TiGER

TRANSFORMATION, INTEGRATION and GLOBALIZATION ECONOMIC RESEARCH
CENTRUM BADAWCZE TRANSFORMACJI, INTEGRACJI I GLOBALIZACJI

TIGER Working Paper Series

No. 87

Institutional Economics and Transition Economies: Some Analytical Issues

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Warsaw, May 2006

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Abstract

It is argued in literature that two schools of thoughts might have been most relevant and influential to the policy formation and implementation in transition economies, with distinguishable economic and social outcomes. While Russia and some countries in the Central and Eastern Europe have commonly been perceived as the subscribers to "the Washington consensus," the transition practice in China is seen by some as a vindication of "the evolutionary-institutionalist perspective." This study attempts to assess the validity of this latter argument and, on that basis, to raise some analytical issues which may warrant further scholarly investigations. These include the role of the government in transition economies, the characteristics of China's "gradualist" approach, the essence of an economic transition and the criteria for assessing its progress. For the benefit of a fruitful analysis, these issues need to be more carefully addressed.

* JEL Classification: B25, P2, P3, O5. Key words: institutional economics (evolutionary), transition economies, the Chinese economy.

1. Introduction

The economic transition that started some two-and-half decades ago[1] has been one of the most profound experiments in the modern history, with the livelihood of about 30% of the world population being directly affected in every way imaginable. Disappointed with the slow improvements in the standard of living, pronounced economic inefficiency, and serious resource misallocation, countries that installed the Soviet-type command system have all made attempts, at a varying degree, to break away from it. The effort is intended to overcome the shortcomings of the previous practice by putting the economies onto a more market-based, outward-looking, and private-sector-led growth path. The transition in the economic front has been accompanied and reinforced by significant political, social, and cultural changes, with long-lasting implications for geopolitics and the world economy as a whole.

The economic transition can be best described as an ongoing process of "learning by doing," which was initiated against the backdrop of "no-no"—there were no well- established theories that can provide useful guidance for policy-making, and there were no contested practical experience from which references can be drawn to shape up the overall transition path. Although this characterization may be equally suitable to virtually any economic, political, and social processes, it fits the case of transition economies particularly well and does so at a grand scale. As the transition process continues to evolve over time, policy-makers in various countries have been struggling to move up along their learning curves; so do professional analysts and cautious observers.

Since the 1990s, studies on issues confronting the transition economies have grown in volumes and sophistication.[2] In contrast to the early 1990s, when writings were largely confined to position papers with specific policy focuses, the literature have now been featured with more carefully developed analytical models and empirical tests, as well as more systematically crafted case studies and cross-country comparisons. The scope of the studies has expanded considerably, from the early days' narrow focus on certain economic and

[1] In literature, the fall of the Berlin Wall in 1989 is commonly referred to as the symbolic beginning of the transition. Although this "cutting point" may be generally applicable to some countries in the Central and Eastern Europe, as well as to the former Soviet states, considerable deviations do exist. China, for example, embarked on such a process in 1979. In Europe, Hungary began to phase in reform measures (e.g., price liberalization), albeit moderate by today's standard, in as early as 1969. In Poland, about 75% of the prices for consumer goods, and 68% for industrial goods were already set free by 1987 (Jeffries, 1993). Even in case of the former Soviet Union, the departure from the traditional command economy may at least be traced back to the Gorbachev era, when the well-known *perestroika* and *glasnost* were introduced in the mid-1980s.

[2] The reference made here is to the publications in English language. The literature on transition, written in various native languages of the countries involved appeared much early and in greater volumes. In China, for example, debates on the related issues can at least be dated back to the 1970s, if not earlier.

political issues to broader, society-wide considerations, encompassing institutional, social, historical, and cultural dimensions.

Of the varying themes that have emerged from this learning process, two competing perspectives have received greater attention and often served as the source for heated debates over widely ranged issues. These two views are sometimes termed, respectively, “the Washington consensus” and “the evolutionary-institutionalist perspective.” The “big bang” or “shock therapy” approach toward transition and its counterpart, the “gradualist” or “incremental” approach, are the corresponding alternative labels. [3] Referencing to the transition practice, the Washington consensus is seen as more applicable to the cases of Russia, certain Central and Eastern European countries, as well as other former Soviet states. In contrast, the Chinese practice has been argued by some as a vindication of the evolutionary-institutionalist perspective.

