassical economics is based on the Jevons-Walras model, which stipulates the efficiency of markets in allocating resources and achieving equilibrium in production and distribution.

2 Post-Keynesian economic analysis

The assumption of the neoclassical model, that individuals are utility maximisers and firms maximise profits, is questioned. Using the concept of aggregate demand, where consumption is determined by disposable income and planned investment by expected profitability and 'animal spirits', there would be persistent labour market disequilibrium. Prices are determined within an oligopolistic environment by cost-plus pricing with the presence of market power.

3 Marxist economic analysis

Power is an essential characteristic of the market economy and results in exploitation and alienation. In addition, the malfunctions of the capitalist system are inherent and fundamental rather than the imperfections of an otherwise harmonious economic mechanism. Marxist economics predicts that the capitalist system will suffer crises, which will become increasingly severe and ultimately lead to its collapse, facilitating the development of a socialist system.

3.1.2 What is a good society?

The three possible bodies of economic analysis above may be combined with three different possible views of ‘what is a good society?’, since “the choice of economic system is profoundly ideological” (Aslund, 1995,p.5). The three alternatives are:

1 Competitive capitalism

The neoclassical model of transition encompasses an approximation of competitive capitalism as a vision of a good society. Market power is a consequence of the use of discretionary power by the state. Without the discretionary power of the state, individuals will behave as if they are in competitive capitalism, thus eliminating all forms of discretionary power. The state should play a minimal role, and should be allowed to act only where there is market failure. It should also provide a ‘safety net’ to avoid physical deprivation. Justice means equal treatment by the state for all citizens. The state should not be involved in redistribution of income and wealth. The market outcome is the just outcome; thus, there are no discretionary income and wealth redistribution policies.

2 Social-democratic capitalism

The Post-Keynesians favour a social-democratic capitalist system. Post-Keynesians seek as much freedom as is compatible with a socially desirable outcome, thereby justifying a series of interventions by the state. Post-Keynesians in no way discredit the primacy of individual values, the principle of private ownership or the advantages of the market. They stress the importance of the right combination of the above elements with the common good, state property and planning. The welfare state is the expression of the common good, the means of achieving the objectives of society, especially those of minorities and the disadvantaged. However, the discretionary power of the government can improve the outcome of the economic system and stimulate the development of a civilised society (Davidson and Davidson, 1996,p.22; Marangos, 2000/2001).

3 Market socialism

As the name of the model implies, this is a combination of a market system with socialist principles. The market socialist model is concerned with the optimal combination of centralisation and decentralisation, of markets and planning, of individualism and the common good, and of public and private property. A market socialist model is distinct from other models owing to its different goals, which are to prevent exploitation, to reduce alienation, to achieve greater equality of income, wealth, status and power and to satisfy basic needs. These can be realised only through the establishment of a socialist economic system, according to market socialists, as the negative outcomes of the capitalist system are inherent and cannot be avoided merely by using the discretionary power of the state.⁴

3.1.3 *Speed*

The movement towards a market economy may take two forms: the ‘shock therapy’ or ‘big bang’ approach, and the ‘gradualist’ or ‘evolutionary’ approach. Campbell (1991,p.7) queried “whether the socialist reformers can ‘create’ these markets or whether they must grow organically”. This addresses the issue of human consciousness and perceptions when a dramatic change in behaviour is required, such as the transition from central administration to markets. The opposing views, with regard to speed, reflected the different beliefs about individual responses, which can be either rapid or time-consuming. The distinction with regard to speed was relevant only for the neoclassical model, since both Post-Keynesians and market socialists were in favour of a gradual approach. They agreed with the neoclassical gradualist economists that change had to be slow since institutions, organisations and patterns of behaviour and thinking could not be changed immediately.

3.1.4 *Political structure*

It was important to recognise that “politics denote the activities and institutions that determine authoritative public decisions for society as a whole” (Caporaso and Levine, 1993,p.20). Consequently, the transition process also depended on developments in the political structure. “In the transition, the liberalisation of political markets is often as important as the liberalisation of economic markets” (Parish and Michelson, 1996,p.1043). This is because market reforms initiated ‘modern’ civil societies, stimulating the emergence of autonomous interest groups, political parties, independent media and opportunities to participate in political processes. Political legitimacy and cohesion were essential elements of the transition process, which was so extensive and radical. In terms of the political structure, there are three types of transition models:

1 Political pluralism

A transition model with political pluralism introduces fundamental changes with consent, debate and discussion, agreement and compromise. With pluralism, there is recognition that antagonism and conflicting interests exist in society, based on the diversity of human beings. There is no single correct line, no sole and invariably correct perception of issues. It means that the common good will not be laid down in an authoritarian manner by the state, but is determined through a plethora of different opinions which are freely discussed. Most importantly, pluralism does not involve discretionary power; individuals have to follow nondiscretionary rules. The shock therapy model is consistent with political pluralism (Marangos, 2002,pp.47–48).

2 Democracy

Democracy is the continuing responsiveness of the top authority to the preferences of the members of the society, through a structurally defined procedure like elections. Within a democratic system, all members are considered political equals. Democracies generate and sustain the right of participation in the choice of government, in the process of legislation and in the control of administration. Democracies require the existence of political parties that compete to win office within defined periods of time. In a democratic political system there is a combination of rules and the government exercises discretionary power. The neoclassical gradualist, Post-Keynesian and the Pluralistic Market socialist transition models are in favour of a democratic political process.

3 Non-pluralism

This is where the transition to a market economy is characterised by a non-pluralistic process, based on a party that is a leading role party (with a monopoly of power), which adopts a leading position (its views determine most decisions) and a correct line (the party scientifically derives the correct understanding of things). An example of this is the Chinese model of transition.

3.1.5 Ideological structure

Ideology refers to a cohesive set of values and beliefs about others, the world and one's own self. It embodies a distinct 'worldview' as to how society and, thus, the economic system, function. "Ideas and ideologies shape the subjective mental constructs that individuals use to interpret the world around them and make choices" (North, 1990,p.111). The introduction of market relations in the former centrally administered economies unavoidably eventuated in a change in ideology. This was because human behaviour takes place within a given ideological framework, with its specific values, beliefs and worldview. Ideology assists in overcoming the free-rider problem.

