Journal of Economic and Social Policy

Volume 5 | Issue 2 Article 4

1-1-2001

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John Marangos
Monash University

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John Marangos*
Department of Economics
Monash University
Clayton Melbourne Victoria

Abstract

The implementation of the orthodox policies in transition economies resulted in a substantial reduction in output, large unemployment and hyperinflation. The orthodox policies were implemented without any concern for the appropriate institutional development to support the market mechanism. A Post Keynesian approach to the transition process would have first and foremost developed by state action an appropriate institutional structure to foster a civilised society. As well, a civilised market society required labour market institutions, which substantially reduced the opportunities for criminal and illegal activities during the transition process.

Introduction

The implementation in Russia and Eastern Europe of the orthodox principles and policies, which were imposed by the IMF and the World Bank, had renowned results: a significant reduction in output, hyperinflation and double-digit unemployment rates. The orthodox economists argued that these 'short-term' negative outcomes were necessary to achieve sustained economic growth in the long run. In addition, an outcome of the orthodox policies was the rise of corruption and illegal activities, which were unaccounted for and caught the reformers by surprise. In contrast, for the Post Keynesians, the rise of corruption and illegal activities was a natural outcome of the orthodox policies. Orthodox economists underestimated the role of institutions for a

* I am grateful to John King and two anonymous referees for their useful comments.
Home page: http://www-personal.buseco.monash.edu.au/~mara/

well-functioning economy and a civilised society. This is because, for the orthodox economists the institutional structure, as for any good, as long as, there is effective demand the good would be produced by the market; the market in due time would deliver the most efficient institutional structure.

Post Keynesians reject the three assumptions of orthodox economic theory: that the economic environment is ergodic (that the future can be estimated from past statistical information), the neutrality of money (changes in money cannot influence real economic variables) and gross substitution (everything is substitutable for everything else). The non-ergodic economy argument erases automatically the remaining two assumptions of the orthodox model. Post Keynesianism is a more general theory because it is based on fewer assumptions (Davidson 1996, p. 494). The transition process was a nonergodic process because neither the result nor the probability distributions could be deduced from the past. The transition was an unfamiliar idiosyncratic process. Keynes (1936) declared that 'we simply do not know', which clearly was relevant for transition economies. Thus, given the non-ergodic nature of economic processes, it was a priori unlikely that the market can deliver efficient institutions. Essentially, all long-term economic problems, especially the transition process, are structural and institutional. Institutions affect not only economic growth but also the ideology and culture which prevail in society, consequently the purposes and goals to which people aspire (Hodgson 1988, p. 271).

However, even if it was possible for the market to produce an efficient institutional structure it would have been an extremely time consuming process; allowing, in this way, the opportunity for criminal activity to surface. Most importantly, the market was incapable of satisfying effective demand, so it was also unable to respond to the immediate demand for a complicated institutional structure. For the Post Keynesians the immediate establishment of the appropriate institutional structure by state action was indispensable, in view of the fact that the goal of Post Keynesians in transition economies was the development of a civilised society (Davidson G. & Davidson P. 1996; Marangos 2000). Post Keynesians are essentially institution builders: institutions attempt to provide some stability in an uncertain world, full employment (Arestis, Dunn & Sawyer 1999, p. 546; Dunn, 1999, p. 10) and a civilised society. The immediate establishment of civilised institutions may have prohibited the rise of corruption and illegal activities in transition economies.

Post Keynesians have been criticised by institutionalists that their study of institutions is pretty thin. Hodgson (1988, p. 241) argued that there exists a foundation for the extension of Post Keynesian analysis along the institutional paradigm; 'it was with institutionalism as a midwife that Keynesian macroeconomics was born' (Hodgson 1993, p. 260). Actually, Post Keynesians are now realising that the institutional framework can assist their understanding of economic behaviour (Dunn 1999, p. 10). A synergistic synthesis of a Post Keynesian-Institutional approach is attempted in this paper with special reference to the transition economies of Russia and Eastern Europe.

