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Paradigm Shift – Information, Knowledge and Innovation in the New Economy

Conference proceedings

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László Csaba

Growth Theory and the New Economy in a Neo-Institutonalist Perspective

he study surveys new trends in the international comparative and development literature addressing he issue of growth, the related institutions and the role of new economy therein. It highlights the need to ddress the basics while the economic paradigm may or may not be shifting under the conditions of ITC evolution and changes triggered by it.

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The issue of institutions in generating growth remains a major and controversial topic in the literature on the new political economy of emerging economies. Ever since the publication of the World Bank report, *From Plan to Market*/1996/ and ever since the Nobel Prize of Douglass North in 1993 and of Joseph E. Stiglitz in 2001, it is no longer trendy to downgrade institutionally informed analyses as `poetry`. Likewise policy failures in post-Communist and developing economies over the past two decades, the crises in east Asia and in the ITC sector have triggered new interest in institution-related and policy-relevant academic research. Judging by the output of major publishing houses and of leading journals in the international economics profession this seems to be a lasting trend. And a fore-fighter of the mainstream, Robert E.Lucas/1988,p5/ established some time ago, that numbers on long run development were hard to interpret in other than institutional terms.

In the first decade of the 2000s the question, it seems, is no longer if institutions matter, rather the question needs to be re-formulated: *how do they matter?* The preceding analyses have supported the claim by Havrylyshin and van Roden/2003/, namely that institutions do matter, but only in the context of supportive policies. And conversely, policies matter and sustain only if the rules of the games – institutions – are supportive of certain economic insights.

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Useful comments by Bart Nooteboom and Balázs Hámori are appreciated, with the usual caveats.

In addressing this field we enter on a slippery slope: similarly to many other eve in the social sciences in general and in economics in particular, there is no co view on which we could rely upon. The nexus between investment and g remains largely unanswered, or likewise, the interrelationship between human ca accumulation and growth remains largely unclear. Conditions that trigger innova and embedded technological progress are also at best approximated in the nega – that is in listing what is *not* conducive to innovation, rather than being positive a it. Therefore our subject has also more unknowns than equations. However, it may m sense to sum up, without aiming at being exhaustive, of what we may claim to k about the role of institutions in promoting growth. In so doing, it is not our inten to replicate the thorough and detailed literature review provided by Aron/2000/ also concludes with a slightly agnostic tone on the ways academic findings ma channeled into policy-making. However, even a rudimentary summary may wo try, in attempting to *generalize what our analysis contributed to more general knowle* that is which insights have been supported and which ones not.

Endowments, Policies and Culture

Our analysis is supportive of previous research by de Melo et al/2001/ highlighting over-emphasis on geography and path dependence in the policy discourse explai failures and successes. We may join these researchers in underscoring the rol *microeconomic incentives for restructuring*, and the resultant emphasis on bringing a and sustaining such rules of the game, that are conducive to high domestic *sav* – high domestic *investments* scenario, with due emphasis on the efficiency of reso *allocation* and prudential *regulation* of the financial sector/not only of banking/. *institutions* are often *path dependent*, and conflict-ridden political situations, na civil wars, but also milder but lasting forms of civil conflict, even lack of consensus the fundamental values and strategies of development among major social a and political agents, is conducive to *sustainingly weak core state*, and the ens lack of anchors for sensible, growth-oriented policies[1]. This is the reason, why lagg countries are unable to operationalize those academic insights that could, in th lead to improvement.

The agenda of good governance, local ownership of reform and the anti-corru drive all point toward the need for a strong, technocratic and *professional administra* committed to the public good and thus *dis-embedded from vested interest gro*. However this maxim is hard to adhere to. In societies where it has traditionally ne paid investing into civil service, where rule-abiding always resulted in losses, wh informal rather than formal institutions and dispute settlement mechanisms have b dominating, it is hard to see how the fixed point of change, the anchor may eme We do have convincing historical examples, from Kemal Atatürk to Lee Kuang Yew Singapore that charismatic personalities can change the name of the game. Also

[1] *Dornbusch/1993/ assigns the following tasks to the core state in orchestrating policy reform: a/provide a g ideology; b/ensure strong administrative capacity; c/target instruments according to well defined objectives; d/ decentralization and accountability, that is features that are bound to be built up in a decade or longer; e/ open economy; f/ make it attractive to FDI; g/restore regular access to global financial markets. From this it follows, th of consensus over fundamentals may render even a strong state ineffectual.*

ic transitions – the famous Huntingtonian third wave – have lent support to normative claims that changes for the better might be feasible.[2] More recent Williams, 2003/ have highlighted the role of technocrats, policy advice, and the to create *independent agencies* where technocratic considerations are provided degree of autonomy, if not insulation, from countervailing pressures. In short, ng term or collective rationality is *institutionalized* against vested interest politics, on individual rationality, inevitably dominating daily politics in a democratic ty. However, this is unlikely to be quick and unlikely to produce results in a single oral cycle.

This finding might explain why macro-economic policies have proven less ant in the longer run than they looked. *Unless macro-policies are anchored in some ution* – be that balanced budget rules, privatization plans, Constitutions supportive ivate enterprise, EU accession, international accounting standards etc – *these are ely to survive the counter-reaction of vested interest groups.*[3] Likewise, unless sound o-polices are supported by micro-economic foundations, brought about in part omestic legislation – such as the rules on bankruptcy, solid finances, or regulating ork industries and deregulating product and factor markets – these are bound to teeth' and be rolled back. Experience with the inefficiency of these polices lends ort to claims of national uniqueness and to justifications for not even attempting ain what in academic terms may look the obvious goal.

Foreign assistance, once highlighted by Gunnar Myrdal/1971/ and his followers as ore component of development policies, has proven to be inefficient in countries, many states of sub-Saharan Africa, where the domestic institutional infrastructure roven inadequate for absorbing these/more on that in van der Walle, 2001/. ilar finding is emerging through the observation of the quasi-states of Bosnia-egovina, Kosovo and the like in the NIS. In these cases a culture of aid dependency already emerged, without however any prospect of self-sustaining development. her words, *lack of progress can not and should not be blamed on inadequate external cing*, the lack of a new Marshall Plan for eastern and central Europe, or for the ans for that matter. Recent empirical analyses/Ovaska,T, 2003,p186/ has found n the period of 1975-98 in a sample of 86 developing countries one percentage increase in aid as a percent of GDP *decreased* per capita growth by 3.65 per cent, aid has not contributed to better governance, but allowed for postponement of stment.

The focal role of institutions is also highlighted by the insight /Easterly and Levine, Erdős, 2003/ that questions whether factor accumulation would be the ultimate ng force of development. As we have seen in the case of South-East Europe, baijan and also Russia, more investment, even plenty of new investment may well to more waste, *provided the mechanisms of efficient resource allocation, control of nditures, incentives for recoupment are not being created.* The existence of capital

[2] *stingly a leading East Asian analyst/Jung, 2003/ considers as weakening the core state the measures that ish the previous executive overweight and create checks and balances in Japan and South Korea in the turn of the ennium, such as the abolition of 'head of family' position in the public administration. In the European perspective nterpretation would run the other way around.*

[3] *is similar to the problem of anchoring in terms of stabilization, though the anchor needs to be broader than the ange rate.*

flight in all countries at lower level of development is a plain warning, since it is realistic to expect foreigners to risk their property when better informed locals do no venture the same.[4] As we have shown, in some economies the low absolute level of investment is also a cause for concern. But in the majority of cases it is rather efficient allocation and lack of trans-nationalization that may be at the root of prolonged economic difficulties.