Ideology can encourage within a market system:

1 Self-interest

With respect to the ideological structure, market economies have developed an ideology that emphasises and encourages self-interest and self-help based on Smith's (1776/1986,p.119) famous arguments. Neoclassical economists stress that in order to be able to understand social phenomena, we need to understand individual actions. Individuals are allowed, within defined limits, to follow their own values and convictions rather than somebody else's, and individuals should not be subject to coercion. The neoclassical model would be in favour of stimulating a self-interest ideology.

2 Common good

The question arose of whether there was a need to bring together the goals of the individual and society. Should there be any restriction on individual behaviour in a market system in the name of the common good? If the answer were yes, then how would the common good be determined? Perhaps by an open pluralistic/democratic process where individuals come together to plan for the common good, or through a leading-role, leading-position and correct-line party? The answer needs to be incorporated in each transition model. The Post-Keynesian model combines a self-interest ideology with the common good within a democratic political environment.

3 Participation

The decision-making process does not involve only the formulation of the common good, but may also involve the breakdown of hierarchical relations within the enterprise and society. The question then arises of whether the transition model will allow the effective participation of the workforce in the decision-making process of the enterprise. The market socialist model integrates self-interest, common good and participation. While the pluralistic market socialist model would encourage participation in all aspects of decision-making, the non-pluralistic Chinese model encourages participation only through the party mechanism.

3.1.6 Initial conditions

The transition process was characterised by uncertainty and the absence of any historical paradigms. Hence, the *Economist's* (Anonymous, 1990,p.18) metaphor about the transition process was that there was no known recipe for unmaking an omelette. However, models are the result of abstractions and do not include all the elements observed in reality. The same applies to the transition process. The transition process was a set of heterogeneous phenomena. In other words, while the Central and Eastern European and Former Soviet Union (CEEFSU) economies were structured on the basis of a central administration, this did not mean that these economies were identical. The need for change was recognised long ago and the political authorities in these countries had experimented, to varying degrees, with reform. In addition to each country's initial economic structures and economic condition, there was a need to incorporate their own political, cultural and ideological elements, the institutional elements, power relationships and the role of the state. All these elements were unique to each country.

The shock therapy supporters argued that the transition programme they proposed had general application across economies with immensely different initial conditions and political environments. The neoclassical gradualist economists showed some concern for the initial conditions since they shaped the gradual transformation of the society. However, this should not have been used as a pretext to substantially delay the reforms and distort the achievement of a free market. The Post-Keynesians considered the initial factors important, while for the market socialists they were extremely important in shaping socialism, because of the hostile capitalist world the transition countries would be surrounded by if they chose the socialist path.

The distinguishing features of the different transition models, based on each set of unique primary elements, are presented in Table 1.

Table 1 Alternative models of transition based on primary elements

Primary elements	Models of transition				
	<i>Shock therapy</i>	<i>Neoclassical gradualism</i>	<i>Post-Keynesian</i>	<i>Pluralistic market socialism</i>	<i>Non-pluralistic market socialism Chinese Model</i>
Economic analysis	Neoclassical	Neoclassical	Post-Keynesian	Marxism	Marxism Maoism
What is a good society?	Competitive capitalism	Competitive capitalism	Social democratic capitalism	Market socialism	Market socialism with Chinese characteristics
Speed	Shock therapy	Gradualism	Gradualism	Gradualism	Gradualism Two track system
Political structure	Pluralism	Democracy	Democracy	Democracy	Non pluralism
Ideological structure	Self-interest	Self-interest	Self-interest Common good	Self-interest Common good Participation	Self-interest Common good Participation through the party
Initial conditions	Irrelevant	Some concern	Important	Extremely important	Special Chinese Initial conditions

3.2 The secondary elements of the transition models

After identifying the primary elements unique to each transition model, the next step is to identify the elements of each model with respect to the desirable reforms. The following aspect of the developmental process of transition modelling involves an analysis of the secondary elements. Each model has to answer questions relating to: a) price liberalisation; b) privatisation; c) institutional structure; d) monetary policy and financial system; e) fiscal policy; f) international trade and foreign aid and g) social policy.

3.2.1 Price liberalisation

The transition models implied alternative processes of price liberalisation. The shock therapy supporters advocated an immediate price liberalisation and, thus, the removal of any restrictions on prices. Advocates of the remaining models supported price controls and the gradual removal of administrative controls over prices.

3.2.2 Privatisation

Most economists identified the privatisation of state enterprises as the most pressing issue to be solved. “The success of privatisation will be decisive for the Russian reform programme” (Chubais and Vishnevskaya, 1997,p.76). Private property is the foundation of market economies: without private ownership the market cannot exist, and vice-versa. However, the establishment of private property did not exclude the development of other forms of property. Whether a majority or minority of property should be privately owned depended on what was deemed to be a good society.

The following alternatives are ways in which privatisation could take place:

- Restitution

There was a legal requirement for the property to be returned to the rightful owners, where former owners existed and could prove their past ownership before the state expropriated their property, or for the provision of compensation.

- Auctions

Kornai (1990,p.83) and Chubais and Vishnevskaya (1997,p.74) argued strongly that the transformation of state property into private property could take place only by auctioning state enterprises and selling them to the highest bidder. In this way all individuals would have the opportunity to become owners at real market prices. Foreigners would also have the ability to participate, so long as some guidelines were imposed to protect the nation’s interests, which, of course, depended on what was considered to be a good society.

- Financial intermediaries

This involved the transfer of ownership of enterprises to financial intermediaries whose ownership structure may consist of pension funds, worker and/or management funds, citizen funds, or private financial institutions such as banks and government agencies. The advantage of this method was that it was fast and could be viewed as equitable. However, there was a loss of government revenue involved.