This study attempts to assess the validity of this latter claim and on that basis, to raise some analytical issues which may warrant further scholarly investigations. To set the stage, the main themes underlying the two perspectives are highlighted in Section 2.[4] The discussion is confined to those aspects that are directly related to the purpose of the paper; there is no intension to exhaust every element. Certain analytical issues are raised in Section 3, with special references made to the Chinese transition practice. Section 4 concludes the paper with a brief summary.

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[3] See Roland (2000). Roland used these phrases in describing the two alternative perspectives, and argued that the pairs, such as the “big bang” or “shock therapy” vs. the “gradualist” or “incremental” approaches, are “too narrow,” since their focus has been, in his view, mainly placed on the speed of a transition. (See Roland, G., *Transition and Economics: Politics, Markets, and Firms*, Cambridge, MA: The MIT Press, 2000) But to characterize the debate as “the Washington consensus” vs. “the evolutionary-institutionalist perspective” is debatable in itself. The Washington consensus, for instance, contains more specific policy prescriptions and does not require, explicitly at least, a price liberalization to be carried out “over night,” as what the shock therapists insisted. In addition, the Washington consensus was originally intended to outline a broad set of reform agendas with the economies in Latin America, rather than the economies in transition, in mind. (See Williamson, J., “In Search of a Manual for Technopols,” in *The Political Economy of Policy Reform*, Washington, DC: Institute for International Economics, 1994; “Differing Interpretations of the Washington Consensus,” *Distinguished Lectures Series*, No. 17, Leon Kozminski Academy of Entrepreneurship and Management (WSPiZ) and Transformation, Integration and Globalization Economic Research (TIGER), Warsaw, 2005.)

[4] The topology is drawn mainly from Roland (2000). References may also be made, for instance, to Murrell, P., “Evolution in Economics and in the Economic Reform of the Centrally Planned Economies,” in Clague, C. and G. Raisser, (eds.), *The Emergence of Market Economies in Eastern Europe*, Cambridge, UK: Blackwell, 1992; Stiglitz, J., “Whither Reform? Ten Years of the Transition,” in Pleskovic, B. and J. Stiglitz, (eds.), *Proceedings of the World Bank’s Annual Conference on Development Economics*, Washington, DC: the World Bank, 1999. For the purpose of this paper, such phrases as “the Washington consensus” and “the evolutionary-institutionalist perspective” are used, as did in Roland (2000), but does so in a more or less interchangeable manner with the notions of “shock therapy” and “gradualist approach.”

2. Understanding Transition: the Washington Consensus vs. the Evolutionary-Institutionalist Perspective

To understand the issues confronting transition economies, two interrelated questions of fundamental importance must be addressed: what does a transition entail, and how to go about the process? To the first question, the advocates of the Washington consensus and the evolutionary-institutionalist perspective share a common ground: the goal for the transition ought to be the establishment of a (free or freer) market economy based on private ownership and with a democracy of some sorts. The Anglo-American model is thought of, explicitly or implicitly, as the reference for such a configuration. What differentiate the two perspectives lies mainly in their responses to the second question, namely that how can one get there? Albeit not always a clear-cut, the differences may be seen from assumptions made, policies emphasized, and the scope against which relevant issues are raised or examined—all of which can be boiled down to the differences in the readings of how does a market-based (or capitalist) system work.

The Washington consensus tends to hold a firm belief in the magic of the market mechanism in delivering sure efficiency outcomes, and pay relatively less attention to other forces that may influence the functioning of such a system. In the context of transition, the essential matter is seen as to shift the economies from one type of the system to another. The model for the new system is considered to be readily available and is believe to be capable of generating better, longer term payoffs. What matters is thus to find the ways to get there; the faster the pace of a transition, the quicker would it be for the economies to reap the promised payoffs. In contrast, the institutional economics, with its long tradition in emphasizing the role of social, political, and economic organizations in shaping up market outcomes, is not as certain about these expectations as the Washington consensus does. As a country undergoes a system-wide transition, the complex and multifaceted interactions among various forces may or may not always produce the kinds of economic outcomes that one would like to anticipate. Uncertainties involved can be profound. The transition should thus proceed in a more pragmatic fashion and allow for greater flexibilities in making the needed adjustments. To ensure a market-based system to work properly, the importance of developing the underpinning institutions and inducing behavioral changes should not be underestimated. This is necessarily an evolutionary process - something that can not be superimposed onto a society from the top, nor can it be accomplished over night. That is, the transition, by its very nature, must be gradual.