Finally special mention should be made of the *resource curse*/as elaborated in inter alia in Ross, 1999, or in Karl, 1997, pp44-67 on petro-states/ which seems to be particularly relevant for the new independent states but also in South-East Europe. While some analysts/Jones-Luong, 2004/ develop sophisticated theories of why this is not a strong pre-determination, empirical studies are not supportive of the latter claim. Empirical [5]evidence, provided recently, inter alia, by Kim/2003,pp31-34 and41-45/ has been indicative of the immediate relevance of the revenues from fuel extraction in sustaining authoritarian methods of control, both politically and in terms of corporate governance. This works by providing windfall revenue to the government, thus relieving it from the burden of painful adjustment. Growth could, indeed be recovered without major privatization and liberalization measures, thus the incentive to change must have been diminishing also during the Putin Presidency. What could be observed in the oil producing monarchies in the three decades following 1973 oil price hike/ Glasser 2001,pp24-26 and p.lo9/ seems to have been replicated in Russia and Kazakhstan since the late 1990s. As simple products do not require sophisticated management techniques, nor do they allow for it. And while neither historical determinism nor economic structuralism is by any means our perspective, it is hard to overlook the strong interrelationship. Thus we may only join more recent analysts/Atkinson and Hamilton 2003/ observing two items. First the significant negative correlation between resource abundance and slow growth is a statistical fact hardly to be disputed away. Second, the *inability of governments to manage revenues* is at least as important an explanatory factor as the availability of quick/cheap money on its own right. The two together culminate in regularly low savings, that in turn translate into low investment and low growth in the long run scenario.

The interaction between the sophistication of social structures and efficiently deployable management techniques has been one of the eldest insights in sociology. Likewise in management literature it has been among the established facts to ascertain that more sophisticated intertwining, better educated workforce, more IT, generally what is known as Toyotism, requires different incentives and different forms of control, including less hierarchy, more collective rather than individual incentives etc/. Thus the burden of proof remains on the shoulders of those who advance theories doubting such fundamental insights.

[4] *True in exceptional cases, such as start-up situations, transnationals with large bargaining power may well venture in areas where locals are suppressed by governments. But this colonial type of intervention hardly produces the forward and backward linkages a la Hirschman/1981/.*

[5] *Aslund/2004/ certainly has a point in underscoring, that it is not so much the resource based development per se, as the ensuing authoritarianism and the disrespect for property rights which lays at the heart of the ` resource curse` in Russia and elswhere. Still it would be wrong to see a unidirectional causation in a complex matter where it is the interaction between the two factors that is the key.*

In reality, our empirical and analytical survey of the post-Communist economies has clearly pointed towards the traditional lines. The prolonged rule of despotic regimes of central Asia, or the less pronounced forms of authoritarianism in other Newly Independent States would be hard to explain, if we abstracted away from the lack of structural change, lack of post-industrialism and lack or weakness of civil society. As long as most of wealth creation requires simple management methods, well suited to the endowments of the fuel and energy sector, the incentives to change may come from the diplomatic arena, owing to the broadening of the focus of international agencies. These adopted, already during the second Clinton Presidency, a vigorous anti-corruption stance, advocacy of universal human rights and the like. Over and above this the entire approach to poverty alleviation and development has undergone a change. As the volume of the chief economist of the World Bank/Stern, 2002/ illustrates, the international agencies have internalized those insights from newer generation development economics, that had been critical of the earlier view that treated recipients as objects of action. Rather than following the earlier passive approach, the idea of *empowerment* has come to the fore. Here the major objective is not to remedy certain static shortcomings, but facilitate change and learning, spread knowledge, and foster entrepreneurship. In this approach *bringing about the abilities that allow for future value creation and innovation* come to the fore.

By contrast, if resource abundance allows for rents to be appropriated, even if these are in part shared with the population, there is no receptive environment for the empowering approach. Rather the traditional *culture of dependence* and self-reinforcing processes of *patriarchal approaches* and policies are likely to cement themselves. The fact that when the resource boom will have been over, the challenge will be all the greater, will hardly change the overall landscape. The more a country sustains the *economic base of a traditional society,* be that resource dependence, or control over foreign trade, or over a few revenue generating sources, such as smuggling, public monopolies, control over ports, transit routes, or tourist places, the *less sophisticated* the economic and the ensuing *social structure* remains, the better are the chances for *enduring authoritarianism.* Trivial economic costs of opting for the inferior are unlikely to change the balance of forces on their own, short of external influences.

The light at the end of the tunnel comes with *transnationalization* and the *ITC revolution.* While in the short run features of path dependence render the continuation of authoritarianism probable, and when fuel prices are high, this may even work, in the long run it is unlikely to remain so. Rather, those processes that have triggered the implosion of the Soviet Empire and the collapse of authoritarian regimes worldwide will exert influences on the resource dependent authoritarian states of the Middle East and Central Asia alike. In the case of Russia the European orientation of society and of the elite, as well as the ongoing process of integration in the global organizations, such as WTO, the political priority enjoyed by G8 and the IMF, membership of many international agencies, altogether will exert a strong *demonstration effect* with the time passing.

Formalization and Enforcement

Institutions are known to be rules of repeated games/ more on that, also in game theoretic terms in: Aoki /2001/. Both formal and informal institutions, such as norms, habits, value judgements and perceptions are important for shaping outcomes. As we have also seen, copying formal institutions is though easy, still in most cases ineffective in bringing about improvements. Institutions emerge in part as an outcome of human deliberation – system design – and in part spontaneously, in ways that are not yet properly understood by the various social sciences. From the perspective of North-inspired neo-institutionalist approach *formalization and enforcement* have been shown to be formative in the Russia, China and Trans-nationalization chapters in Csaba /2005/.

From the point of view of economic development the defining moment is if, and under what conditions, new institutions may contribute to the better combination of the factors of production, better allocation of resources and a generally innovation-friendly environment. It is hard to overemphasize the importance of rule of law considerations and property right regimes. The longer horizon we take,[6] the more convincing is the insight that security of savings, the possibility to transfer property/and bequeath it/, the solid allocation of financial resources in a flexible and safe financial system *constitute a single chain*, what German economists term as the *economic order.*[7] This approach implies that there is a strong *interdependence among the individual elements* of the macro-system, and changing only one of them, while keeping all the rest intact, is unlikely to be effective. Privatization in the Czech Republic in the early nineties, or severing monetary policy in Russia in the mid-1990s are cases in point.

Neither social sciences in general, nor our empirical analysis in particular has produced anything that can be termed as *a cookbook of optimal policies,* including sequencing and monitoring, that could serve as a general guide to any country in any period of time. What is particularly remarkable is the wide variety of interplay among formal and informal institutions, as well as among institutions and policies may interact. It seems that, in some cases, the *self-reinforcing logic of virtuous circles,* in other cases those of *vicious circles* are demonstrable.Testing the empirical validity of suggestions by Olson and North, Gradstein/2004,pp516-517/ has found a self-reinforcing tendency between the protection of property rights and growth , with *law enforcement being crucial.* Likewise in the vicious circle scenarios the lack of these mechanisms can be blamed for the elf propelling processes in the opposite direction. While we share his conclusion about law enforcement being a public good we definitely do not subscribe his second finding, that would consider formal enforcement to be a luxury of rich countries. On the contrary, as we have indicated in several places, poor countries should actually value more public administration and the independent judiciary as a scarcity good. Therefore they are well advised to spend more lavishly on these/in order to pre-empt other private agents, such as TNC or maffiosi to do the same to an underpaid

[6] *This is precisely what is often missing, especially if and when nationalism and the related ideology of catching up turns haste into a virtue in the eyes of the public – a big change over the pre-18th century period, as explained by Landes 1998/.*

[7] *Heitger/2004,pp399-400/ in his posthumus article rightly draws the conclusion from empirical statistical analysis, that if properly accounted for indirect impacts, private property counts among the ultimate sources of economic growth.*

or demoralized administration/. In triggering the outcomes, as well as in the potential change of trajectory the interaction of transnational markets with local politics has been shown to be the key. Major components of development, such as good governance, rule of law, accountability, trust, social intangibles are all soft categories, that are known to emerge slowly and in ways that are non-trivial for the formal economic analysis. The limitations of the latter must herewith be clearly acknowledged.