- Distribution of vouchers

Under this scheme, every adult member of the society was supplied with vouchers that could be used to buy shares in the enterprise in which they worked or at a share auction, to subscribe to investment funds, or sold for cash. This was privatisation through free distribution of shares to the whole population, because all citizens had contributed to the development of state enterprises through their taxes. This type of scheme was adopted in Russia, Czechoslovakia, Lithuania, Mongolia, Poland, Romania and Latvia (Aslund, 1992,p.83). Free distribution could be justified on the basis of equity, since those who were otherwise able to purchase property were likely to have accumulated wealth either illegitimately or by abusing their power under the previous regime. The advantages of this method were speed, relative transparency, and the creation of an instant capital market, less political opposition from insiders and popular support for the reform process. In addition, it helped develop a share-holding culture. The scheme was also difficult for a future government to reverse. “From both the equity and the efficiency viewpoint, championing the public is a very wise privatisation strategy” (Shleifer and Boycko, 1993,p.51). However, a voucher method of privatisation did not provide any revenue to the government.⁵

- Spontaneous privatisation

The collapse of the centrally administered system conveyed power to the enterprise management and provided managers with the ability to appropriate state enterprises for their own benefit. In other words, those who managed state enterprises took possession of the enterprise’s assets and transformed them into a joint-stock company, thereby effectively becoming owners of the enterprise. This was an easy way out of tackling the complexities involved with privatisation and could also be implemented very fast. However, it violated the principles of equity, since managers became owners by, in effect, confiscating the enterprise. Managerial self-interest motivated spontaneous privatisation and there was an inclination for managers to lower, as much as possible, the value of the assets, consequently being able to secure the enterprise at a very low price. It was a selective privatisation process without pluralism, consultation or debate, an auto-appropriation process by the few well-informed individuals in a position of power. The collapse of central administration passed power from the central authority to the managers who appropriated – stole – the enterprise’s assets through spontaneous privatisation, transforming themselves into a new bourgeoisie (Howard and King, 1999,pp.3–4; Holmstrom and Smith, 2000,p.5).

- Labour-managed firms

Another alternative was to transfer the ownership of the enterprises from state to the workforce, creating labour-managed/cooperative firms. This had the advantage of very low administration costs and it could be implemented extremely rapidly. In addition, labour-managed firms had a useful role to play, since they would be able to fill the gaps left by the private and state sectors. Unsuccessful state enterprises might become labour-managed firms/cooperatives.

- Leasing

For some state assets, where privatisation was not desirable or not possible due to the high risks involved, privatisation could take the form of leasing state property to individuals. As long as the lease was market-determined, this would result in the productive exploitation of resources, as well as the creation of the preconditions for transforming these assets into private property.

The shock therapy model was in favour of the immediate privatisation of state enterprises through restitution, auctions and free distribution of vouchers. Conversely, neoclassical gradualist supporters were in favour of a slower pace of privatisation through auctions. Post-Keynesian economists were in favour of a gradual privatisation process, which would involve restitution, the free distribution of vouchers, the transferring of ownership to financial intermediaries that were state controlled and labour-managed firms. Pluralistic market socialists favoured transferring ownership to the workers and, thus, encouraging the development of labour-managed firms to enhance participation and retain a large percentage of state-owned enterprises, together with leasing land and capital equipment. However, non-pluralistic socialists suggested the retention of state enterprises and encouraged the development of cooperatives in the form of township and village enterprises and private enterprises in special economic zones together with the leasing of land.⁶

3.2.3 Institutional structure

A radical change, such as moving towards a market economy, required reform in the institutional structure consistent with the institutional arrangements that were fundamental for the proper functioning of a market economy. The transition economies, without the heritage of a market economy and democracy, had to provide a hospitable foundation for the establishment of institutions for a market economy (North, 1997,p.16). An institutional arrangement can be formal or informal.

The question that was required to be answered by the transition modelling process was, how would an appropriate institutional structure be developed in the transition economies? Would it involve government action? As Lin (1989,p.4) and Kregel *et al.* (1992,p.28) argued, institutions often emerge spontaneously and through repeated social interaction; however, in most cases they have to be made by conscious state action, a statement with which the Post-Keynesians and the pluralistic market socialists would agree. However, Rapaczynski (1996,p.87) and Dietz (1992,p.34) disagreed with this argument, stressing that institutions are largely the product of market forces, rather than the result of government action. The neoclassical model would follow this argument. The Chinese model of transition put emphasis on the development of informal institutions. The emphasis placed on informal institutions, rather than formal contracts, seemed to be a response to deficiencies in the explicit institutional structure (Smyth, 1997,p.242). Once the integrity of the traditional economic system was cracked by the introduction of enterprise autonomy, institutional changes occurred in a way that was self-propelling. China's path-dependent institutional reforms have followed a path that can be explained by induced rather than designed institutional innovation. Basically, the absence of a well-defined legal framework encouraged implicit interfirm arrangements. In addition,

the absence of well-developed capital markets contributed to the growth of informal rural credit cooperatives. It is clear that informal arrangements are preferable to none at all (Smyth, 1997,p.248).

3.2.4 Monetary policy and financial system

In addition to privatisation and the development of institutions, there was a requirement to develop specific institutions to enforce hard budget constraints. This would be achieved by reforming the banking system, dividing its functions between a central bank and commercial banks. Enterprise restructuring and privatisation could not be meaningful without reform in the banking sector. The enforcement of a hard budget constraint was required by commercial banks, operating under bankruptcy laws. The budget constraint is the sum of financial resources available to the decision maker that places a constraint on spending. However, firms under central administration encountered a soft budget constraint, instead of the hard one faced by capitalist firms; whenever a socialist firm was in the red, the central authority would bail it out with financial assistance in the form of subsidies, reduced taxation, provision of credit, or increased administered prices (Kornai, 1986; 1992,p.140,p.145). Instead, in a market system, the banking system could deal with enterprises on the basis of commercial principles. They would lend only to creditworthy borrowers for specific purposes, allowing entrepreneurs to finance their long-term economic projects and plan their production and trading activities. The lack of substantial progress in institutional reforms, particularly in privatisation and the financial sector, had not prevented major structural adjustment and efficiency gains as a result of hard budget constraints (Kornai, 1993,p.320; 1995a,p.140; 1995b,p.146).

