

# Studying the Economics of Transition<sup>1</sup>

## Economics of Transition

Over the past thirty or more years, the economies of China, Vietnam and many countries in Eastern Europe have undergone dramatic change, transforming themselves from centrally planned to market economies. This is an unprecedented process as no economy has ever moved from a comprehensively controlled economy to a market economy, although many have traversed the reverse path. It is rather easy to get a general idea of what has to be done -- privatize, create a functioning legal system, liberalize prices and wage -- it is much harder once we have to get down to specifics.

The Economics of Transition is a new area. Transition is a comprehensive change, involving all aspects of the economy, including labor markets, capital markets, and the organization of industry, especially privatization. This requires an examination of a number of problems. It will also require the adoption of a methodology that takes into consideration an understanding of various principles.

Transforming an economy from plan to market is also an unprecedented historical event. The development of market economies in industrialized countries was a process that took centuries. This was a gradual process, unguided by any plan of goal for the end result. Transition, on the other hand, represents an attempt to transform an economy in a conscious fashion. Transition thus involves the study of the creation of markets. Transition is thus a social experiment and tells us something about the ability of policy to drive economics processes. It may also turn out to be a measure of our understanding of the conditions needed to support a market economy. A key question is whether it is possible to design and implement a blueprint for transition.

Transition is also interesting to study from the perspective of development economics. Typically development economics studies the experience of poor countries; poor in a particular way. No just low per-capita income, but underdeveloped. Most transition economics (other than China and Vietnam) were relatively poor, but they were already industrialized, urbanized, and had educated work forces. Underdeveloped countries do not. There is, however, a key question that applies to both development economics and transition economies. That is, what is the importance of institutions to development? If transition were relatively cost-less and painless, than the argument could be made that institutions are not important to economic development.

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<sup>1</sup> Some of the material is taken from Ickes, Barry, Introduction to Transition. Used with permission.

### **Question: What is the importance of institutions to Development?**

One answer to the above question is that institutions are precisely what transition economies lack. The fact that transition to a market economy is rocky suggests that developing these institutions is tricky. This also suggests that institutional gaps may be the key problem that faces developing countries, rather than the lack of resources. Thus, the problems of developing countries and transition economies may not be all that different.

### **The Nature of Transition**

Transition is interesting because of the pace of institutional and structural change that is taking place. Processes that took centuries in the West are taking place at breakneck speed in the former centrally planned economies. This allows economists the study the evolution of markets in real time. The comprehensive nature of these changes makes this more exciting, but also is the source of the major analytic hurdle to the field. With so many changes taking place simultaneously, it is hard to analyze these processes with the economist's normal tools. Conventional economic analysis focuses on the comparative statics of equilibrium states. Transition, however, is primarily concerned with the path taken between states. This leads to the suggestion that an evolutionary approach is more suitable to the study of transition economies. An evolutionary approach dispenses with the notion of equilibrium, focussing instead on processes.

The essential insight of the evolutionary view is that organizations solve coordination problems through routines. Using routines eliminates the necessity to optimize at each moment in time and it economizes on information a world of uncertainty. Perpetuation of organizational routines may thus be a means of protecting against the conflict that would arise in any attempt to find alternative solutions to problems. This creates an environment in which change will not occur or will take place at a very slow pace. The advantage, however, is that it creates organizational stability.

If organizational routines are slow to change, what accounts for the dynamics of society? In capitalist countries we can point to three mechanisms which are crucial. First, markets reallocate resources from the less efficient to more efficient organizations. This is an automatic mechanism. Second, bankruptcy, takeovers, and mergers are means by which inefficient organizations can lead to new routines. Third, entry of new organizations can lead to new routines.

### **Questions: What are some of the organizational conflicts that may exist in a transition economy? What should be the pace of these changes?**

We can summarize the nature of the evolutionary model.

- *persistence in organizational behavior*: this follows from the use of routines and the fact that search for new ideas reflects the historical experience of an organization.
- *focus on economic environment*: in a stable environment the type of routine and behavior that are present in any society will be conditioned by the environment. in other words they adapt. (Does this mean that over time the society will become more productive? No. Productivity will only increase if the social system encourages productive behavior) If the fittest survive, then those organizations will be those most suited to the environment.
- *entry and exit are emphasized*: change from competition from organizations takes precedent over change within organizations.

One of the critical insights of the evolutionary view is that it is easier to create new private firms than to change the behavior of state-owned enterprises. Organizations have their own routines in which formal change in ownership are unlikely to change right away. For, example, the enterprises that survived central planning have routines that are conditioned to the administrative-bureaucratic system of planning. Not only the routines, but the personnel in these institutions were selected according to the needs of the environment of the pre-transition. This is not to say that introducing market reforms does not put pressure (profit maximization, for example) on enterprises. Rather the effect of the movement to a market economy may be different than what would be predicted in the market economy model. The inherited institutional structures lead to different responses and thus unintended consequences. Thus, the evolutionary approach would suggest that a radical change in the economic system will require large changes in organizational design.