Finally mention should be made of a quickly changing institution, that has been playing a pivotal role in shaping the outcomes of the past fifteen years: *the European Union.* Through its existence and changing policies the EU has been shown to play a pivotal role in shaping institutional change and in orchestrating policy consensus in the frontrunner countries. Meanwhile among the laggards the lack of this anchor has allowed for the reproduction of inefficient and path dependent structures, of recombinant property and of inward looking coalitions. As the soul-searching assessment of the reflection group headed by former Dutch premier Wim Kok has rightly noted in November 2004, EU arrangements are far from perfect. Nor do they serve the purpose of maximum competitiveness. Still, EU arrangements have been and still are, as a rule, superior to locally developed alternatives, if for no other reason because of *their superior enforcement and monitoring mechanism.* This explains why opting for the sub-optimal may be a shortcut solution in policy-making for many years, even if not for ever. By providing the anchor and monitoring functions the EU has helped to change the rules of the game in the frontrunner group. Here path dependent forms of management could be overcome primarily via FDI, and on the macro-economic level, via harmonizing laws to the EU arrangements, the acquis. All this explains why it has not been *the monetary component* through which the EU assisted the more successful cases of transition. Likewise, it is *the EU perspective* rather than any other arbitrary criterion that *has created a dividing line* among transition economies. In one group we find those for whom Communism is no longer a defining feature of their development. In the other group, by contrast, those where this weighty heritage still predominates structural change and policy options alike.

Meanwhile it is equally important to re-iterate that the EU *has never been meant to be a growth promoting organization* in its main functions.[8] The EU, especially following enlargement and the adoption of the Constitution, remains primarily a political architecture. This implies a stronger *emphasis on primarily non-economic matters,* such as citizenship, the common foreign and security policy, or environmental protection. While EU has contributed to bringing about sound macroeconomic policies in a number of its incumbents and also in the new member states, the ongoing debate on the modification of SGP is a clear indication that it has been built on *voluntary compliance.* In other words, independent enforcement mechanisms are and will remain limited, by virtue of its predominantly, though by no means exclusively, *inter-governmental nature.* Therefore it remains within the competence of *each and every member-state,* old and new, *to bring about conditions favorable to innovation and growth.* Some of the regulatory frame, including monetary regulation, fiscal codes of conduct, and many detailed regulations is allocated to the Community level and enforcement is secured

[8] *This applies, of course, to the IMF as well/given its mandate being on assisting short-term balance of payments crisis/ – a point often overlooked in the heated debates on globalization, for instance.*

by the European Court of Justice and the ECB[9], two supra-national organizations. S... this framework may or may not be conducive to growth, as the juxtaposition of Ireland and Germany in the 1990s would clearly illustrate. As the empirical analysis of Hughes Hallet et al/2003,p59/ show, the disciplinary effects of the SGP might have been eroded by 2004 and the consolidation fatigue of large countries could not be overcome by the international/non-enforcable/ rules alone.

Policies and Trans-nationalization

It is a clear consensus view in the literature to state that *policies clearly matter.* While macro-economic theory clearly advocates non-inflationary growth, as the only sustainable solution for the long run, prudence and solid fiscal stances are easier preached than practiced. Macroeconomic stability can *not* be taken as given, *it needs to be recreated from time to time.* Fiscal sustainability, though easily conceptualized, is hard to attain under democratic framework, unless what the Germans call *Stabilitaetskultur* emerges. This term implies that none of the major actors conduct policies and pursue agendas that are in open conflict with the virtue of price stability. On the one hand wage restraint may be attained if monetary targets are credible. On the other hand, the expenditure side of general government can be calculated so that it would not offset the maxim of price stability. Irrespective of the role ascribed to cyclical fine- tuning fiscal policies can remain solid. Likewise, state administration should not be seen as pork to be handed out for clientele. Rather a technocratic/British style/ approach is required. This lengthens horizons, especially if rule-based rather then discretionary decision-making becomes dominant.

These *normative considerations can not be taken as given,* not even within the European Union. While in academic terms the overall policy frame, what Walbroek/1998/ aptly termed the `one world consensus` is no longer subject to serious professional debate,[10] myopic policies and parochial public debates do allow for recurring populist pressures, from Poland to France. *Policies* in a democratic environment are inevitably, at least to some extent, *the independent variable* in the growth equation, even if there is no absolute freedom of choice/`sovereignty` in the old sense/.

Policies and policy agents may be instrumental in bringing about, or torpedoing change by way of their contribution to *institution building*, or conversely, by avoiding action even if it is overdue. The Swedish Social Democrats` policies under Goran Persson in the post-1999 period indicate, that even the most entrenched structures, such as the investment funds administered by trade unions, or the previously purely public and overly lavish pension system may be reformed. By contrast the experience of Poland and Hungary in the 1997-2004 period is indicative of the dangers of falling to victim

[9] *When Ecofin decided not to launch a formal excessive deficit procedure on Germany and France, but be content with their promise to redress public finances by 2005, the ECB issued a reprimand and reassured the public of its hawkish stance. This of course implied that both big countries pledged to return to fiscal prudence, and the public backtracking was avoided/Neue Zürcher Zeitung, 26 November,2003/.*

[10] *This is in part, at least, due to the rather general, non-specific formuli and approaches, allowing for adjustment to different contexts. In fact, already beginning with the East Asian financial crises of 1997-99 international financial organizations, such as the IMF and the World Bank, have also adopted this differentiated approach, in contrast to their previous rigid standardization attempts.*

...e's own success. In both of these countries high growth rates brought about by ...ly reforms allowed for a prolonged policy of doing nothing in terms of institution building. Only the latter that could have laid the groundwork for further convergence to EU levels. Similarly, policies play a pivotal role in either strengthening/internalizing, or conversely, watering down and marginalizing the new institutions that emerged in various stages of systemic change.

There are a couple of areas where policies and institution building go hand in hand in bringing about improvement in the virtuous circle scenario. Prudential regulation and enforcing the appropriate, that is impartial, rules of the game do run counter to the immediate interests of the businesses concerned. When network industries are privatized, the role of regulation of entry comes to the fore. Here again, incumbents do have a vested interest in prolonging market opening, and if they manage to get their agenda through, the entire society pays the bill. Sluggish opening of European electricity markets, or the creeping liberalization of the European airline industry is just as indicative of this issue as the inability of the EU to agree on the joint regulation of European stock exchanges, thereby depriving the region from one of the more obvious advantages of economies of scale and scope alike.

One of the recurring themes in the related debates is, if, and to what extent, regulatory functions could be outsourced from the government, in order to keep it lean and avoid the hypertrophy of public agencies. While entrusting public functions to private firms obviously carries the danger of partisan enforcement and degrading regulation, the emergence of independent regulatory agencies, not under immediate government supervision, with technocratic leaders elected/appointed for much longer periods than a single electoral cycle, show the tendency toward *institutionalizing sustainable policies.* On the other hand it would be hard to deny that this option puts some fairly strong limitations on contest as a major component of democratic decision-making. The way public choices are made in these ever extending areas are anything but trivial, nor is the way how these agencies should co-ordinate their activities with elected, thus directly legitimated governments.

Policies are crucial in *promoting or hindering trans-nationalization, primarily through FDI and involvement in global institutions,* such as WTO, and in applying or diluting such meso-level regulations as international accounting standards, transparency enhancing measures and empowering policies. True, mere formal adoption/promulgation/joining for diplomatic reasons will be of no avail, unless the rules are internalized and enforced, quite in the sense of Douglass North. But being outside of the multilateral framework may be yet another attempt to reinvent the wheel, or a mere waste of scarce academic and administrative resources on establishing a frame that is likely to be overrun by the existing global rules of the game anyway, at least in business practice.

Relying on FDI is crucial for microeconomic modernization and restructuring. Likewise it is hard to see how the capital power and professional knowledge, furthermore the needed personal integrity of bankers and fund managers may come around unless Western experience and players are allowed to penetrate the markets of emerging economies. True, knowing the accounting scandals in the USA and elsewhere, not even this seems to be a truly safe bet. What we can and do maintain is *a weaker proposition.* We do know that lacking these close ties no modernization and catch-up is feasible, whereas the inversion of the thesis does not automatically yield good results. One of the reasons explaining this that owing to conflict in interest, especially in the financial sector, but also in terms of micro-economic integration/regulating networks, health care, rural development, environment etc / *the regulatory and monitoring function can not be outsourced from the domain of public policy.* This is so, if for no other reason because of the need for a referee in any games that are often, though zero sum in the short run. Thus while most of the tacit knowledge, capital and learning by doing is bound to come from the corporate sector, the *monitoring* and *macro-economic steering function* can only come from public policies.