The role of the central bank was a controversial issue. Should the central bank be independent and pursue monetary policy with the aim of achieving a predetermined target rate of inflation? This question was inexorably linked with the perception of whether the money supply was exogenously determined and, thus, controlled by the central bank, or endogenous. Neoclassical economists highlight the danger associated with the prerogative of commercial banks to create money which, if excessive, will cause excess demand and place pressure on prices. Consequently, there is a need for regulation by the central bank through the imposition of liquidity constraints. The prime aim of the central bank, in the neoclassical view, should be to control the money supply to avoid inflation. "Inflation is not a natural disaster; it is created by government or the political powers behind them, and only the governments and political powers can put an end to it" (Kornai, 1990,p.106). For the neoclassical economists, the development of a privately owned, competitive and stable financial sector was essential to the operation of a market economy, as it was the centre for the mobilisation and distribution of financial resources and the pricing and allocation of risk. Meanwhile, "Post-Keynesians rank the supportive responsibilities of the central banks above their control duties" (Moore, 1979,p.126), indicating the need for a state-controlled central bank and a combination of a privately and state-owned banking system. Marxists highlight the need to eliminate the power of the financial establishment so that the government can control the money supply and be able to use it as an effective instrument of discretionary policy. This implies a government-controlled central bank and only state-owned commercial banks.

3.2.5 Fiscal policy

Each transition model had to identify the role of budgetary policy and specify whether there was a link between government expansionary policies and inflation. Further considerations were whether the taxation system should be neutral, attempting to minimise dead weight losses, or whether the government should use its discretionary power to tax people differently, perhaps based on ability to pay. On the one hand, the neoclassical economists argued that the tax system should be neutral and the budget balanced. Accordingly, the government should not use the tax system as a means to encourage or discourage certain behaviour because this would create distortions, except where market failures arose, as in the cases of public goods and externalities. It was essential to abolish all subsidies and establish a hard budget constraint, since subsidies distort the market, increase the budget deficit and encourage waste. Instead of subsidies, loans from commercial or other institutions or even from other enterprises would become part of the normal financial life of each enterprise. On the other hand, Post-Keynesians favoured the use of the government's discretionary power to implement fiscal policies to achieve full employment. Post-Keynesians believed that the labour market does not automatically equilibrate independently of the budget. Market socialists argued that the discretionary fiscal policies of the government proposed by the Post-Keynesians were totally ineffective. According to market socialists, power was the natural result of private property, which was able to neutralise government fiscal policy. Consequently, together with discretionary fiscal policies, there was a need to have the majority of property in a social form.

3.2.6 International trade and foreign aid

International trade was an important ingredient in the development of markets and in fostering structural change and economic growth. The liberalisation of foreign trade was an essential part of the transition process. The dispute with regard to foreign trade between alternative models was about whether a uniform and convertible exchange rate, with imports and exports moving freely between borders, contributed to economic welfare, as the theory of comparative advantage stipulated.

The shock therapy supporters favoured the immediate establishment of free trade and a fully convertible exchange rate. They argued that a fully convertible currency would restore faith in the currency, reduce inflationary expectations and stimulate foreign trade. A fully convertible exchange rate would make it possible to attract foreign investment, which was essential to overcome stagnation, since foreign investment provided resources, technology and expertise (Frydman *et al.*, 1997,p.68). Some allowance was required to be made to protect infant industries; consequently, the state would be able to raise a certain amount of revenue from tariffs. The neoclassical gradualist economists were in favour of a gradual process of achieving full convertibility through a payments union.

The Post-Keynesians were in favour of maintaining tariffs through a permanent clearing union. They argued that the principle of comparative advantage was valid only in the ideal world of full employment. Thus tariffs and a discretionary exchange rate policy were essential. Market socialists were in favour of maintaining tariff and non-tariff barriers through a socialist customs union. The non-pluralistic socialists in China, on the other hand, maintained tariffs and non-tariff barriers and implemented a discretionary exchange rate policy.

All schools of thought recognised that foreign aid and credits could have assisted in avoiding a crisis in transition economies. Neoclassical and Post-Keynesian economists highlighted the need for conditional foreign aid to assist with the transition process, while market socialists were suspicious of the terms and conditions associated with the provision of foreign aid. For the market socialists, only nonconditional foreign aid could be accepted. However, mature market economies and international organisations were not willing to assist in the development of a market socialist system.

3.2.7 Social policy

The development of a social policy was urgently required in order to avoid hardship due to the transition process. Social policies during the transition consisted of interventions by the state, designed to sustain or enhance the welfare of poor and vulnerable groups. As a result, in CEEFSU, social programmes were an indispensable part of the transition programme. Most importantly, social policy played a political, as well as social welfare, role, by helping to protect large numbers of unemployed people from major decline in their standards of living and, at the same time, by maintaining support for the reform programme. Thus, the transition and social programme required transparency and participation from the disadvantaged, so that this group was not marginalised.

For the neoclassical economists, the introduction of welfare benefits had to be nondiscriminatory and available for a limited period only, to discourage dependence. The social programme was only a 'safety net'. In this context, neoclassical gradualist economists argued that discretionary measures were necessary as long as a gradual transition process was taking place, which, hopefully, would endure for only a short period of time (Kornai, 1990,p.147). For the Post-Keynesians, the welfare state, which was an expression of the common good and the result of government discretionary power, was the means of attaining the equity objective of society. The market socialists were very critical of the effectiveness of the welfare state, particularly because capitalists always avoided tax payments, thereby creating a fiscal crisis for the government. An effective welfare state required the elimination of power in society and the establishment of a basic liveable income for all, independent of individual economic conditions. For the Chinese model of non-pluralistic market socialism, welfare provision took the form of the enterprise-funded 'iron rice bowl'. However, during the 1990s, the enterprise-funded welfare provision became an obstacle to labour mobility and to the institutional configuration of the market economy, so the Chinese government initiated a reform to welfare provision. The emerging national social security system administered by the government can meet only the basic needs for welfare services and beyond this level commercial insurance provides additional coverage (Gu, 2001).

The schematic representation of the secondary elements of the alternative models of transition appears in Table 2.