Institutions: Post Keynesian versus Orthodox View

Most of the institutional literature on transition, which is based on orthodox principles, perceived that the creation of guaranteed property rights was the ultimate goal of institutional development (Smyth 1998, p. 362, 365). This is a very limited view of the institutional development required in transition economies. Consequently, the orthodox transition model recommended economic policies independent of the institutional structure because the same economic principles were supposed to be present in all societies. This presumably reflected their basic assumption that the economic environment is ergodic. In the certain or calculable probabilistic world of orthodox economics there is no need for forward contracts since there cannot be any deviation from the foreseeable agreed terms of the contract (Davidson 1994, p. 99). However, equations do not embody institutions (Clower 1999, p. 400). For example, monetary policy can never be independent of the institutional structure in the financial sector (Arestis & Howells 1992, p. 135).

The future is uncertain and not calculable so rational expectations in the orthodox sense are impossible; most economic activity is based on accepted conventions and social values (Robinson 1974, p. 8). Conventions and social values are a means to mitigate uncertainty and enable agents to successfully broach an uncertain future; they govern, condition, limit and facilitate how an act could or should be performed (Lawson 1997, p. 163). Non-market institutions and rigid ‘imperfections’ play a necessary role in enabling the market to operate (Hodgson 1988, p. 240). For example, preferences were not exogenous in transition economies. Socially defined conventions and social values about consumption substantially influenced consumer preferences. Because information was difficult to acquire and limited, individuals depended on socially determined behaviour and conventions. Thus the income available to the consumer in transition economies, combined with socially defined conventions about consumption patterns, determined consumer choice (Hammer & Akram-Lodhi 1998, pp. 421-2). Therefore, 'the concept of 'market culture' is more broad than just property rights' (Smyth 1998, 367).

For the orthodox transition models there was no concern with the efficient design of institutions, the political and cultural consequences, or how the existing institutions influenced the transition to a market economy. Orthodox economists ignored the importance of implanted social institutions and the role of the state in the market (Taylor 1994, p. 65). In contrast, Post Keynesians stressed that institutions develop as a result of a specific cultural framework, that is, social experience and social norms, and by local characteristics (Walder 1996, p. 1070). This was because pre-existing institutions influence the shape of what would be developed. Hence, the development of the institutional structure should be conceived as a path-dependent process that necessitates readjusting existing institutions to the changing economic framework since institutions are both outgrows and reinforcers of routinised thought (Hodgson 1993, p. 253). Accordingly, institutional change was path-culturally-dependent, making 'the process of transition so difficult and uncertain' (Grossman 1997, p. 254).

In pursuing a highly abstract analysis based on supposedly universal propositions, orthodox economics neglected institutional specificities and cultural variations in transition economies. The focus on equilibrium outcomes, neglected structural transformation and ongoing dynamic change (Hodgson 1999, p. xvii). For the Post Keynesians, economic policy cannot ignore institutions since the institutional framework of an economic system is a basic element of its economic dynamics (Kalecki 1970, p. 415). Economic processes, which are the subject of Post Keynesianism, are dynamic while economic equilibria, the subject of neoclassicism, are static (Dugger 1996, p. 33). Post Keynesians emphasised path-dependence, the presence of which results in past states influencing later ones (Setterfield 1998, p. 168; Arestis Dunn & Sawyer 1999, p. 537). Economic action in times of uncertainty is part of the economy in real time. The economy cannot be separated from history; 'institutions matter and history matters' (Smyth 1998, p. 378). Thus, 'our actions are informed by history and limited by history' (Brockway 1998, p. 164). Economic action takes place in historical time where past experiences - we are creatures of the past - together with the incremental evolution of institutions, influence present actions that determine the future (Arestis, Dunn & Sawyer 1999, p. 537; Setterfield 1998, p. 168; Argyrous & Stilwell 1996, p. 145). The future is different from the past. The social nature of individual behaviour is highly influenced by institutions and organisations; institutions enable ordered thought and action by imposing form and consistency on the activities of human beings (Hodgson 1993, p. 253; Arestis & Sawyer 1993, p. 5). This is because economic behaviour is positioned in socially constructed institutional structures and not in an impersonal market process. Economic behaviour takes place within a 'socio-economic context', with individual constraints 'which promote and prevent, reward and punish his or her actions' (Kregel, et al., 1992, p. 85). Political-economic reforms fail not because market liberalisation proceeds quickly or slowly, but because supportive institutional reforms develop too slowly (Thomas & Wang 1997, p. 238). The pace of institutional development determines the speed of reforms.