This gives raise to the issue of sequencing, which is related to the different views from the two camps about the complementarities of policy reforms. The Washington consensus tends to treat the policy complementarities as fundamental, not only to setting a transition in motion, but also for creating much needed irreversibility. The argument is that if one were to introduce reform measures piece-by-piece, the lack of reform in one area could very well drag down the progress in another area, much in the same way as the problems in the downstream of a production chain can put the operation in the upstream to a halt. In order to push the transition process forward, the reform policies, therefore, must be introduced in a comprehensive, all-at-once manner. A speedy and all-out overhauling of the existing system would also leave those who refuse to go along with no choice for turning the process backward. In comparison, the evolutionary-institutionalist perspective places more weight on how to keep the overall reform momentum going. Given the complexity and uncertainty involved in a transition, it is unlikely that one can come up with an error-free, overriding blueprint and use it to guide the process from the beginning. Introducing one reform measure may, in fact, trigger the demand for another; and in so far as the sequencing of the policy introduction is properly monitored and adjusted when needed, the transition can still move ahead in a healthy manner. As long as the reforms continue to bring about positive changes to the society and to benefit the population at large, the reversal of the process should not be a major concern, for the political support could be strong enough to offset potential resistance. This is to say that the transition can, indeed, be carried out in a step-by-step fashion.

A related aspect is the perception about the importance of initial conditions. The advocates of the Washington consensus seem to have a strong resentment toward the existing institutions in transition economies, and are preoccupied with the idea that unless these institutions are being turned upside down quickly and decisively, the chances for reforms to succeed would be rather slim. After all, these institutions are meant to be compatible with the old-day command economic system, and the individuals affiliated with the governing bodies may have little knowledge about how to behave in a market-driven economic environment. The way to overcome these obstacles is, thus, to get rid of them altogether and, as a replacement, to install something that imitates the "international best practice." Viewing economic transition as a gradual process, which interacts with social, political, historical, and cultural factors at all levels in a given society, the evolutionary-institutionalist perspective does not consider such a radical and harsh demand for institutional changes as reasonable and necessary. Instead, preserving the existing institutions and allowing them to adapt over time to a changing environment are seen as not only feasible, but also desirable for maintaining the basic social and economic orders during the transition.

In the context of transition economies, the Washington consensus prefers the government to play a minimum role in economic affairs in general, with maintaining macroeconomic stability as a notable exception. The government not only should leave its hands off at the microeconomic level, but it should also do less in areas where the market mechanism is considered to be more efficient—e.g., international trade, cross-border capital movements, and financial transactions. What the government should get involved is mainly in the area of enforcing laws and contracts and securing private property rights. In this regard, the evolutionary-institutionalist perspective holds a similar position.[5] As to the government itself, the evolutionary-institutionalist perspective is more interested in how to alter the incentive structures so as to induce the necessary changes in governmental behavior and, in doing so, to assist the developments of markets and private sectors. In comparison, the Washington consensus appears to be more concerned with the size of the governmental agencies, and much less enthusiastic about their reform-ability.

The views of the two camps differ considerably, when it comes to the issue of public ownership and how to go about its transformation. The Washington consensus has a profound distaste about the public ownership in general, and regards the state-owned enterprises (SOEs) as the major source for inefficiency in transition economies. To pave way for a market-based economy to emerge, it argues that the SOEs must be dissolved quickly, and the productive assets must be transferred to the private hands at whatever a cost. The mass privatization and assets give-away (notably in Russia and the Czech Republic) are the good examples for how the proposition has been translated into the policies on the ground. With the predetermined negative attitude toward the public ownership, it is only natural to think that any privatization

[5] This emphasis on role of the government in law and contract enforcement and securing property rights has been made by many commentators. For much of the 1990s, especially during the first half of that decade, establishing and protecting private property rights were widely seen as central to economic transition. So widely spread indeed that the view had been phrased by some as the "dominant paradigm of the west." (See, Sachs, J., C. Zinnes, and Y. Eilat, "System Transformation in Transition Economies," *HIID Discussion Paper*, No. 61, 2000; Murrell, P., "Transition According to Cambridge, Mass," *Journal of Economic Literature*, 33(1), March 1995, pp. 164-178.) This emphasis on the role of the government is, however, not limited to those in the west, but many in the transition economies as well. (See, for example, Blejer, M. I. and M. Skreb, (eds.) *Transition: The First Decade*, Cambridge, MA: The MIT Press, 2001.)
Kornai, for instance, argued that granting and securing private property rights alone would be sufficient for setting the transition process in motion, although the end-state may likely to be influenced by the reform policies implemented. (See Kornai, J., "What the Change of System from Socialism to Capitalism Does or Does not Mean," in *Journal of Economic Perspectives*, 14 (1), 2000, pp. 27-42.) Referencing to the Chinese practice, some have argued that this view of the governmental role is "too narrow." (See, for example, Newbery, D. M., "Risk, Reform, and Privatization," in Arnott, R., B. Greenwald, R. Kanbur, and B. Nalebuff, (eds.), *Economics for an Imperfect World: Essays in Honor of Joseph E. Stiglitz*, Cambridge, MA: The MIT Press, 2003.)