Table 2 Secondary elements of transition models

Secondary elements	Models of transition				Non-pluralistic market socialism Chinese model
	Shock therapy	Neoclassical gradualist	Post-Keynesian	Pluralistic market socialism	
Price liberalisation	Immediate price liberalisation	Gradual price liberalisation	Gradual price liberalisation	Gradual price liberalisation	Gradual price liberalisation
Privatisation	Restitution, auctions and free distribution of vouchers	Auctions	Restitution, free distribution of vouchers, state financial intermediaries, labour managed firms	Labour managed firms	Development of TVEs and private firms in special economic zones. Leasing of land
	Minimum state	Minimum state	Majority private with some social property	Majority social with some private property	Majority social with some private property
Institutions	Formal and informal institutions product of market forces	Formal and informal institutions product of market forces	Formal institutions product of state action and informal product of market forces	Formal institutions product of state action and informal product of market forces	Informal Institutions product of market forces
Monetary policy and financial system	Independent central bank and privately-owned banks	Gradual establishment of independent central bank and gradual establishment of privately-owned banks	State-controlled central bank and privately and state-owned banks	State-controlled central bank and state-owned banks	State-controlled central bank and state-owned banks
Fiscal policy	Neutral taxing system and balanced budget	Gradual neutral taxation system and gradual balanced budget	Discretionary taxation system and discretionary fiscal policy	Discretionary taxation system and discretionary fiscal policy	Discretionary taxation system and discretionary fiscal policy
International trade and foreign aid	Free trade, fully convertible currency	Payments union	Clearing union	Socialist customs union	Tariffs and non-tariffs barriers, discretionary exchange rate policy
	Conditional foreign aid	Conditional foreign aid	Conditional foreign aid	Non-conditional foreign aid	Non-conditional foreign aid
Social policy	Safety net	Gradual safety net	Welfare state	Welfare state	Enterprise funded Iron Rice Bowl moving towards government and privately funded welfare

4 An optimum model of transition

In the preceding analysis alternative models of transition were developed, based on a political economy approach. It was stressed that comparisons between models were inappropriate, before demonstrating the goals and method of analysis, which are associated with the assumptions regarding economic behaviour, institutions, ideology and the initial conditions. An attempt would be made to identify whether, from the models developed, an optimal model of transition existed. Without doubt the issue of determining an optimal model is complex. It is too much to expect very precise and conclusive results that are applicable everywhere. But to assert that economists should not at least attempt to recommend a solution to the transition problem is intellectually myopic, not to say disingenuous (Cox, 1998,p.2). “Of course, social science does not equip us to give a definite answer” (Lipton and Sachs, 1992,p.249). Consequently, my ambition is modest: to provide some insights to this important problem. The following conclusions are meant to be applicable with some general tendency.

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 unpopularity of the governments which implemented shock therapy. High inflation and unemployment caused social and political instability and threatened the fragile democratic governments. The risk was substantially increased by the adoption of proportional representation as the basis for parliamentary representation, which resulted in multiparty coalitions that were weak, fragile and easily pressured. Transition governments suffered head-on confrontations with the powerful political and economic blocks, which resulted in populism, together with a public disillusioned with the shock therapy process. Intrinsicly, 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 shock therapy resulted in the ultimate downfall of these governments through the electoral process. The new governments reversed the course of reform and proceeded with a gradual transition approach (Marangos, 2002).

The neoclassical gradualist process of transition combined a democratic political structure with a market economy. Meanwhile, a neoclassical gradualist approach entailed the maintenance of short-term inefficiencies. However, these priorities presented an unfortunate policy dilemma for the neoclassical gradualist economists. In order to secure macroeconomic stabilisation 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 liberalisation. 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, the recommendations were for the reregulation of the financial system, international trade and state enterprises (Kolodko, 1999b,p.236; McKinnon, 1995,p.106; Stark, 1990,p.376).

As 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. However, reregulation and renationalisation occurred during the transition period. The government’s discretionary power was increased in the name of gaining control of economic affairs. However, there was a direct link between increased government power

and the interests of the bureaucracy and other lobby groups. The crucial question 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 reveal how this would have been achieved. Strangely enough, state power was expected to 'wither away' (Csaba, 1995,p.89; Abel and Bonin, 1993,p.230).

The Post-Keynesian propositions for transition economies were disregarded by transition governments, the mature market economies and international financial institutions. The Post-Keynesian recommendation for extensive government intervention, not only during the transition period, but also as a permanent feature of the economic system, was associated with centrally administered socialism. The Post-Keynesian propositions for transition economies faced a set of unwelcome political and institutional barriers, the same ones that blocked the use of Post-Keynesian policies in mature market economies.

The market socialist model was not attractive because any form of socialism was considered a form of Stalinism. The word 'socialism' was discredited and brought bad memories to the people in CEEFSU. In transition economies there was political fatigue; there had been enough societal experiments and there was no taste for new ones. People in transition economies wanted a system that had proved its workability. Thus the transition economies were not interested in adopting a market socialist model, even if it was Chinese-style. The maintenance of non-pluralism as a strategy incorporated in the Chinese transition process rendered the Chinese model undesirable for the transition economies. The governments of transition economies neither had the mandate nor wanted to reimpose tight state direction of the economy and politics.

Tentatively, we can state that the market socialist models in either form, pluralistic or non-pluralistic, did not have any chance of being implemented because of the fact that both the people and governments in CEEFSU desired the establishment of a market capitalist system. In addition, the non-pluralistic nature of the Chinese model was intolerable. The Post-Keynesian model had the same fate, since the maintenance and dominance of government intervention was considered undesirable. Effectively, the only alternative was the neoclassical model of transition in either shock therapy or gradualist form. The experience of transition economies reveals the dominance of the neoclassical gradualist model of transition. In actual fact, no transition economies implemented the Post-Keynesian or market socialist models. Those governments that implemented the shock therapy model lost power and were not able to maintain the necessary shock therapy reforms, and the newly appointed governments implemented the neoclassical gradualist model. In addition, the governments that initially implemented the neoclassical gradualist model were able to maintain internal and external support for their reforms. Nowadays, all transition economies are implementing the gradualist variant of the neoclassical model. Thus, the neoclassical gradualist model can be interpreted as the optimum model of transition under the internal and external constraints faced by transition economies. An acceptance of the 'efficient market hypothesis' would conclude that competition between alternative transition models would only result in the 'survival of the fittest'. It can be argued that, in hindsight, the neoclassical gradualist model maximised social welfare under the given internal and external constraints. A more formal process deriving the optimum model of transition is attempted.