Meanwhile, 'economic principles are neither timeless nor independent of the civic setting and the prevailing institutions' (Davidson G. & Davidson P. 1996, p. 64). This is because the market *per se* is not the important issue in the economic system. The institutions, which define markets, are more important (Walder 1996, p. 1060-1). The perception of the rules held by society determined the cost of contracting. If the rules were considered fair they reduced the costs of contracting, if unjust they increased costs. The 'deficiencies [of the shock therapy model] are associated with the side-stepping of the institutional hysteresis associated with any market or government action (Yavlinsky & Braguinsky 1994, p. 90). Accordingly, the institutional structure could not be left entirely to market forces; its development was an active and deliberate process. Schlack, (1996, p. 619) argued that institutional development is the result of discretion and not natural selection. Thus, institutional change cannot be based on the universal principle of market solution adopted by the orthodox transition model. Instead, the market must be tempered by legislation and social practices that enhance considerations of fairness and cooperation (Hodgson 1988, p. 272).

It should be recognised that the orthodox approach to institutions can be distinguished between 'old' Institutional Economics[1] and New Institutional Economics[2]. While both approaches are embedded in neoclassical economics

[1] The representatives of the old institutionalist school are Thorstein Veblen and John Commons. Some of the characteristics old institutionalism are: positing a holistic alternative, individuals are situated and moulded in a evolving social culture, regard institutions as additional or alternative analytical units and focusing on processes of cumulative causation (Hodgson 1993, p. 301)

[2] Orthodox economics used to ignore institutions and treat the firm as a 'black box'. Since the 1970's there have been sustained attempts to remedy this defect. Representatives of the new institutionalist school are Douglas North, Mancur Olson, Rirchard Posner, Andrew Schotter and Oliver Williamson (Hodgson 1999b, p. 12).

the policy implications for transition economies are quite distinct. New institutional economics was used to rationalise the gradual approach. Murrell (1991a, 1991b, 1992, 1994) in particular, has been very critical of the shock therapy approach to institutional development in transition economies, since institutions matter, favouring a gradualist approach. However, the development of the institutional structure of the shock therapy and the gradualist neoclassical process appear to be quite similar. While both argued that market institutions could only result from market forces, gradualist neoclassical economists allow institutions to develop concurrently with market relations. For shock therapy supporters, the goal was the development of market relations first with the assumption that efficient institutions would follow in due time. The gradualist neoclassical argument suffered from the same flaws. Gradualist neoclassical writings fail to offer a concrete process of institutional development. They simply leave the end-state to be determined by the market, assuming that the most efficient institutions would emerge. The gradualist neoclassical break with shock therapy was far less complete than it appeared to be (Smyth 1999, p. 387).

State versus Market Produced Institutions

Societies bolster a productive balance between self-interest and civic values through specific institutions. The historical development of markets was associated with pre-existing institutions, which made possible the development of market societies in such a way as to maintain 'liberty, prosperity and justice in their societies for many generations' (Davidson G. & Davidson P. 1996, p. 15). Thus, the aim of market institutions was to encourage self-interest and, at the same time, safeguard the society from any tarnish of civic values by individualism. Institutions control the diverse individual interests in an efficient manner (Smyth 1998, p. 374). The incentives built into the institutional structure determined the skills and knowledge that were rewarded. Actually orthodox economics misunderstands the nature of learning and knowledge in a modern economy. An understanding of the nature and importance of learning in modern socio-economic systems undermines the individualistic and free market utopia (Hodgson 1999, pp. 10, 12).