Finally it would be hard to disagree with a conclusion by T.N.Srinivasan/2005/ that it is *a quality, rather than the sort of institutions which is decisive* for long term economic performance. The example of the stock exchange in Moscow and Shanghai clearly illustrate, that simply introducing a formal institution with well known characteristics per se is a long way from bringing about the outcomes normally associated with these. It is the social and overall context that determines the outcomes, though as frontrunner emerging countries and the newly industrialized economies have demonstrated, the `tyranny of history` is no longer a general all-valid argument for justifying any failure. From this insight it also follows that any *external influence,* should this come from the EU or transnational agents, *is bound to be limited in any non-disintegrating society.*[11] It is precisely the ability to adjust and adopt new forms of organization and the concomitant values and behavioral norms that is the name of the game. In a way, there is no way to eschew organic change, that is ` domestically owned` and supported by societies, if good policies are to survive one election cycle.[12]

The Politics of Economic Reform

Already early analyses, such as those coordinated by Bates and Krueger/1993,pp444-472/ have highlighted how little is known about the precise inter-relationships between the economics and politics of institutional reforms. Reforms in a broad sense are understood to be more than administrative tinkering. Thus they involve *comprehensive overhauls of how the system and its defining institutions operate,* on the base of policy initiative from above, and conducted in an organized, rather than spontaneous, manner. Experience with policy reform is varied. It is indicative of the *feasibility* of such projects under a variety of socio-economic conditions in all emerging economies. However, as the authors rightly warn, it would be *simplistic* to postulate an *immediate relationship* between poor economic performance and `ensuing` corrective reforms. As many stagnant developing economies, and more recently Japan/Saxonhouse and Stern 2003; Hoshi and Kashyap, 2004/ and Germany and other core European economies/ Siebert,2002/ testify, there is no `inevitability` to change once intrinsic interests can

[11] *This explains, alas, why so little can be done even through pre-emptive wars and humanitarian intervention to overcome consequences of dictatorships in a sustaining and human manner. It also explains, why various international organizations tend to be more silent than they should when encountering problems of oppression and obvious mismanagement/corruption among their member states.*

[12] *The contextuality of good policy is an issue highlighted by the summary chapter by Stiglitz/2000,pp556-561/.*

sabotage change.[13] Also there is no pre-ordained way of overcoming a predatory state that continues to maximize distributional objectives rather than public welfare. What is known for sure that doctrines/ideas/perceptions play a *much bigger role* than customarily assumed. Furthermore it is also known that such major change never comes about when interest groups dominate the scene. Therefore the classic insight of Mancur Olson/1982/ are also valid for emerging economies, the more they become mature democracies, the more so.

What policy reform means, in broad terms, is the institutionalization of `the public purpose`, or in political science terms `collective rationality`. This may happen by the adoption of rules of fiscal discipline, limitation of immediate, electorally motivated distributory policy, cut public spending back to limits set by considerations of fiscal sustainability, redirect expenditure priorities according to the bottleneck principle. It may further require enhance transparency, and extend the role of technocratic or independent regulatory agencies, not under the control of daily political games. These changes are called in the political science literature as institutionalizing *collective rationality* against the individual rationality of `handing out pork directly` to the clientele. In standard economic terms we may speak about *the public good character* of the above listed principles and practices. This is so, since the substance of these is the non-exclusive, non-excludable nature, further that each member of the society benefits, while no single individual is directly interested in attaining these qualities[14].

In short, policy reform is the *set of actions,* usually triggered by political exigencies, such as revolution, recession, balance of payment crises and the like, that *re-tailor the rules in repeated economic games.* Policy reform is excluded by definition in public choice approaches to political economy. Still these could be observed, among others, in the reality of frontrunner countries and other emerging economies, like Mexico, Argentina, Turkey and Israel. Despite the voluminous literature we know precious little about the exact *mechanics of successful change,* that would go over the anecdotal evidence and case description, which in one group of countries ended up in success, and in an other groups in failure and reversal. Given the crucial role of social, historic, cultural and other contextual factors, *it is impossible to elaborate in abstract/analytical terms a cookbook that would contain the ingredients of optimal policies* that could be resorted to in any country and under any circumstances. As a recent overview/Nijkamp and Poot, 2004,p118/ concludes, ` there remain severe limitations on what can be learned for policy from highly aggregative models of endogenous growth`. In their reading of the evidence

[13] *It may well be exchanged for `preferences of the population`, or `preferences of a given generation`, that may well change over time. For instance, self- sufficiency in foodstuffs used to be a trivial point for generations having survived World War Two and civil wars; much less for people having been raised in welfare states and growing transnationalization. Likewise growth is much less of a priority of a more green-minded young generation in Western Europe.*

[14] *For instance each producer is interested in higher rather than stable prices, while the community as a whole is not interested in other than stable price levels. Thus a central bank ensuring price stability is not `embedded`, nor representing any particular interest, rather the public purpose only. In this respect new international political economy literature uses even such terms as `international public goods` when talking about transparency, or properly audited government and corporate reporting. These, of course, can never obtain `microeconomic foundations`, as overzealous analysts would require from any macroeconomic category in recent years.*

governmental activity through education and infrastructure[15] is rather positive, investment and growth is rather weak if any. Thus policies can not be assigned with the task of generating growth through immediate action.

This implies, *inter alia*, that adopting EU regulations in the course of harmonization of legal and regulatory systems *may or may not provide additional impetus for improved developmental perspectives* in the new member countries. If and when local conditions, at the end of the day, translate these formal rules in the old, established inefficient practices, this `inculturation` may actually deprive these arrangements from their civilizing and monitoring functions. It is clear, for instance, that no amount of harmonization and external monitoring will substitute for an administratively efficient core state, a lean and non-corrupt civil service, high levels of professionalism in financial regulation and non-partisan enforcement of existing laws by an independent, properly paid judiciary. Likewise many of the categories re-discovered in recent political economy theorizing, such as regulatory quality, prudence, good governance, transparency, fair trading practices, social intangibles *hardly lend themselves to quantification*. By contrast, some *other features* of sound policies, such as fiscal sustainability, or a pension system not carrying over implicit debts, clearly *can and should be phrased in quantitative terms only*. These dual insights show up in the corporate governance literature where advocacy of particular, culture-dependent, contextually well functioning models has given way to insights/primarily in Aoki /2001/ over the inevitability of *lastingly diverse forms* that lead to success.

The Role of Financial Institutions

We may venture to formulate some of the *necessary, though by no means the sufficient conditions* for an environment that is *favorable to sustainable economic growth*. Since the earlier surveyed, and generally the more technical, literature on growth is inconclusive over the mechanics of its generation. Thus we can only refer to those policy-relevant insights that definitely count among the necessary components of success, without being able to deliver the *sufficiency* conditions for emerging economies.