**Question: What are some changes in organizational design that need to be done?**

The real difficulty in using economic analysis in transition is the degree of flux in the institutional environment. In conventional economic analysis the institutional environment is taken for granted. We assume the existence of well-defined property rights, an effective financial system, and a functioning legal system. In conventional analysis we do not think about the institutional environment because of its existence. But in transition economies it is precisely the absence of these market institutions that is at the heart of the phenomenon. In transition property rights are ill-defined, the financial system is underdeveloped and the legal system is ineffective. This means we must think about economics behavior when such institutions are missing. This is very difficult, especially when we think about ill-defined property rights; ownership is at the heart of a market economy.

**What is the importance of property-rights in an economy?**

## **How can we define property rights in an economy like China or Vietnam?**

Yet although economic analysis is not all that well-suited for this endeavor, there is definitely a need for such an analysis. Economic analysis is still useful, for without an organizational framework for analysis we move along with no plan or objective course. The difficulty is to incorporate knowledge of the institutional environment into economic analysis.

While most people agree on the need for institution development, this is much less agreement on the question on how this can be promoted. Some argue that institutional development must arise from below. That is, the supply of institutions is created by the demand; it is a bottom-up phenomenon. This is argued especially strongly by those who emphasize particular cultural and historical factors. The problem with this approach, as policy is that the success of transition depends on the rapid development these institutions.

**Do you believe there are cultural and historical factors impedes the development of institutions?**

**If you answered yes to the above question, how would you go about addressing the problems?**

### **Transition Dichotomies**

Discussion about transition focuses on dichotomies. The most important one is that between the so-called "shock therapy and "gradual" approaches. This is a question about the pace of transition. Should the economy be transformed rapidly, or should there be a more gradual approach to the new system. Often this debate focuses on issues such as liberalization or privatization: should prices be freed on all goods on day one of transition? should enterprises be privatized in a mass program, or should they be sold off gradually? This is perhaps the most controversial issue in the whole area of reform.

Related to the pace of transition is the question of *sequencing*. This refers to the order in which reforms should be introduced. The fundamental question is really whether all reforms must be implemented simultaneously, or whether there are certain reforms that must proceed others. The question is thus one of how comprehensive the reform program must be. Those that argue for rapid, comprehensive transformation point out that it is better to minimize the duration of the inevitable pain. Others point to China as a case where partial reforms have been more successful than the more comprehensive reforms undertaken elsewhere.

*Gradual versus Big Bang* differs from partial versus comprehensive reforms. Partial versus comprehensive reforms refers to the question of how complete

reform will be: is there a commitment to move towards a private property market oriented economy?

**Questions: Which is better, a big bang or gradual approach? What are the benefits and costs of each type of transition?**

### **Credibility Issues**

One of the key elements involved in transition is the concept of credibility. An important lesson from economic reforms around the world is the importance of government creditability. Will the policies convince the markets (both domestic and foreign investors, for example)?

Suppose, for example, that in a big bang approach the government commits to freeing prices and also commits to a tight fiscal and monetary policy to counter inflationary pressures that may result. Now suppose that unemployment results, and there is pressure to increase expenditure to meet social needs (compensation to workers and pensioners). If the government gives in to this pressure then the budget deficit will increase, and inflation will increase.

It may be easier to gain credibility by a choosing a sequence of smaller, piece-meal steps that can be followed. The notion is that gradualism requires steps that can be implemented. That is, those steps for which policy instruments exist. In fact, there may be an advantage to gradualism precisely because elements of reform are often complementary. If, for example, a satisfactory exchange rate system is implemented, there may be more support for the next stage of reform such as eliminating trade barriers.

While it is interesting to discuss various blueprints for transition, what really counts are the programs that are implemented. It is a lot easier to design a blueprint for transition than it is to implement it. Part of the reason why implementation is difficult is that the personnel in much of the bureaucracies have not changed over time. Though there may be change at the top, it is "down below" where programs are actually implemented.

**Question: How can the issues of credibility be addressed?**

### **Additional Transition Questions**

1. What determines the reform strategies in a transition economy? Are they primarily due to initial conditions, or the political choices of the government?
2. How crucial is privatization to developing a market economy? Is it necessary to privatize to create markets, or can markets be introduced without the conversion of state property?
3. Does transition require that divisions emerge between winners and losers? What has happened to poverty and health during transition in many countries? Can social policies be designed to reduce the pain of transformation that does not, at the same time impede the process?