5 A formalistic approach to determining an optimum model of transition

The aim of the transition process, independent of the model implemented, was first and foremost to increase social welfare in transition economies by the adoption of market relations (nonmarket alternatives are not considered in this paper). The problem of social choice in transition economies was to derive social preferences with regard to alternative models of transition based on the preferences of individuals, which required a minimum level of pluralism/democracy within the society or within the party. The presumption was that the governments in transition economies, responding to social preferences, party preferences or international pressures, would or should pursue social optimality, that is, the maximisation of social welfare. An attempt is now made to formulate propositions by which we can determine whether the social welfare that could be achieved by a transition model was higher or lower than that associated with another transition model. Effectively, the goal is to formulate propositions by which we can rank, on the scale of better to worse (or from worse to better), alternative transition models open to the societies of CEEFSU. The level of social welfare associated with each model would be equal to the Net Benefits of Transition:

$$\begin{aligned} \text{Social Welfare of Transition} &= \text{Net Benefits of Transition} = \dots \\ &\dots = \text{Benefits of Transition} - \text{Costs of Transition.} \end{aligned}$$

Whether a transition process would have increased or decreased social welfare depended both on the effects on the objective world (a change in income and wealth distribution, changes in the level of output, an increase or decrease in positive and negative externalities, a change in output mix, *etc.*) and the effects on the subjective world (changes in ideology, knowledge, beliefs, aspirations, *etc.*). The benefits of transition were associated with the implementation of the model of transition that achieved the ultimate goal of ‘What is a good society?’, under the assumption that within a ten-year period (Fischer and Gelb, 1991; Fischer and Sahay 2000), the transition process would have been completed and a market economy would be achieved on the basis of the values and trade-offs to which each transition model subscribed. It has been demonstrated that a view of ‘What is a good society?’ is based on value judgements that is on normative analysis. A good society regarded as optimal according to one set of values may rank very low according to another set of values, and, as such, comparisons were meaningless without taking into account the value system. Consequently, disagreement on ‘What is a good society?’, what ought to be done in CEEFSU, was a matter of different value judgements. However, if we define the benefits of transition in some positive sense and confine ourselves to the study of factors affecting the net benefits of alternative models of transition, then we can derive a positive study of the benefits of alternative models of transition.

The objective of all models of transition was the establishment of a market economy; all models of transition aspired to achieve a higher social welfare associated with the benefits of a market economy. The advantages of market relations over central administration have been highlighted, but the exploitation of those advantages depended on geographical, historical and cultural differences. Nevertheless, by arguing that all transition models aspired to achieve a market economy, we are not committing ourselves to value judgements behind the objective common goal of all transition models. Therefore, one way out of the dilemma of reducing the difficulty of measuring the

benefits of alternative models of transition is to argue that the benefits of all transition models were the product of the establishment of a market economy, ignoring the type of market economy. In other words, in the absence of better information and specific evidence to the contrary, we may disregard the value judgements of alternative market economies and concentrate on the objective goal of the establishment of a market economy. Consequently, the transition from central administration to markets as the dominant form of organisation would result in the achievement of a minimum level of benefits, independent of the transition model implemented, owing to the intrinsic nature of market relations being superior to central administration. Further exploitation of the benefits of market relations depended on the geographical, historical, cultural preexisting factors or the initial conditions. By ignoring these preexisting factors associated with the further exploitation of the advantages of market relations, a minimum set of benefits common to all transition models would have materialised. Thus, each transition model achieves a minimum level of benefits of transition by the mere fact that all transition models aim to maximise social welfare by the adoption of market relations. By restricting ourselves to the minimum level of benefits associated with market relations, the question of the measurability of the benefits of transition is answered by assuming that the minimum level of benefits coincided for all transition models.

Therefore the maximisation of social welfare, the maximisation of the net benefits of transition, can be interpreted as minimisation of the cost of transition. An optimal model of transition should minimise the cost of transition, on the assumption that the benefits of transition for all models equal the common minimum level of benefits, as a result of the establishment of a market economy. The cost of transition is the opportunity cost of implementing a model of transition. The implementation of a transition model involved an opportunity cost, the value of the best alternative forgone. In our case the best value alternative forgone is interpreted as the alternative transition model forgone. The measurement of the cost of transition does not need, for our analysis, to be cardinally measurable: ordinal measurability is adequate. Ordinal measurability involves the ability to rank. With ordinal measurability one can say that the cost of transition for Model X is higher than or the same as that of Model Y, but one cannot say how many times higher, nor can one compare differences in the cost of transition.

The implementation of a transition model, independently of the nature of the model, confronted a set of objective constraints. These constraints were associated with the domestic and external environment within which the transition process was unfolding. Reforms that satisfied the constraints could be implemented with a lower cost than reforms which conflicted with the constraints, giving rise to a higher cost. It should be taken as given that the people in CEEFSU strongly desired the implementation of the necessary reforms to establish a market economy with the lowest possible cost, interpreted as economic and ideological-behavioural cost. People were able to show their approval or dissatisfaction with the reforms by exercising their newly established democratic rights, giving rise to a political cost associated with the reform process. With regard to the external environment, governments in transition economies faced a set of constraints regarding financial aid and foreign direct investment. Mature market economies and international financial organisations were willing to provide financial aid only to transition economies which pursued a shock therapy approach, giving rise to a financial aid cost associated with the transition model implemented. As well, foreign

companies were willing to invest only in transition economies which allowed a high degree of freedom in decision-making, consistent with the free market approach, giving rise to a direct foreign investment cost.

The cost of transition consisted of the economic cost, political cost and international cost. International cost consisted of International Financial Aid Cost and Foreign Direct Investment Cost. Each transition model can be ranked from the highest to the lowest transition cost on the basis of each element of cost.