would be better than none; more would be better than less. When it comes to assessing the effectiveness of these efforts, the criteria applied is, not surprisingly, “how many SOEs have been privatized during a given period of time,” rather than to evaluate whether the privatized firms have, in fact, demonstrated a better performance than under the previous public ownership. The Washington consensus maintains, implicitly at least, that once the productive assets have been transferred to the private owners, the entrepreneurial spirits, driven by profit-seeking desires, would naturally flourish, and the free entry and exit of the marketplace by these firms would naturally lead to an improved resource allocation and utilization economy-wide.

In comparison, the evolutionary-institutionalist perspective appears to be less entertained by the idea of mass privatization, especially when it involves large-scale SOEs. The preference, instead, is given to the efforts that encourage the entry by new firms with varying forms of ownership (e.g., private-, collective-, or foreign-owned), alongside with the efforts in restructuring the existing SOEs. There is more emphasis on the importance of changing enterprise behavior and on nurturing the kinds of managerial skills that are more suitable to new business environments, instead of on changing ownership structure alone. The emergence of the township-and-village-owned enterprises (TVEs) in China during the early 1980s and the significant role that the firms have played since then, both in promoting economic development in rural areas and in reshaping the overall ownership structure in the economy have been most commonly cited examples in elevating these ideas. The key here is to allow for a “dual-track” pattern to prevail: developing a new sector alongside with the existing one, rather than destroying the old first and replace it later by something different.

The similar arguments apply to price liberalization as well. There is no fundamental disagreement between the two camps about the central role of the market-determined prices in an economy. In the context of transition economies, the question is not so much about whether the previously plan-determined prices should be liberalized, but when and how to do it. The Washington consensus insists that the prices must be set free at the very beginning stage of a transition, and be done “over night.” When the price shocks of this magnitude are introduced to the economies that had long been troubled by a chronic shortage, hyperinflations obviously followed. The supporters of the evolutionary-institutionalist perspective praise the dual-track scheme that China initiated in dealing with price liberalization, precisely for its effectiveness in lifting price controls while avoiding the potentially damaging high inflation. Under this scheme, producers are allowed to sell extra outputs at above-plan prices (with an initial price ceiling), while continue to fulfill their plan-determined production quotas. This provides producers with incentives to produce more and with better quality, and allows for the excess demand to diminish over time without imposing rations. As the supply condition continues to improve, production quotas are adjusted downward and price ceilings are increased in stages. By the time when the full liberalization is launched, potential price shocks have already been subdued. We see here again how a carefully designed "dual-track" process at work and worked better.[6]

3. Some Analytical Issues

Assuming these outlined, however simplified and schematic, are generally agreeable as the broad characterizations for the two perspectives, then one may argue that, as an *ex post* interpretation, the evolutionary-institutionalist perspective does provide some valid points that matched reasonably well with the transition practice in China. To be sure, China has not followed the prescriptions of the Washington consensus. With that said, the transition experience in China suggests that much more ought to be considered, both in terms of the analytically scope and depth, than those highlighted in the previous section. Several main issues are now in order.

What is the role of the government?

As indicated earlier, the discussions, along the lines of the evolutionary-institutionalist perspective, on the role of the government in transition economies have largely been confined to such areas as enforcing laws and contracts, securing private property rights, and maintaining macroeconomic stability. Some mentioning has also been made in terms of the need for government actions in curbing corruption and ensuring fair competition. Important as they are, the scope is, nevertheless, too narrow to fit the Chinese practice. By and large, the transition in China may best be characterized as a progress of controlled decentralization, which has been accompanied by the induced behavioral changes in both private and public institutions. In this process, the role of the government has been redefined, and the governing mechanism redesigned, but not minimized.