Meanwhile, failure by suitable institutional structures to restrain the pursuit of self-interest inhibits the development of a cohesive society (Kregel et al., 1992, p. 1). This, based on Post Keynesians principles, was exactly what happened in transition economies. Corruption could not be reduced in transition economies until the institutions of a market economy were fully established (Oberschall 1996, p. 1028). When the state started to disintegrate, which resulted in the inability to foster a civilised institutional framework, the only path remaining was that of a criminal sociopath (Bunknall 1997, p. 21). There was a danger that transition economies might have developed an institutional structure, which served the interests of the criminal elements. In Russia, especially, this actually materialised. Consequently, a broad variety of institutions of non-market co-ordination were necessary for high performance market orientation in transition economies (Stark 1996, p. 1018) and the establishment of a civilised society.

Post Keynesians argued that the institution of private property and property laws must set clear rules of ownership and control. Private ownership could not be effective without establishing property rights. This would provide a stable framework for doing business. The success of institutions is the result of their capability in enforcing claims and not simply in achieving allocative efficiency (Bowles & Gintis 1993, p. 87). Private property rights in the transition economies of Russia and Eastern Europe were ambiguous and insecure, so that privatisation did not really have a meaning (Olson 1992, p. 289). The privatisation of state enterprises should have taken place at a much later stage, once an appropriate institutional structure had been established by state action.

Without a social commitment to the rule of law, legislation remained unenforceable and was ignored. If the members of society loose their confidence in state institutions to enforce contracts, the monetary system breaks down and the society returns to barter (Davidson 1994, p. 102). The transition economies experience reveals exactly this outcome. The shock therapy approach removed in one shot the institutional structure without replacing it, consenting to the free market to set up the appropriate institutional structure. Relying on the market to produce efficient institutions and concluding that their survival and superiority was the result of efficiency, ignored path-dependence and multiple equilibria (Bowles & Gintis 1993, p. 97). In particular, orthodox economics is narrow and formalistic, unable even to grasp the institutional and cultural essentials of the market system (Hodgson 1999, p. xvii). This was the reason for the substantial fall in output, reiterating that economic reforms could not be initiated before the introduction of institutional reforms.

Contrary to the orthodox transition models, the setting up of the institutional structure required government action: ‘it cannot be left to chance or left until later’ (Rider 1994, p. 8). Government institutions provided certainty in an uncertain market system. It should be emphasised that institutional intervention had to be both broad and deep (Hodgson 1988, p. 272) in transition economies. The goal of the institutional structure was to initiate some basic changes in social relationships and personal goals in Russia and Eastern Europe to deal with the kind of crisis which was affecting transition economies due to the orthodox approach.

The institutional structure not only facilitates the smooth functioning of the market process, but also provides solutions to market failure. There needs to be a regulatory framework, which internalises any externalities. 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. Consequently, 'the solution then is for countries in transition to 'get the institutions right' (not prices, as neoclassical theorists have maintained)' (Grossman 1997, p. 251).

Market-produced institutions, as the orthodox transition model postulated, were assumed by orthodox economists to be efficient. In contrast, Post Keynesians argued that market-produced institutions could not be always socially efficient. A civilised society required institutions, developed as a result of purposive action to satisfy specific needs consistent with the society's civic values. Market-produced institutions based on self-interest were the product of interests wanting to maintain the status quo or lobbying for preferential treatment. As such, the institutions were based on how powerful these interests were, which could not result in an efficient outcome. The implementation of shock therapy without the institutional structure in place, and the allowance of spontaneous market forces to create those institutions, resulted in an institutional structure, which was uncivilised, inefficient and difficult to remove because it was linked with vested and criminal interests.

Labour Market Institutions

Labour market institutions are essential for an efficient and civilised market economy. Labour market institutions should regulate and stabilise the nominal and real wage by means of collective bargaining between trade unions, employers' organisations and government. In view of the fact that the labour market is not a 'true' market in the sense that the price of labour, the wage, is insufficient in executing the market-clearing function; variations in the wage rate cannot reduce unemployment (Applelbaum 1979, p. 100). Thus, the

determination of wages has to be done outside the ‘free’ market as to establish norms of fairness (Hodgson 1988, p. 272).
It is firms, not labour, that determine the real wage in the product market when firms decide the mark-up (Cornwall & Cornwall 1997, p. 533). The government could use its discretionary power and intervene whenever the outcome is considered undesirable. In fact, the participation of the state in the economy parallels the growth of collective bargaining and the changes in the nature of the wage contract (Caporaso & Levine 1993, p. 119). Economies that do not have adequate labour market institutions are susceptible to inflationary and deflationary movements (Herr & Westphall 1991, p. 322). The realisation of a civilised society, which achieves full employment and also controls inflation, requires an incomes policy through a defined institutional structure. Through an incomes policy, workers are willing to constrain their wage demands if management invests their profits in increases in productivity.

