The Journal of Socio-Economics 37 (2008) 2107–2113

Contents lists available at ScienceDirect

The Journal of Socio-Economics

journal homepage: www.elsevier.com/locate/soceco

The pitfalls of transition: Crowding out the “National Virtues”

Dragan Miljkovic*

North Dakota State University, Department of Agribusiness and Applied Economics, 221G Morrill Hall, Fargo, ND 58105-5636, United States

ARTICLE INFO

Article history:
Received 15 May 2007
Received in revised form 11 April 2008
Accepted 8 May 2008

Keywords:
Economic transition
External monitoring
Institutional portfolio theory
Washington Consensus

ABSTRACT

In this paper a view is advanced that explains why the transition to markets did not always lead to the outcomes predicted by the Washington Consensus type strategies. Institutional portfolio theory is used to define a myriad of interests and goals of a transition economy. A model is developed in which external intervention and increased external monitoring are shown to lead to lessening of the intrinsic motivation within transition economies to pursue the reforms as prescribed by Washington Consensus sometimes resulting in very slow growth rates or even a decline of the GDP.

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1. Introduction

Following the dissolution of the Soviet Union and the fall of the Berlin Wall, former socialist Central and Eastern European states (CEES) and newly independent states (NIS) embarked on the transition towards markets. While that transition turned out to be anything but smooth for almost all the countries of the region, some countries were much more successful in that process than the others (Rodrik, 2006). Most countries followed the well-known prescription to first stabilize the economy, then to privatize it, and finally to liberalize it. This “recipe” was most transparently codified in the Washington Consensus (Williamson, 1990).[1] Ten recommendations in the original Washington Consensus were the fiscal discipline, reorientation of public expenditures, tax reform, financial liberalization, unified and competitive exchange rates, trade liberalization, openness to direct foreign investments, privatization, deregulation, and securing the property rights. These were the policies strongly advised and promoted by the World Bank and the International Monetary Fund (IMF).

Many of the transition economies, in particular several NIS states formerly republics of Yugoslavia or the Soviet Union, could not manage to reach the levels of their 1990 GDP even 10 or 15 years after they started the transition process (IMF, 2006). There are a few explanations for this phenomenon but one seemed to have been dominant until recently. Predominantly it was suggested that the Washington Consensus type policy reforms are a great path to follow and only the lack of total commitment to these policies or “too little reform” may be responsible for prolonged transition characterized with serious recession (*e.g.*, Collier and Dollar, 2001; Krueger, 2004). Indeed, this view implies that the nature of the reforms should not be questioned but their success is dependent solely on the thorough implementation of these policies. Another view championed by Sachs et al. (2004) and illustrated in the U.N. Millennium Project (2005) puts the emphasis on the availability of foreign aid as a necessary condition for the success of the reforms. Admittedly, this approach is more pertinent to the reforms in the less developed countries (LDCs) rather than in the CEES or NIS region.

* Tel.: +1 701 231 9519; fax: +1 701 231 7400.
E-mail address: dragan.miljkovic@ndsu.edu.

[1] It needs to be clarified that stabilization in Washington Consensus focuses exclusively on stabilizing inflation and neglects the Keynesian case for stabilizing the real economy.

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doi:10.1016/j.socec.2008.05.005

An alternative view has emerged recently, surprisingly in the World Bank (2005) and was published in their report titled *Economic Growth in the 1990s: Learning from a Decade of Reform*. For the first time, it has been acknowledged that different countries may need to follow different paths in their transition to markets and thus policy diversity, selective and modest reforms, and experimentation, rather than the uniform cook-book type of policies, are needed in guiding the process. While this seems to be a fairly obvious proposition to a non-economist, it complicates the lives of a number of the western-trained economists, business and economics practitioners, and western economic advisors, both independent and those operating within the World Bank, the IMF, a variety of government agencies, or other commercial or think-tank entities.