[6] The "dual-track" practice has been described and its effectiveness assessed by many, whom may or may not be identified as the subscribers to the evolutionary-institutionalist perspective. See, for instance, Cao, Y. Z., G. Fan, and W. T. Woo, "Chinese Economic Reforms: Past Successes and Future Challenges," in Woo, W. T., S. Parker, and J. D. Sachs, (eds.), *Economies in Transition: Comparing Asia and Europe*, Cambridge, MA: The MIT Press, 1997, pp. 19-39; Lau, L., Y. Qian, and G. Roland, "Pareto-Improving Economic Reforms through Dual-Track Liberalization," *Economics Letters*, 55(2), 1997, pp. 285-92; "Reform without Losers: An Interpretation of China's Dual-Track Approach to Reforms," *Journal of Political Economy*, 108(1), 2000, pp. 120-63.

From a more general analytical point of view, it may be argued that the very nature of the transition would demand a much more active and broader role from the government than under other "normal" circumstances. This is so for following reasons.

First, at the early stage of a transition, the markets were either at their very infancy, or did not exist at all. Even after years of development, the markets in the transition economies can, at best, be characterized as being incomplete and imperfect. Under these circumstances, it would be naïve to expect that the market-determined prices can deliver proper signals to guide resource allocation and does so efficiently. Second, the transition involves necessarily externalities of all sorts. As such, the private returns reflected in the market-determined prices are inconsistent with the social returns. Third, after being insulated from the outside world for decades, the enterprises, or the newly emerged entrepreneurs, for that matter, are in desperate need for fresher knowledge and information about better technologies and managerial skills that the rest of the world can offer. With the high transaction cost involved in knowledge and information transmission, this is not an obstacle that individual enterprises or entrepreneurs can easily overcome. Fourth, for the private sector to emerge and grow, suitable economic and social environments must exist. These may include, to name a few, adequate physical infrastructure; the availability of properly trained workforce; the public institutions that promote R&D activities, facilitate technology transfer and diffusion, provide market information both at home and abroad, and so forth. Fifth, accompanying the restructuring of enterprises and governmental institutions, the kinds of state-guaranteed social protections under the command system have been fading away fast, but workable replacements are yet to be fully developed. In addition, the pattern of income distribution in the transition economies has become increasingly uneven; the rapidly enlarging gap between the haves and have-nots has emerged as a serious threat to social and political stabilities.

This list may certainly go on, but is long enough for making the point: in all these areas - crucial to a smoother and more successful transition, the government must fulfill its duty and do more, as the experience of many countries, including China, would testify. Recognizing this, the scope of discussion on the role of the government in the transition context should be significantly enlarged, certainly going beyond enforcing contracts or securing private proper rights.[7] What matters the most is not so much about the form or the size of a government, but

[7] Poland is widely regarded as one of the most successful transition economies in the Central and Eastern European region, for it has experienced a relatively shorter period of initial transition recession, and resumed subsequently more rapid economic growth, while many others are still struggling to regain their pre-transition levels of output and income. This impressive performance has not been a result of the magic of market

whether it is competent, adaptive, and has a strategic, long term vision and is capable of managing the process of transition in a consistent fashion. In these aspects, the literature on economic development has much to offer; the detailed counts on the successful experience of the later-comers, especially those in Asia, can certainly help to advance the discussion in a fruitful fashion.[8]

Is China a "gradualist"?

The word "gradual" is often coined with the word "slow." It is for this very reason that, whenever it comes to the debate about the gradualist approach vs. the shock therapy, the notion of speed has always been brought to bear on the issue. The central focus of this interpretation is on the pace at which transition policies are being introduced: a gradualist does so in a step-by-step, evolutionary manner, whereas a shock therapist wants to get it done "over night" in an "all-at-once," revolutionary fashion. China is widely perceived as a gradualist, but with this interpretation, is it really after all? To address this question, it is useful to differentiate reform measures and to group them according to the uncertainties and difficulties involved in both decision-making and policy implementation.[9]

The first category covers those reforms that are relatively low in risks and are easier to be phased in. These include, for instance, attracting foreign direct investment; opening up to foreign trade (export promotion, followed by import liberalization); rural reforms (e.g., abolishing collective farming, introducing household production responsibility system, granting land-use rights to farmers, promoting TVEs, and lifting controls on rural-urban

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mechanism, but, rather, a well thought and coordinated government policy effort. As Kolodko pointed out, the "Strategy for Poland," which the Polish government implemented during 1994-1997, has played a crucial role in lifting the economy up from its previous years' downturn due to what he described the "shock without therapy" initiatives. Similarly, the more asserted role of the government since 2002 has been largely responsible for the growth acceleration in recent years. (See Kolodko, G. W., "Transition to a Market: Why Gradualism Works and Radicalism Fails?" *Montenegrin Journal of Economics*, Vol. 1, No. 1, July 2005, pp. 19-25; "Transition to a Market System: Gradualism versus Radicalism," *TIGER Working Paper Series*, No. 60, Warsaw, August 2004; *From Shock to Therapy: Political Economy of Postsocialist Transformation*, New York, NY: Oxford University Press, 2000)