Keynes’ (1936, pp. 377-379) policy recommendations were designed to ensure that there was never a lack of effective demand. This did not necessarily require government intervention. All that was necessary was the development of institutions to ensure that effective demand was maintained at the full employment level (Davidson 1996, p. 503). Thus, institutions established through public policy play a vital role in determining the performance of market economies (Minsky & Whalen 1996-7, p. 161). Meanwhile, ‘the dominant, neoclassical theory of labour markets is institutionally naked’ (Tilly & Albelda 1996, p. 199). The lack of labour market institutions in transition economies, consistent with the orthodox economic theory, resulted in the well-known results aforementioned. When people were ‘naturally transitional unemployed’ and there was no welfare state, the only option in times of desperation was corruption and illegal activities. These ‘short-term’ negative outcomes were not necessary and actually do not appear to be only short term. The level of corruption and illegal activities in transition economies cannot be interpreted as ‘short-term’. The Post Keynesian analysis revealed that the ‘short-term necessary negatives of transition’ could easily have been avoided by the development of labour market institutions, which eliminated ‘natural transition unemployment’.

A tax-based incomes policy is a ‘clever’ anti-inflationary policy (Davidson 1994, p. 149). It is consistent with a civilised society, because it combines self-interest and civic values in the determination of wages. Under a tax-based incomes policy, firms that pay a wage increase above the socially acceptable non-inflationary level, which is based on civic values and the average labour productivity growth, would be penalised in the form of higher taxes. Also, the government would have to educate people that there were no 'winners' or 'losers' in any income distribution battle and explain the factors affecting the magnitudes involved in tax-based incomes policy. Davidson (1994, pp. 150-1) compares the tax-based incomes policy to road regulations controlling driving behaviour. While speed limits are set at a socially acceptable level, the magnitude of the speed changes based on the driving conditions. A tax-based incomes policy is fundamentally linked with expansionary fiscal and monetary policies. As a result, 'planned recessions would be a thing of the past' (Davidson 1994, p. 151). An incomes policy was essential for an effective anti-inflationary policy (Eichner 1979, p. 175; Kenyon 1979, p. 44). Surprisingly, Sachs and Lipton (1990, p. 56) recommended a tax-based incomes policy for transition economies.

Conclusion

The development of market institutions was one of the most challenging tasks for reformers in transition economies. The Post Keynesians considered that the absence of dependable market institutions could only result in an undesirable outcome from society's point of view (Davidson 1994, p. 234). The inadequacy of market institutions in transition countries made liberalisation policies ineffective (Thomas & Wang 1997, p. 238). Empirical evidence also supports this proposition: the differing economic performance of transition economies, after factoring the initial conditions and the external environment, depended mostly on the institutional structure and not so much on the progress of liberalisation *per se* (Popov 2000, p. 36). Market institutions were supposed to be the result of the market processes, which never eventuated. Meanwhile, the unregulated market failures worsened the quality of life (Esty 1997, p. 372). Post Keynesians recommended active state intervention in institutional development, which blended self-interest with civic values to encourage the development of a civilised capitalist society.

The analysis of alternative strategies for institutional development revealed a paradox. The Post Keynesians, while advocating a gradual transition process, required immediate state intervention to formulate, implement and enforce market institutions to create the pre-conditions for a civilised market economy. Instead of immediate price liberalisation the Post Keynesians proposed immediate establishment of civilised institutions. It was essential, to immediately establish the civilised market institutions by state action, to guide gradually economic behaviour towards the development of a civilised society.

Thus, substantially reducing the opportunities for criminal and illegal activities during the transition process.

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