One of the emerging new consensus points in the literature is the *focal role of savings*. This used to be part of the conventional wisdom. However, with the triumph of Keynesianism the per se true insight, that savings always equal to investments at the macroeconomic level, has been too easily translated into a policy where savings did not really matter.[16] By contrast, the studies on underdevelopment, surveyed in our chapter on the developmental dimension of transition have clearly indicated the enhanced policy relevance of savings. Unless the domestic savings` rate can be kept sufficiently high there is no way how FDI could replace this, nor could activist state policies compensate for the loss. The East Asian growth miracle/Nelson and Pack, 1999/

[15] *The latter point is obviously contestable. Physical infrastructure projects are prime examples of `cathedrals in the desert`, from the Brazilian highways crossing the Amazon rain forests to the Danube Bridge of Szekszárd, serving two hundred/sic!/ cars per a day in its year of construction. In general big prestige projects may be the hotbed of corruption at the phase of their planning, implementation, completion/controls and retrospective evaluation alike.*

[16] *Analyzing the role of savings in the Hungarian economy Erdős/2004/calls attention to the frequent occurrence of forced savings, primarily in the corporate sector, as well as to limitations to increasing household savings in a transition economy, especially through interest rate policy.*

also our comparison of China and Russia in the respective chapters in Csaba /2005/, further the contrary experience of South-East Europe and Central Europe also has drawn attention to the crucial importance of savings. Not only savings in general, *but savings in monetary form, preferably in domestic currency and kept in the domestic system of financial intermediation that is needed.*

Looking from this angle, the financial system has been shown – in line with the traditional ideas of Ludwig von Mises quoted in the chapter on market socialism – to be crucial for the dynamic efficiency and setting the feasible rate of economic growth in the long as well as in the short run. From this perspective it is instructive, as Harvard economist Dale W.Jorgenson/2004/ recently emphasized, that during the 1996-200 boom and bust of the IT/new economy bubble financial markets have proven to be extremely inefficient as forms of capital allocation. This has had its root of the imperfect information economists and statisticians were able to provide on the size of the contribution of the IT sector to overall growth. This also established their limited ability to predict, on the micro-economic level, the ability of individual assets to generate income in the future. The conclusion to be inferred is of course not to limit the scope of financial institutions, but improve the quality of underlying data, as suggested by Jorgenson, in allowing for a more accurate reflection of *consumer surplus* and the value generating contribution of the IT sector in general.

Each component of the above normative has been shown to matter. Savings may well be high, but kept ` under the pillow`, or invested into housing, or kept in the form of precious metals, paintings and other objects of art. These phenomena are well known from developing economies struck at a low level of steady state equilibrium. The reason for this may be in the generally business unfriendly environment, governmental policies hostile to financial investments[17], that are often portrayed as particularly exploitative in the public perceptions. Under these circumstances savings often *do not take place at all*/people produce less and immediately consume it/. Alternatively, they treasure what is needed for unforeseeable events in such forms that are *not accessible* to external agents. Therefore *financial intermediation is bound to remain shallow* and the resources of investment meager. Low tax revenues and the tradition of not investing in the state administration, that is often seen as a handout for loyalty, result in *low state capacity*, particularly low capacity to tax, but equally low capacity to implement policies.

Under these circumstances the room for participatory development/Dalay-Clayton – Dent - Dubois, 2003/ is bound to remain limited, for bottom up development and co-decision capacity would *pre-suppose* the existence of the lean and technocratic bureaucracy. African, South Asian and Latin American experience thus lends support to our claim on the focal role of the core state. This in turn can conduct policies favoring savings and developing the *formal system* of financial intermediation,[18] primarily of banking and the stock exchange. Actually, experience with the Russian `virtual economy`, when in the 1995-99 period mutual non-payments of bills had become the

Ideological considerations and the tradition of predatory state have been combined to deliver the above outcome in Africa in the post-de-colonialization period, as reported in/Tangri, 1999/.

As Lord Peter Bauer/2000/ recurringly noted, there is always an informal system of trading and money lending, else famines and shortages become extreme. A similar argument is advanced in a more general level in Hayek/1989/, while Bauer provides empirical evidence, primarily from West Africa.

norm in the exchanges among Russian corporations, has lent support to the insight that de-monetization is a fairly successful way of *keeping the `grabbing hand` of the state away from private pockets.* This in turn reinforces our claim that the inability to tax, the lack of incentives to save, the lack of formal institutions of finance, and the low level of investments constitute *a single chain* in explaining underdevelopment.

Savings therefore need to be in *monetary form*, that is as deposits in the banks, stocks and government bonds. If this norm is violated, the corporate sector has to rely exclusively on retained profits for financing its expansion. Particularly if taxes are high – say for concerns of re-distribution – firms will *sustain low profitability.* They turn to `costing`, include various items of consumption among the operating expenses of the establishment. This is not only distortive, that is not allowing for the best use of resources, and massaging the signals of the price system. It also provides an incentive to invest within the fences of the firm only, rather than searching for the best returns across the board/nationally and abroad/. In turn, *the low level of efficiency, rooted in the misallocation of resources will sustain*, therefore we are back to square one of the vicious circle of underdevelopment. Even if in this less pessimistic scenario investments will be higher than in a `pure socialist` solution, like the one experienced recently in Zimbabwe, and previously in Mozambique and Ethiopia, growth is unlikely to be impressive. It may not even be attaining potential trend rates of growth, because of the built-in inefficiencies in the system. This is the situation typical of most sub-Saharan and Latin-American small economies. As we have seen in the various chapters, South-East Europe, the Caucasus and Central Asia is clearly trapped in a situation reflecting the above listed stylized facts.

Even if financial savings are high enough, say, because of the dominant precautionary motive that allow for poor societies like China or Vietnam to sustain high savings rates, that need to be *in domestic currency.* If that is not the case, there will either be dis-intermediation, or the function of mediating between savings and investments will be taken over by *foreign financial institutions.* The latter might well be inevitable to some degree, say at the *early phases* of transformation, as discussed before, or in countries where policy reform is *initiated in a low trust – low credibility environment.* However, this should *not become a lasting feature* of the system, else the chain of savings-investments-taxation-public goods and services – more incentive to produce and generate revenues/even if that is taxed/ will be broken. Moreover foreign banks obviously cream off the best clients and more profitable businesses, since these are no charity foundations. Therefore much of the profit that should be re-invested for building up the financial sector and its costly physical infrastructure in the emerging poor economy will never be made. The second best option thus may turn to be not at all so lucrative. In this context, reference should be made to the old insight, namely that anybody using other countries` currencies is in the end *financing the deficits of the issuing government.* That is not a very lucrative perspective for any poor country trapped in stagnation, among others due to its low rate of savings.[19]

What has been unfolded does not contradict to our previous favorable assessment of the role of foreign banks in the process of bringing about conditions of sustainable

[19] *This explains why, despite its recent popularity in the financial literature, so few economies have resorted to full dollarization/actually Panama, Ecuador and Grenada being these/.*

growth and its financing in emerging economies in general, and in post-communist countries in particular. Nor should these ideas be interpreted as counter-arguments to full currency convertibility. Arguments favoring trans-nationalization allow for the full capacity and the full scope of micro-economic optimization decisions to unfold. In reality, due to non-negligible transaction costs, it is unlikely that in a normal economy profits would be immediately turned into currency and re-patriated abroad, *unless the threat of a /return of the/ predatory state is very real.* Short of this policy option it is rather likely that foreign investors will *increase* the scope of their local sourcing – an experience shared by Hungary, Ireland, the Czech Republic and Portugal. The strengthening of domestic tacit knowledge allows for *deepening and broadening of financing.* The latter in turn allows for *more efficient combination of factors*, and better external financing of expansion projects of local businesses, small and large alike. Growth in turn allows for *more revenues to be channeled to public coffers.* If for no other reason, because big foreign banks /and investors in general/, according to Hungarian and other experience, are unlikely to undermine their brand name by under the counter dealings, or not paying public dues. This holds, if the host country, following the principles of optimal taxation, levies lower burdens than in the country of origin. The resultant inflow, in turn, *allows for the broadening of public services,* for improving tax collection, professionalizing the state administration, and replicate the *virtuous circle scenario* we described in the empirical section and in the chapter on trans-nationalization. It goes without saying, that secure property rights, law and order, contract enforcement and generally rule of law considerations matter even more in the financial sector. This finding is in line with those of Calderón and Liu/2003,pp331-332/ stressing that the causality goes from financial sector development toward growth, however financial liberalization and institution building is helpful only if supplemented by other supply side policies. In their panel of 109 countries the mechanics of change works through the chain of capital accumulation, allocation and technological upgrading, stressing the need for financial development already at lower and intermediate levels of development.

Once we accept the insight that *rule of law* and a *deep financial sector* definitely count among the defining conditions that allow for innovation and endogenous growth, *we can assign this task to public policy.* There is a world of difference between two concepts. One is the assignment the task of growth generation, particularly of attaining quantitative targets – such as high growth rates, above the average of OECD countries – to economic policy, normally also charging it with the task of ensuring full employment. It is a different one to hold it responsible for *bringing about and sustaining those side-conditions that are known to contribute positively to growth.* An overall business-friendly atmosphere does contain a number of non-quantifiable tasks, but definitely includes priorities on price stability, rule of law, fiscal sustainability, cutting back red tape and the like.