5.1 Economic cost

Economic cost is associated with the reduction in output and employment and increases in inflation that each model recommended. The shock therapy process of transition involved the highest reduction in output and employment, followed by the Post-Keynesian model, then the Market Socialist model. The neoclassical gradualist model, which has the least economic cost, together with the Chinese model, shares the ranking in position four. It should be remembered that the neoclassical gradualist approach used as its prototype the Chinese model of transition and maintained centrally administered directives.

5.2 Political cost

Political cost is associated with the maintenance of political support for the reforms each transition model recommended. The Post-Keynesian model and the Market Socialist models did not have any, or had very small, political support, while the shock therapy and the Chinese models initially had political support, but as time passed, the political support was substantially reduced. The Neoclassical gradualist model appears to be the model with stable political support.

5.3 Ideological cost

Ideological cost is associated with necessary change in the ideological and cultural foundations of individual behaviour required by the chosen model. Given that people in CEEFSU were initially willing to tolerate and accept a combination of radical and gradual changes in the reform process towards the establishment of a capitalist system, the model with the highest ideological cost would be the Chinese model, followed by the pluralistic market socialist model, then the Post-Keynesian. The people in CEEFSU place both the neoclassical gradualist and the shock therapy models at the lowest ideological cost, since both approaches were consistent with the willingness to change towards a capitalist economic system. However, the neoclassical gradualist approach involved a less radical change in behaviour.

5.4 International cost

International cost is associated with the external environment in response to the model implemented. International cost can be distinguished by the following two elements:

1 International financial aid cost

International financial aid cost is associated with the provision of international financial aid by international financial institutions and mature market economies in response to the model implemented. International financial institutions and mature market economies were willing to substantially fund the transition economies that implemented shock therapy, and, to a lesser extent, the neoclassical gradualist model. They were not willing to finance transition economies that implemented any of the remaining models.

2 Foreign direct investment cost

Foreign direct investment cost is associated with the voluntary movement of financial capital to the transition economies in response to the transition model implemented. International financial capital would not be willing to invest in transition economies, which implemented the Post-Keynesian, or the Pluralistic Market Socialist models. While financial capital financed projects in the transition economies, which implemented the shock therapy approach, the instability caused by the radical reforms was a deterrent, and the dominant form of privatisation was through free distribution of vouchers. The neoclassical gradualist model offered stability in the reforms, as did the Chinese model, with the establishment of special economic zones, which were consistent with a free market approach. Privatisation took place by auctions in the neoclassical gradualist approach.

By assuming that each element of the cost of transition has equal weight, each transition model can be ranked from the highest to the lowest cost on the basis of each element of the cost of transition. The ranking can be interpreted as a cost index for each element of the cost of transition. Tentatively, the following table can be created.

Table 3 Ranking of alternative models of transition on the basis of elements of cost of transition

	<i>Economic cost</i>	<i>Political cost</i>	<i>Ideological cost</i>	<i>International financial aid cost</i>	<i>Foreign direct investment cost</i>
One (highest)	Shock therapy	Post-Keynesian	Chinese model	Post-Keynesian	Post-Keynesian
Two	Post-Keynesian	Market socialism	Market socialism	Market socialism	Market socialism
Three	Market socialism	Chinese model	Post-Keynesian	Chinese model	Shock therapy
Four	Neoclassical gradualist	Shock therapy	Shock therapy	Neoclassical gradualist	Neoclassical gradualist
Five (lowest)	Chinese model	Neoclassical gradualist	Neoclassical gradualist	Shock therapy	Chinese model

We can rewrite the table based on the ranking of each model of each element of the transition cost. In the case of an equal ranking, the average is taken as an indicator of ranking.

Table 4 Cost indices of alternative models of transition

<i>Transition model</i>	<i>Shock therapy</i>	<i>Neoclassical gradualist</i>	<i>Post-Keynesian</i>	<i>Market socialism</i>	<i>Chinese model</i>
Economic cost	1	4.5	2	3	4.5
Political cost	3.5	5	1.5	1.5	3.5
Ideological cost	4	5	3	2	1
International financial aid cost	5	4	2	2	2
Foreign direct investment cost	3	4.5	1.5	1.5	4.5
Sum of ranks (R _j)	16.5	23	10	10	15.5

The best estimate of the 'true' ranking of the five alternative models of transition is provided by the order of the various sums of ranks R_j, when the Kendall Coefficient of Concordance W is significant. If one accepts the cost criteria by which I have ranked the alternative models of transition, and assuming equal weights, then the best estimate of the 'true' ranking of the alternative models according to the cost criteria is provided by the order of sums of ranks (Siegel, 1956,p.238).

Kendall's Coefficient of Concordance:

$$W = \frac{s}{\frac{1}{12}k^2(N^3 - N)}$$

$$s = \sum \left(R_j - \frac{\sum R_j}{N} \right)^2$$

where:

k = number of sets of rankings (= 5 cost criteria)

N = number of elements ranked (= 5 models of transition)

R_j = sum of ranks:

$$\sum R_j = 75, \quad \frac{\sum R_j}{N} = \frac{75}{5} = 15,$$

$$s = (16.5 - 15)^2 + (23 - 15)^2 + (10 - 15)^2 + (10 - 15)^2 + (15.5 - 15)^2 = 116.5$$

$$\frac{1}{12}5^2(5^3 - 5) = 250$$

$$W = \frac{111.6}{250} = 0.466.$$

W expresses the degree of agreement among the five cost criteria in ranking the five models of transition. $W = 0.466$ is significant at 0.05 because $s = 116.5 > 112.3$ the value of significance (Table R in Siegel, 1956,p.238). Consequently, we can use the order of the sum of ranks as the best true ranking of the five models of transition based on five cost criteria of transition. Thus:

Ranking of the Alternative Models of Transition based on the Cost of Transition = ...
 ...= Economic Cost + Political Cost + Ideological Cost + ...
 ...+ International Financial Aid Cost + Foreign Direct Investment Cost.

The sum of ranks reveals the following order.