The complexity arises due to several reasons. First, different CEES and NIS nations have different cultural, historical, political, and economic heritage. Second, different nations have a different vision of where they want to go in their future and how they are to arrive there. In other words, most nations have multiple objectives in both short- and long-run strategies of their national development. Creating a market economy may be only one of the objectives, often in direct conflict with some other objectives. Third, developed market economies have their own agenda and set of goals into which they are trying to fit the actions of the CEES and the NIS economies. Fourth, most existing international financial, trade, political, economic, or military organizations have been clearly designed with the interest of the current member-countries in mind. In other words, for potential member-countries it is necessary to either significantly adjust their development programs to fit the views and the visions of these organizations if they are to become a part of them, or these organizations must exhibit a great deal of flexibility and change the way they operate, to some extent, in order to ease and accommodate joining of the potentially new member-countries.

In this paper, a view is advanced and a simple model is developed that explains why the transition to markets in some of the CEES and NIS countries did not always lead to the outcomes predicted by the Washington Consensus type policies. Indeed, the involvement of the international organizations and promoting of the joining of the various economic and political entities such as the European Union (EU), the World Trade Organization (WTO), NATO, etc., as the ultimate goal for the transition, economies may have impeded the progress of the reforms in these countries and ultimately their economic growth. Organizational portfolio theory is used in its modified form, called the institutional portfolio, to define a myriad of interests and goals that a transition country normally has in its development program. Then, a model is developed in which external intervention and increased external monitoring may lead to lessening of the intrinsic motivation within transition economies to pursue the reforms as prescribed by Washington Consensus. This sometimes results in very slow growth rates or even a decline of the GDP and conditions under which this situation may occur are identified. Finally, implications of this model are discussed.

2. National interests, institutional changes, and the organizational portfolio theory

Organizational portfolio theory represents a relatively new theory that treats the organization as a portfolio of causes of organizational performance (Donaldson, 1999, 2000). This theory is designed to explain the performance-driven organizational change at the firm level. Miljkovic (2006) extended the theory to fit the international non-profit membership organizations in which the members are independent and sovereign nations (or regions) with very diverse interests.

Organizational portfolio theory begins with a premise that there are various internal and external causes that affect organizational performance. Organizational performance, in turn, feeds back to drive organizational change such that the organization moves into fit with its situation. Organization theorists argue that organizational performance has to become low so there is a crisis before it triggers adaptive organizational change. Adaptive organizational change will not occur if there is only a decline of organizational performance from the maximum level. This is because organizations have a tendency to satisfy rather than maximize (Simon, 1976). There exists a satisfying level of performance, substantially below the maximum level, that the organization strives to maintain. The satisfying level is that level of performance that the managers of the organization consider to be satisfactory or acceptable. Organizations satisfy rather than maximize because of bounded rationality. In other words, there are limits on the decision-making capacity of managers given inadequacies, such as in their knowledge (March and Simon, 1958). Managers solve problems to restore performance so as to regain the satisfying level. Since the satisfying is a property of managerial decision making in general, it follows that adaptive organizational change of any kind should occur only when organizational performance falls below the satisfying level, because all adaptive organizational changes result from managerial decisions. Empirical research supports satisfying theory, in that low organizational performance is the trigger for adaptive organizational change in organizational strategy and structure (*e.g.*, Cibin and Grant, 1996; Donaldson, 1994, 1987; Smith et al., 1990). Specifically, low levels of sales, profit, and earnings per share produce the needed adaptive structural change among large corporations (Donaldson, 1987).

A key question is then *why does the crisis or low performance of an organization occur*? According to the organizational portfolio theory (Donaldson, 2000), we need to consider that the causes of organizational performance form a portfolio, and each cause is termed a factor in the organizational portfolio. These organizational portfolio factors include causes of organizational performance inside the organization and outside it. Each organizational portfolio factor has a risk, defined as the variation over time in organizational performance that results from that factor. Each organizational portfolio factor is also correlated to some degree, positively or negatively, with each other organizational portfolio factor. Thus, each organizational portfolio factor becomes a trigger of change when, either, it reaches a particular threshold, or interacts with another factor, stimulating threshold levels that trigger change. The greater (lower) the risk of each organizational portfolio factor and the higher their positive (negative) correlation with each other, the higher (lower) the organizational risk, defined as the

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