It has long been a contentious issue in the literature, not least in the context of financial globalization, if and to what degree countries at a lower level of development or at lower level of institutional maturity should liberalize and deepen their financial sector. Also the traditional East Asian developmental state did not rely on deep financial markets. However the latter model has not proven to be sustainable. In a recent study Rioja and Valev/2004/ have shown on a panel of 74 countries, that the finance/development nexus does change with the level of development. At low level of development financial improvements have uncertain effects. At intermediate level of development *large* *positive* impacts on growth were demonstrable. Finally at high level of development influence is still positive, but smaller. The conclusion from this analysis may be twofold. First: *emerging economies eminently need* improvements in their financial sector if they are to enhance efficiency of the use of their limited resources. Second, at higher levels of development long term factors of growth are not conducive to equally high rates of further improvements for reasons detailed in growth theory. Therefore it might be unjustified to extrapolate mechanistically the efficiency gains of the intermediate levels to the long run.

Freedom in this context is not just an instrument of attaining the supreme technical objective, growth, as Amartya Sen/1999/ reminds us in his seminal monograph. Yet another Indian economist, T.N.Srinivasan/2001/ calls attention to the fact that dictatorships, in historical and statistical evidence, have *not proven to be more efficient in generating higher rates of savings and growth, let alone welfare*, than democratic societies. Moreover the more we appreciate the insight of the new developmental paradigm, that it is not physical capital accumulation that is the engine of growth, but a broad set of policies and institutions that *together add up to a favorable environment*, the less likely we shall see the virtues of authoritarian regimes. The insights on the growing role of ITC, on the changing business paradigm, on the growing importance of decentral tacit knowledge and endogenous innovation, all point toward the non-replicable role played by various forms of market co-ordination, as well as of state policies and regulations *supportive of these*. Economic freedoms are therefore positively required for growth to take off, while political freedoms need not be postponed – a finding supported also by the empirical study of Vega-Gordillo and Álvarez-Avce/2003/.

Finally special mention should be made of the crux of *micro-economic restructuring* and the entire system of incentives, which is the set of institutions and rules *regulating entry and exit*, which together define the type of market economy we are addressing. As illustrated in preceding sections, one of the major unresolved problems of both socialist, post-socialist and statist developing economies has been the *lack of market social control over the arbitrary selection of winners*. Furthermore this initial failure tended to be aggravated by the lack of monitoring and retroactive control by the consumers, local and international alike. The more we move away from textbook-like tasks of the SLIP agenda, and approach what has become customarily termed second and third generation reforms, such as those in the health and pension systems, in network industries, in former natural monopolies, in many previously publicly provided services as waste management or water management, the greater is the importance of the quality of regulation, or as the international agencies christened it, of *good governance*.

It is equally important, on the one hand, to sustain gate- keepers, following the earlier described consideration of public purpose in regulating *entry* into such sensitive systems as finances, pipelines, air transport or health care. These should follow the prevention and pre-emptive principles. On the other hand, it is equally important to provide a regulated *exit possibility* for those failing, and not only/not even primarily/in the small business sector. This call for updated and sharpened bankruptcy legislation, anti-trust activities, strict enforcement of accounting and transparency rules, and also discretionary intervention when big crises are in the making. Experience in the United States in the 2001-2004 period has provided new evidence of the need to act, even if government adopts a general non-interventionist stance.[20] Whereas expansion is more often than not taking care of itself, *divestment often requires assistance from public authorities*, for considerations of employment and regional development alike.

Self-Correction and Coordination in Complex Systems

One big complex of unknowns revolves around *the political-institutional preconditions of sustainable policies for growth promotion. This includes issues pertaining to self-correction and the coordination issues in complex systems.*

Sustainability has gained prominence both in the more academic and in the more policy-oriented literature in the 1980s and 1990s for a simple reason. The more the focus of attention turns away from issues of fine tuning and managing the business cycle, that used to figure prominently in Keynes-inspired thinking, the more the *longevity of policies*, rather than their coherence comes to the fore. Simply put, if one contemplates the vices and virtues of changing the pension system, from pay as you go to fully or partially funded, the horizon of analysis is bound to involve the *overlapping generations*, their diverse interests, and not least the several decades long period in which the processes take place. Similar – in part identical – issues emerge during the partial privatization of health care and related services.

Likewise the more we include such items in economic analysis as *trust* and *credibility*, *social norms* and the like/in the context of informal institutions and considerations of implementation and enforcement/ the more we have to face the fact that *these do not change overnight*. For this simple reason, but also with reference to frequent policy reversals, experienced not only in Latin America, the consideration of how to orchestrate policies and arrangements that last long enough to bite, has become endogenized in the economic analysis. While traditional economics considered these outside the scope of its attention, the nature of things has changed so that it can no longer be the case.

The more we consider *democratic environment* as given, the less we can employ the traditional concept of the benevolent dictator and that of the black box of politics, both being extraneous to economic analysis. Balanced budget rules and independent regulatory agencies may though help, but unlikely to save the laboriuos task of building up and sustaining *reform constituencies*. The more the deliberations need to be continuous, like in health care, where no obvious solutions are at hand, the more important this component is bound to be. Also the availability of a *lean and non-partisan state administration* devoted to the public purpose rather than to vested interest representation, is a condition that needs to be *continuously recreated*. The more complex the areas of regulation grows, the longer it takes and the more costly it will be to find and sustain high professional level in the macro-regulation and in the operation of formal institutions.

We have already seen /Srinivasan, 2001/ that *increased participation may or may not improve the quality of governance*. The experience of water management projects in India, where – non-representative – local elites pursued their own agenda, or the presence of

Crisis management in the auditing sector, managing the crisis of airline industries, of insurance and many others, rather than the narrow-minded and old fashioned steel quotas that show the direction of both academic and policy reflection.

equally non-representative but vocal NGOs in various international negotiations, a clearly indicative of the limitations of a ` the bigger the better` approach. Meanwhile in a democratic society there surely is a –perhaps changing – limit to freeing up regulatory agencies from political accountability, at least in the long run. The more these rules and nominations follow some principle of qualified majority – be that two third or three fourth – the higher may be the legitimacy and their ability to withstand cyclical policy pressures.

True, the reverse problem of *the ability for self-correction* is equally important in a quickly changing world. This requires, among others, observance of the principles of transparency, accountability, contestability and the continuous operation of various checks and balances that constitute the heart of democracy.[21] While all this looks straightforward, nothing is more difficult to deliver in practice than adherence to these simple maxims. *Transparency* of general government accounting may seriously inhibit the discretionary handing out of pork to constituencies, creative accounting and cover up of practices that deviate from the principle of serving public purpose only. *Accountability* tends to be an abstract category if turnover in the state administration is high, and by the time of finishing investigations nobody, that could be held responsible, is available any longer. Likewise decisions taken in collective, like in cabinets and behind closed doors, without taking votes, may never be fully turned to controls, as everybody tends to remember in a different way. Last, but not at all least, political *contestability* is an important issue. As long as one group or line of thinking may monopolize the floor –as for instance the Italian and Austrian Christian Democrats and Socialists, or Japanese Liberal Democrats could for over four decades – this is likely to enhance the chances for ossification, cumulative cover-ups, and general inability to correct mistaken decisions.

Finally, with the growing complexity of economic and social system, in part due to trans-nationalization and the ITC revolution, *problem of macro-coordination is becoming the crucial issue.* This insight, highlighted already in the now classic Bates and Krueger 1993,p.470/ volume has several planes. First, it relates to the *administrative* capacity of public administration. Second, it relates to the *analytical* capacity of think tanks supportive of the government. Third it relates to the *political* ability of the governing group to deliver *coherence and commitment* for sufficiently long periods of time.[22] In order to attain these reliance on such *meso-level arrangements*, as the international accounting standards, enforced auditing requirements, widespread reliance on public procurement and the like may be of assistance. However these can by no means replace discretion and careful case-by-case assessment of the situation – a consideration all practicing policy-maker – or as John Williamson/1994/ called them *technopol*[23] – stresses in their analytical accounts.