[8] In the context of Asian economies, the role of the government and public institutions has been studied by many in a comprehensive manner. To name a few, see Leipziger, D. M., (ed.), *Lessons from East Asia*, Ann Arbor, Michigan: the University of Michigan Press, 1997; Aoki, M., H. K. Kim, and M. Okuno-Fujiwara, (eds.), *The Role of government in East Asian Economic Development*, New York, NY: Oxford University Press, 1996; Camps, J. E. and H. L. Root, *The Key to the Asian Miracle: Making Shared Growth Credible*, Washington, DC: the Brookings Institution, 1996; Stiglitz, J., "Redefining the Role of the State," a paper presented on the Tenth Anniversary of MITI Research Institute, Tokyo, Japan, 1998; "More Instruments and Broader Goals: Moving Toward the Post-Washington Consensus," *The WIDER Annual Lecture*, the World Institute for Development Economics Research in Helsinki, 1998.

[9] For a similar treatment in a broader context, see Thomas, V. and Y. Wang, "East Asian Lessons from Economic Reforms," in Woo, W. T., S. Parker, and J. D. Sachs, (eds.), *Economies in Transition: Comparing Asia and Europe*, Cambridge, MA: The MIT Press, 1997, pp. 217-41.

migration); freeing up small- and medium-size SOEs in manufacturing and service sectors; shifting enterprise financing from state budgetary appropriation to commercial bank lending; labor market reforms (e.g., abolishing life-time employment, introducing merit-based wage schemes, and increasing cross-sector and cross-region labor mobility); liberalizing prices for non-strategic commodities, and so on. In all of these areas, reform decisions were made decisively and the corresponding policy changes were introduced quickly and forcefully, within a fairly short period of time.

The second category involves those areas that either have a higher degree of uncertainty, or require a longer period of time for policies to be fully implemented. The examples include exchange rate unification (which took China for about more than a decade to complete through stages); reforming large-scale SOEs (e.g., changing ownership structure, introducing international accounting standards, improving enterprise governance, and enhancing international competitiveness); reforming the banking system (e.g., moving from mono- to "modern" banking system, establishing central bank, and enhancing its role in conducting monetary policies); developing financial markets and institutions; redesigning legal infrastructure; redeveloping social safety net; opening the capital account, and reforming the exchange rate management system. In some of these areas, reform decisions were made in as early as the early-mid 1980s (e.g., SOE and financial sector reforms), but the policies have only been phased in gradually over time, for the enormous difficulties and complexities involved in actuality. In other areas (e.g., opening the capital account and reforming the exchange rate management system), decisions about actionable policies and their implementations have both came more gradually with greater precautions, for their high potential risks and less predictable outcomes (these are largely unsettled analytically issues in general too).[10]

[10] Drawing upon the observations made up to the mid 1990s, Lin, among others, has described the Chinese transition approach as the "micro-first," a term that highlights the decentralization feature of the reforms (see Lin, J. Y., "Lessons of China's Transition from a Planned Economy to a Market Economy," *Distinguished Lectures Series*, No. 16, Leon Kozminski Academy of Entrepreneurship and Management (WSPiZ) and Transformation, Integration and Globalization Economic Research (TIGER), Warsaw, 2004). Since then, much more attention has been paid to the macroeconomic management, including the restructuring of the financial sector. This was, in part, motivated by the outbreak of the Asian financial crisis in the summer of 1997, and by the country's anticipated reentry into the WTO. For the financial sector reforms, integration, and exchange rate management in China, see Ge, W., "China: Managing Financial Integration," in *Macroeconomic and Development Policies: Management of Capital Flows - Comparative Experiences and Implications for Africa*, UNCTAD, Geneva, Switzerland: September, 2003, pp. 185-225. For an assessment of ownership restructuring (based on a survey of about 700 firms in some 11 Chinese cities), see Garnaut, R., (et al), *China's Ownership Transformation: Process, Outcomes, Prospects*, Washington, DC: The World Bank, 2005.