Table 5 Ranking of alternative models of transition on the basis of total cost of transition

<i>Model</i>	<i>Total cost of transition from highest to lowest</i>
Post-Keynesian Market socialism	10
Chinese model	15.5
Shock therapy	16.5
Neoclassical gradualist	23

The optimality criterion tilts towards the neoclassical gradualist model. The reduction in output was smaller than under shock therapy; political support for the reform was maintained after the election results; foreign aid was provided, albeit less than in the shock therapy model; and foreign direct investment was substantial owing to auctioning of the state enterprises, in contrast to the free distribution of shares by the shock therapy model. Thus it appears that the neoclassical gradualist model of transition reduces the cost of transition, satisfying the optimality criterion. The neoclassical gradualist model can be interpreted as the optimum model of transition under the aforementioned internal and external constraints. It can be argued that the neoclassical gradualist model maximised social welfare under the given internal and external constraints.

6 The influence of the initial conditions on the cost of transition

If initial conditions mattered, what would be the impact of initial conditions on the cost of transition? As analysed, the shock therapy approach did not show any concern about the initial conditions. The neoclassical economists showed some concern about the initial conditions during transition, but these differences would be ironed out as the transition economies drew near to the establishment of a free market. Post-Keynesians considered the initial conditions important and the role of the government, when implementing discretionary policies during and after the completion of the transition process, to incorporate them into their policies. For the market socialists, both pluralistic and non-pluralistic, initial conditions were extremely important in shaping the development of socialism.

The influence of the initial conditions in determining the process and cost of transition is directly linked with the perception that each model had with respect to whether what elements, if any, of the existing structure of the centrally administered socialism should remain. Each model of transition had to determine whether any aspects of the initial conditions of centrally administered socialism were consistent with, and desirable in, a market economy, as perceived in the definition of a good society of each model. It is obvious that the more elements are maintained from centrally administered socialism in the market economic system, the less the reforms that are required, thus the less the cost of transition. The shock therapy approach did not show any concern for the initial conditions since it advocated the destruction of all the elements of centrally administered socialism, so as to instigate 'creative destruction': from the ashes of the destruction of centrally administered socialism the free market would be naturally created. The neoclassical gradualist economists showed some concern for the initial conditions, since during the transition process elements of the centrally administered economy would be maintained and gradually eliminated. Consequently, for the neoclassical gradualist economists, the role of the initial conditions and, as such, of the elements of centrally administered socialism in influencing the process of transition, would be important only at the beginning of the transition. As the transition process gradually gained momentum, the elements of central administration would disappear and, as such, the initial conditions would become unimportant.

The Post-Keynesians perceived that the initial conditions influence the transition process owing to the fact that a number of elements of the centrally administered economic system should be maintained; for example, discretionary fiscal and monetary policies, incomes and industrial policies, fixed exchange system and the coordination of international trade through a customs union. However, with the completion of the transition process, based on the definition of a good society from a Post-Keynesian perspective, the economy would be dominated by private property and markets. Consequently, the transition process required a substantial amount of reforms and the destruction of a number of the elements of centrally administered socialism, thus increasing the transition cost. Of course, the increase in the transition cost would be to a lesser extent than with the neoclassical gradualist and a lot less than with the shock therapy.

The pluralistic market socialist approach considered the initial conditions extremely important, since the model maintained most elements of centrally administered socialism. However, the model required the transformation of medium enterprises to cooperatives and small enterprises into private property, increasing the cost of transition, but to a lesser extent than the aforementioned models. The Chinese model maintained all the elements of centrally administered socialism and allowed the development of markets by eliminating restrictions and 'grow out of plan'. As a result, the Chinese process of transition by putting emphasis on the maintenance of the elements of centrally administered socialism and, per se, on the initial conditions, would have the lowest transition cost, if only the initial conditions mattered.

7 Conclusion

It was demonstrated that a political economy approach to the transition process gives rise to alternative models of transition. An attempt was made to identify an optimum model of transition. The lowest cost of transition is associated with the neoclassical gradualist model of transition. Of course, the aforementioned analysis has its weaknesses. The weights assigned to each cost are the same, which is not necessarily correct, and there might be interdependence between the elements of cost. With regard to the benefits of transition, the preexisting factors or the initial conditions were ignored. However, if the initial conditions mattered, the Chinese process of transition by putting emphasis on the maintenance of the elements of centrally administered socialism and, per se, on the initial conditions, would have the lowest transition cost.

In defence of the process of calculating to identify the optimum model of transition, the process has been able to provide an explanation, using a purely formalistic analysis, of the eventual dominance of the gradualist models of transition. Further research may be able to provide a more robust outcome, identifying the net benefits of transition by using fewer assumptions.

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Notes

- 1 It can be argued that the term 'transition' implies a fixed end-state, which is equated with well-defined property rights and fully operational market relations. As such, the term has been criticised as inadequate and the term transformation is preferable as it is open ended and embraces path dependency.
- 2 It could be argued that the shock therapy approach, because of its narrow transition policy recommendations – 'getting the prices right' and the remaining elements of the economic system would fall into place – was an antithesis of the political economy approach. The shock therapy approach abstracted from the political economy dimension of the gradualist models of transition. Certainly, the shock therapy approach was not a 'holistic' approach.
- 3 I have restricted economic analysis into three methodologies by incorporating the Keynesian approach in the Post-Keynesian methodology and the Monetarist approach in the neoclassical methodology.
- 4 The debate on the feasibility of the market socialist model has produced alternative market socialist models of Lange and Taylor (1939), Bardhan and Roemer (1993) and Lo and Smyth (2002). A generic market socialist model is assumed in this paper.
- 5 The critics of the voucher privatisation process argue that the free distribution of shares produced bad governance, poor performance, tunnelling and looting, as for example in the Czech Republic (Cull *et al.*, 2002; Claessens and Djankov, 1999; Weiss and Nikitin, 1998; World Bank, 1998). In general, management was able to keep its privilege position and, at the same time, increase their fortunes despite the 'free distribution of shares'.
- 6 The success of privatisation policies, independent of the method of privatisation, has been questioned. There is no clear evidence that privatised enterprises perform better than state enterprises just in the aftermath of privatisation (Kolodko, 1999a,p.11; Stern, 1996,p.8; Agnion *et al.*, 1994). For example, for Mongolia, Anderson *et al.* (2000) found that state-owned enterprises perform better than privatised firms.