[21] *In his recent book, based on his famous article, Fareed Zakharia/2003/ developed and revived this old insight, calling attention to the dangers of the tyranny of fifty per cent plus one.*

[22] *International political economy literature tends to allocate a focal role to the Ministry of Finance. However, as the vivid account of Greskovits/2001/ explains, in emerging economies the relationship between the Prime Minister, following general political or even historic aims, and his Minister of Finance, following a narrow economic logic and fiscal crisis management, more often clashes than coincides.*

[23] *This is a merger of the words technocrat and politician, and the article refers to the need of exceptional professional technocratic knowledge combined with charismatic political abilities to communicate the professional agenda. Such public figures as R. Barre, A.Ciampi, J.Stiglitz, L.Balcerowicz, D.Cavallo,, O.Issing or T.Padoa-Schioppa may serve as points of reference.*

Rules, Ideas and Policy Discretion

An immediate follow-up question that may arise from the above said if, and to what degree, *institutions are able to replace policies and exclude discretion?* This is all the more relevant, as rules, by definition, act as *constraints on deliberation.* Thus whatever rule is introduced limits `sovereignty`, `democratic deliberation`, relying on the popular mandate`, or just pragmatism understood as ` common sense`. For instance the rules not allowing parties under five per cent of the popular vote to gain representation regularly excludes 15 plus per cent of valid votes form Hungarian legislation. The 3 per cent ceiling of the Maastricht Treaty does not allow for a government to be involved in growth generating - ` counter-cyclical` - policies in bad times irrespective of the performance of this government in good times. Adoption of a regime of inflation targeting does not allow for monetary authorities to accommodate lax fiscal policies without their loss of credibility/

By contrast, the more academic economics is concerned with long run phenomena, such as non-inflationary growth, good governance, credibility and sustainability in a number of planes, the more inevitable it seems to be the need to provide certain, consensus-based *insights to be supported by rules and institutions that are hard to change*/and by no means to be changed overnight/. Rule-based behavior certainly enhances calculability, thereby allowing for a better interaction between regulators and market players, thus enhancing the efficiency of policies.[24] In concrete terms these allow *major changes* to be accomplished with minor, *soft policy measures,* that of course further increases credibility and efficiency of both policies and institutions.[25] This is the reason why the idea of rule-based behavior enjoys growing popularity in the analytical literature worldwide.

On the other hand assessment of each and every situation can not be saved. In the period between 1999-2004 we could observe a number of occasions when the governing board of the FED, of the ECB and of the Bank of England and of the Bank of Japan have all come to quite *different conclusions* on the measures that were deemed necessary to attain their quite *similar goals.* The ongoing idiosyncratic behavior is per se a proof of discretion, a fact that has never been denied by any of the major actors, from Duisenberg and Trichet to Greenspan.

How can we know that policies are also irreplacable? Besides the earlier quoted insights, recent analyses of ongoing crises/Collier et al, 2003/ call attention to the danger of *reproducing the weak and predatory state,* in part because of sheer disintegration, in part because of the tradition of *not investing in the public administration.* The latter may turn into a self-fulfilling prophecy, with revolving power groups misusing the administration as their self-service shop, thereby further diminishing its efficiency. In some developing countries, mostly in Africa, kinship and political loyalty matters more than professional knowledge; administration also serves as an *employment buffer.* This

[24] *This is much less so with transparency. Empirical analysis by Eijfinger/2004/ has indicated: transparency may though add to credibility, still the latter does not invariably translate into lower/refinancing/ interest rates.*

[25] *Gottlieb/2000/ presents the case of Israeli monetary policy reacting to the East Asian and Russian financial crisis with deregulation and opening up, thus saving a lot of money otherwise needed for intervention, plus restoring the exchange rate of the shekel to the pre-crisis level in only eight weeks.*

is why the above quoted analysis is also calling for the creation of lean and professional civil service as a precondition for further improvements.

One of the recurring themes in the policy reform literature is the *unfavorable experience with transplants.* Arrangements, both at the level of corporate governance and of public policy, that work well under one set of conditions, often fail to deliver under different settings. Once formal institutions become defunct or watered down the functions of co-ordination is taken over by informal institutions. This, as seen with the laggard group of emerging economies, is about the opposite of what rule of law and credibility considerations would require. Once institutions borrowed from abroad remain on the surface, or function only superficially, there is a grave danger of their being eroded. South-East Europe is one of the regions, together with the post-Soviet space, where formal rules tend to be dominated by informal ones. As we tried to show /Csaba /2005// in the case of both China and Russia, this is a sign of inadequate modernization and carries the *danger of inefficiency and lasting slowdown.* In this context Silvana Malle/2004,p42 and p47/ rightly draws attention to the contrasting experience in Central Europe. She is indicating that institutions take root better if and where they had a certain legal and political pre-history, as common law in former British colonies. This insight also means, as she explains, that those transplants that are fundamentally alien to the cultural context are most likely to be rejected by the social fabric and the democratic political process alike.[26]

We know fairly little about how institutions may be successfully transplanted. It seems that processes of trans-nationalization in general, and of ITC in particular may, at a certain level, contribute to this. Also meso-level institutions were shown to have emerged for settling differences and collisions among various national rules. In a way progress in the Millennium Round of trade talks, pertaining to several areas outside commodity trade, like intellectual property, public procurement, export promotion measures and investments,[27] would be crucial to create *civilized rather than archaic ways of conflict resolution.* WTO membership may well serve as an incentive to streamline and modernize their respective institutional infrastructure.

An equally important, though much less explored area is the *mechanism of self correction.* Once an insight gets institutional backing, it will be hard to change. This is the plus and the minus about it. On the one hand, this allows to act it as a bullwark against policy reversal. On the other hand, *priorities and insights may and do change.* Public choice, for instance, favoring more egalitarian provision of services may give way to insights favoring more self-help and vica versa. Professional insights, especially in the social sciences can rarely be taken as given *forever.*The 1960s was molded by the belief in technological progress – called in German *Machbarketisglaube.* By contrast the current age is formed by post-modernist and post-structuralist approaches, and by uncertainty pertaining to the powers of what any administration is up to. It goes without saying that the two approaches translate into different institutions, that are much more difficult to change than policies are. For instance the moving wage setting of *scala mobile*, itself a source of chronic inflation in Italy in the 1970s had been possible to change only at the cost of major social unrest and several years of fights. Likewise the

[26] *A similar conclusion is formulated in an even more pronounced manner by/Winiecki, 2003/.*
[27] *These are dubbed in WTO parlance the Singapore Tasks.*

...ent slow reform of the pension system in Western Europe is a case in point. The idea of inter-generational solidarity, when one generation is significantly more populous than the other, and when perspectives for growth are dim, is hard to sustain, but also hard to change. The more myopic and vested interest dominated political processes are, the longer it will take to institute those changes that ensure elementary rationality from the public purpose perspective.

Last but not at all least *ideas seem to matter,* much more than it was customarily thought in a few decades` time span. If this holds, there obviously is a *trade-off* between *flexibility* needed by the open-ended nature of social and economic change on the one hand, and stability, *calculability and credibility,* provided by the *institutionalization* of insights and behavioral norms. Ideas shape policies in a trivial fashion, but so do they institutions. The big role of *informal institutions* is intimately related to the deep rooted, historically conditioned distrust in the state in general and of the judiciary as a politically instrumentalized arm of the executive in particular. Perceptions and norms are slow to change, which of course is yet another justification for why spending on education, the judiciary and of the state bureaucracy/ensuring its lean and technocratic qualities/ need to be treated as *investment* rather than consumption or social expenditure.