The point can be further elaborated if we consider the regional pattern of the Chinese transition - an important dimension that has received insufficient attention in literature on economic transition. China's transition, in terms of its comprehensiveness, began with the establishment of special economic zones (SEZs) in 1979, when the rest of the country were still concentrated on phasing in agricultural reforms. The purpose of the zones is to serve as a laboratory for experimenting with reform policies and institutional arrangements that are supportive to, and compatible with, a market-based economic system with an outward-orientation. Granted with policy-making autonomies, the zones have since introduced and tested various measures and structures in an aggressive and pragmatic manner. The scope of the experiments has been widely ranged, reaching every aspect of the society. The policy instruments and institutional arrangements with proven results have subsequently been extended to the rest of the country, first to the coastal regions, and then spread further into the inland areas, allowing the overall transition to proceed at minimized economic, social and political shocks. In essence, the SEZs have been at the forefront of the China's transition since the very beginning, setting a workable model that other regions may either imitate or to draw lessons from. It can be said that without the contributions of the SEZs, China's comparably smoother transition would have been much harder to come by. Even if one may wish to regard the process of transmitting the SEZ experience to the rest of the country as something more or less "gradual," the speed at which the experiments have been carried out within the SEZs and the coastal region is certainly not.[11]

What these discussions have suggested is that, as far as the speed of policy introduction is concerned, China may not be understood as a "gradualist" overall, for it has not only been remarkably "fast" in launching many reforms nationwide, but has done so in certain regions at an even "faster" pace as well. This recognition should make the exercise of matching perspectives with country experiences a much harder task to perform. Less carefully done, the analytical value of such an attempt can be seriously undermined, especially when it has to do with policy-related issues.

What does a transition entail?

The preoccupation with the issue of speed leads to a more fundamental question: is this, above all, a meaningful criteria for assessing the progress made in transition economies? For

[11] For a more detailed discussion about the development of the SEZs and the role they played in the overall economic transition in China, which Prof. Lawrence R. Klein has described as "a fascinating story of a bold economic venture," see Ge, W., *Special Economic Zones and the Economic Transition in China*, Singapore, World Scientific, 1999.

the criteria to be valid, one must be willing to assume that there exists a more or less fixed end-state to which the transition economies can move toward. Putting it differently, there must be some proven models, to which the transition economies can imitate and install. This raises two interrelated questions: whether such an end-state exists, and even if it does, how feasible would it be for one to imitate in a wholesale fashion?

There has been a conviction, at least implicitly expressed in literature on transition, that the Anglo-American model is the one to which the transition economies ought to endorse and ultimately install. To this point, the institutional economics may shed some light on. If the working of an economic setup can be understood as a reflection of the complex interactions among various forces in a given society, which may yield multiple equilibrias with unpredictable final results, and if the underlying institutional development can be characterized as a path-dependent process which may evolve only incrementally and marginally, and is constrained by the past arrangements,[12] then it follows that the idea of copying one economic system from somewhere and superimposing it to somewhere else may not be as feasible as one wish to believe, for the required institutional underpinnings may be either insufficient, or missing altogether. For a transition to be meaningful and successful, the countries in question may be much better off to seek a system that is home-grown, rather than busy imitating what a textbook of some sorts might have preached.[13] Furthermore, the Anglo-American model, in itself, is constantly changing, with no ending on sight. Given this, even one is fully committed to "get there," the question of "where is there" must be answered in the first place.

The obsession with the notion of "getting there," regardless of fast or slow, can be very damaging in that it tends to misplace the means with the goals. The result has been a tendency of pushing for a transition for the sake of transition, which mirrors the problem of the forced

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[12] See North, D. C., "Understanding Economic Change and Economic Growth," *Distinguished Lectures Series*, No. 7, Leon Kozminski Academy of Entrepreneurship and Management (WSPiZ) and Transformation, Integration and Globalization Economic Research (TIGER), Warsaw, 2002; "The Contribution of the New Institutional Economics to an Understanding of the Transition Problem," *WIDER Annual Lectures*, March 1997, and *Institutions, Institutional Changes and Economic Performance*, Cambridge: Cambridge University Press, 1990;

[13] In the context of Russian transition, Joseph Stiglitz has this to say: "(t)he failure of the reforms in Russia reflects misunderstanding of the very foundations of a market economy, as well as a failure to grasp the fundamentals of reform processes. At least part of the problem was an excessive reliance on textbook models of economics. Textbook economics may be fine for teaching students, but not for advising governments trying to establish from anew a market economy—especially since the typical American-style textbook relies so heavily on a particular intellectual tradition, the neoclassical model, leaving out other traditions (such as those put forward by Schumpeter and Hayek) which might have provided more insights into the situations facing the economies in transition." See Klein, L. R. and M. Pomer, (eds.), *The New Russia: Transition Gone Awry*, Stanford, CA: Stanford University Press, 2001, p. xx.

industrialization under the command system: pursuing industrialization for its own sake. Indeed, when it comes to assessing the performance of transition economies, it has not been uncommon for such measures as "X percentage of commodity prices has been liberalized" or "Y number of firms has been privatized" being employed. It is not to say that the measures by themselves are less indicative or useful, but that they need to be much more systematically tied to the evaluation of whether the corresponding policies have brought about broadly based welfare gains or losses. It is crucial to keep in mind that the economic transition has been motivated by the desire for improving the standard of living; the progress made should thus be evaluated accordingly. After all, the transition is just a means of facilitating the endless process of economic and social developments; it would be meaningless if it can not bring about welfare improvements for the society at large.

Relating to the transition in practice, this might have been the most striking point that sets China apart from many of its European counterparts (Russia in particular). From the very beginning, the welfare improvement for the population at large has been made the explicit criteria in China for evaluating the effectiveness and desirability of various reforms.[14] Against this yardstick, the reform measures that worked have been kept and improved; those do not, discarded. There has been no interest expressed thus far as to installing an imported system of any sorts on a grand scale. Rather, the course of action has been geared toward the development of a system that can best deliver the welfare outcomes and is most adaptable to the changing social, political, and cultural conditions.

Indeed, judged by this more plausible criteria and with the support of overwhelming empirical evidence, one could argue that the progress made in China during the past two-and-half decades has not been gradual at all. In fact, the pace of welfare improvements in the country has been the most rapid among all of the transition economies.[15] It is the time to rethink about the question of "what does a transition really entail," both analytically and empirically. The very recent development in literature on economic transition has begun to show encouraging signs in this regard.[16]

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[14] It is useful to recall that when China launched its reform programs in the late 1970s, the goal set by the policy makers for the following two decades was to "double the national income."

[15] Some figures are helpful here. Between 1979 and 2004, real GDP in China has grown at about 9.5% annually. Real per capita income has more than quadrupled. Human Development Index has improved by about 0.20, compared with 0.06 in the U.S. and -0.03 in Russia (between 1990 and 2001). On the down side, the pattern of income distribution has become more uneven in recent years, comparable to that of the U.S.

[16] Kolodko, for example, has elevated the discussions about the issues confronting the transition economies to the context of economic development and globalization - a significant change in focus from the earlier emphases in literature. (See Kolodko, G. W., "Globalization and Its Impact on Economic Development," *TIGER Working*

4. A Final Remark

Studies on issues confronting transition economies have come a long way since the 1990s. Inspired by the eventful developments in various countries involved, the validity of the shock therapy has been seriously challenged, and the effectiveness of the Washington consensus as a guide for policy formation and implementation in the transition economies has been widely questioned. Increasingly, the recognitions have been given to a broader set of considerations, including the institutional underpinnings that a market-based economic system relies upon in order to function properly. It is to this important aspect that the institutional economics may provide a useful context for the issues to be further examined. But to match certain perspectives meaningfully with the transition in practice, much caution is warranted. In this regard, the paper has considered the argument about the Chinese experience as a vindication of the evolutionary-institutionalist perspective, and pointed out some analytical issues that remain unsettled. These include, but not limited to, the role of the government in transition economies, the characteristics of China's "gradualist" approach, the essence of economic transition, and the criteria for assessing the performance of the transition economies. For the benefit of a more fruitful analysis, these issues have to be carefully addressed. It is also useful to point out that the importance of institutional developments to the transition economies should not be overly stated. To bring about desirable welfare improvements, sound institutional arrangements must work hand-in-hand with sound public policies and development strategies, and does so in a dynamic and sustained fashion. With its broad interpretation, how does the notion of institution fit into the needed actionable policy agenda remain to be a challenging question that has to be addressed with caution.[17]

Paper Series, No. 81, Warsaw, January 2006; "Institutions, Policies and Economic Development," *UNU-WIDER Research Paper* No. 2006/21, February 2006.)

[17] As Taylor has recent indicated, mishandled, the recent "institutional turn" may undermine the seriousness of economic policy analyses, for the "turn" usually "turns out to be ersatz political science or sociology couched in phraseology that economists can understand." (See Taylor, L. "Development Questions for 25 Years," *UNU-WIDER Research Paper* No. 2006/14, February 2006.)

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