This circumstance may explain the empirical findings of Linda Weiss/2003,pp294-298/ that contrary to widespread claims, the taxing power of states has not diminished. The tax burden – especially on capital – even grew by several percentage points since the 1960s, while difference in the tax/service structures remained decisive. The real change, as the case studies of her collection prove, has been from statism to governed interdependence. In other words, the room for Keynes inspired demand management has diminished. Still the process of trans-nationalization has been enabling the state for a variety of new functions and activities/like the regulatory ones discussed in our chapter on Privatization and regulation/. How enabling these processes work, is a function of *the quality of the institutional framework in the respective society,* as well as on the values governing public choices, among other things, on funding and reforming public administration.

The Democratic Development Alternative

What do we know and what should we know? First and foremost the jury is still out on the mechanics of growth, a major field of general economics. In short, neoclassical theories of Samuelson, Barro, and Solow tend to attribute up to 75 per cent to factors to the analytical frame, such as technological progress and innovation. Endogenous and especially evolutionary theories, by contrast, are much better at explaining processes, not however at `putting numbers` on the factors of growth. We do know that institutions, rule of law, property rights and the like matter. However, *it is hard to establish exactly which is the chain through which they work.* More precisely, what we know are bits and pieces, we are able to explain failures, no however able to create a cookbook to go by.[28]

[28] *Lucas/1988,p5/ notes that figures must be seen as potentials and reflections of social interchange rather than extraneously given variables following a predetermined path.*

The study of emerging economies has, perhaps contributes, though to a limited degree, *to clarifying and understanding these more general considerations of economic theory.* In a recent book /Csaba,2005/ we attempt to show that in the majority of cases it is *not the Communist heritage, but factors common to other countries at similar level of development* that are decisive. For instance the level of trans-nationalization, the broadness and deepness of capital markets, sound banking, incentives to save and to invest, context-specific methods of corporate governance and the like are the `usual suspects`. Cultural and local specifics *modify rather than redefine* the logic of its functioning. Therefore both successes and failures of emerging and other post-Communist economies can be interpreted *within a single theoretical framework.*

While we have found many cases that go along the standard line of explanation, *we have not found any single counter-case.* In all those cases when empirical findings do not seem to be supportive of the general claims, we could spot specific set of circumstances that explain derailment. For China, Russia and the Balkans *the standard set of explanatory variables do seem to deliver acceptable results,* once modifying factors such as path dependency and the weak core state are accounted for. This is the standard way of proofing thesis in the natural sciences, and paradigms need to be re-assessed only if the exception becomes the rule. Although we have seen and cited many claims describing transformation and re-emerging growth in terms of puzzles, we could not find empirical and analytical support to substantiate these claims. The latter look thus *rather wide spread than soundly substantiated.* The predictive power of the findings such as the interrelationship between FDI and export patterns, or financial soundness and growth, seem to hold in line with the general claims/not invented, merely applied by the present analysis/. Thus, as Antoni Kuklinski/2001,pp130-133/ explained, the mere fact of Hungary and Poland each losing ten places in the Philadelphia Index of Scientific Output between 1981-1998 is unlikely to have left the innovative capacity of the respective economies unaffected. The latter is known to translate directly into the long term/trend rate of economic growth. The less policies counteract the anti-innovative bias of transition societies, that has been manifest anyway, the longer and deeper the period of slowdown is bound to be. Likewise, the low level of revealed technological progress is unlikely to leave the Russian growth potential intact, once oil prices consolidate. Decades long neglect of R+D and of quality higher education is far from being a forgivable omission from the perspective of what rates of growth will be sustainable in the coming decades. Claims to the contrary, repeated endlessly by self-justifying public figures, are unlikely to invaldiate the basics of growth theory, neoclassical and endogenous, institutional and evolutionary alike.

The list of conditions for emerging from the ruins of the Soviet Empire, presented here is not meant to be exhaustive. However it does contain at least some of the *necessary, even though not all the sufficient conditions.* One of the reasons for this is the fact that the broader developmental literature also struggles with the normative view it may offer on small, land-locked countries located in big distances from the main growth poles- an obvious disadvantage, currently stressed again by the new economic geography. Therefore we may fall short of offering trivially available remedies for the multiplication of ills in Central Asia and South- East Europe alike.

Our findings on the emerging economies, both the descriptive and in the normative planes, *point to the same direction as the broader developmental literature* represented by the volume of Todaro and Smith/2003/. They are stressing the importance of decentralization, democracy. They also urge to *create stakeholders.* They stress the importance of bottom-up, *organic development* and participation. The latter applies at least in two planes. *First:* participation of the population in the process of macro-political deliberation, through voice and representation, since Amartya Sen/1999/ no longer seen as a mere object of `benevolent dictators`, even at the abstract level of the theory of optimal economic policy. *Second,* participation in the processes of trans-nationalization, rather than rejecting it by way of seclusion, de-linking or searching, in vain, for ` national ways and models` has been shown to be able to produce superior outcomes in terms of wealth creating and well being alike.

Similarly, the great historical overview of Landes/1998,pp217-218/ highlights: that besides institutions committed to `larger goals` over and above vested interest representation, the provision of personal and proprietary freedom, freedom of contract *responsive, honest government, free of any predation*/or simply non greedy government/ have been the major components of economic success across the centuries. Furthermore, as Lambsdorff/2003,pp468-469/ indicates, corruption in poor counties lowers productivity by 2 percentage points per annum on average. For Tanzania for instance he finds that improving its level to that of the United Kingdom would yield no less than 10 per cent of the capital stock. Therefore, at least in part, it is the lack of professional and non-corrupt government that may explain why non-European civilizations fell short of capitalizing on their frequent, but temporary, edges in terms of education or technological innovation.[29]

As we have seen through the publications of the international agencies, as well as of the development literature/as exemplified by the representative volume of Meier and Stiglitz, eds,2001/ a large number of fundamental issues are being re-assessed. The role of policies, institutions, of policy reform and sustainability have put a number of previously settled questions back on the agenda. It is reassuring to observe, that also in political science and international relations a parallel development take place. The empirically based comparative methodology evolves toward *a neo-institutionalist synthesis,* that builds though on rational choice model, without however staying at that level of abstraction/cf the broad overview of Saxonberg and Linde,2003, p14/. *It is an entire new research agenda that is in the making.* The good news is that emerging economies fit into this picture. The bad news is that the process seems to be much *more open ended* than it was thought even a couple of years ago, be that from the angle of growth theory, or from the angle of development studies or new institutional economics for that matter. Attempting even to take stock of these is a task of a subsequent monograph.

[29] *Medieval China is a case in point.*

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Zoltán Ádám

Autonomy and Capacity
A State-Centred Approach to Post-Communist Transition in Central Europe

paper examines state characteristics and their policy implications in five Central European post-munist countries. It argues that state-society relations throughout the post-communist transition shaped policies on macroeconomic stabilisation, privatisation and FDI. Curiously, though, whereas tural and institutional developments exhibited a great deal of path-dependency in some countries, ers significant policy shifts took place. The conceptual tools of state capacity and autonomy are loyed to describe both dynamics, as well as to explain the spectacular variation in the role of FDI across egion.

nal of Economic Literature (JEL) code: *P26, P31, P51*
ords: *transition, privatization, state autonomy, Central Europe*

Introduction

purpose of this paper is to examine state characteristics and their policy implications ng post-communist transition in five Central European countries: the Czech Republic, gary, Poland, Slovakia and Slovenia. States are understood here as institutional actors ing a key role in economic development. How they fulfil this function, depends on policies, which are significantly influenced by such state characteristics as their nomy vis-à-vis societal actors and their internal capacities to implement policies. ever, not only policies are affected by the degree of autonomy and the quality of cities, but policies impact upon state characteristics too. Thereby, a degree of path ndence is involved, usually resulting in polices supporting existing state capacities rivileged social groups. Nevertheless, at times of restructuring, path dependence mes challenged by policy shifts that potentially rearrange state-society relations may alter state characteristics. In this sense we have witnessed in post-communist al Europe in the past 15 years was an intense period of structural change in which characteristics have changed to varying degrees in different countries. Policies on lisation, privatisation and foreign direct investment (FDI) played a crucial role in Nevertheless, not everything has changed. Some countries exhibited extraordinary dependence while others conducted more policy shifts.

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