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On the Relationship Between State and Economy in Transformation

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1. Introduction

The main task of the state in the transition from plan to market is to do what, according to Marx, it should already have done under communism - to wither away. Such de-etatisation is widely held to have been the gospel of Western transformation consultants and their Eastern believers who, therefore, are lumped together under the heading of „neo-liberals". The so-called Washington consensus is considered the accepted dogma of the creed - and the source of all evils that befell the transformation countries after the turnaround.

Looking at the ten commandments of the consensus confirms by implication the view, ascribed to neo-liberals, that abolishing all state authority *in oeconomicis* will spontaneously create markets which by their very nature maximally promote development. These ten commandments are (see Williamson 1990 and Rodrik 1997: 419):

1. Fiscal discipline
2. Redirection of public expenditure priorities towards health, education and infrastructure
3. Tax reform including broadening the tax base and cutting marginal tax rates
4. Unified and competitive exchange rates
5. Secure property rights
6. Deregulation
7. Trade liberalization
8. Privatization
9. Elimination of barriers to direct foreign investment
10. Financial liberalization

The list is the result of the disappointment with active government development policies, especially in Latin America, and of neo-classical micro-theory and new classical macro-theory. It may be astonishing that monetary stabilisation is not mentioned explicitly among the commandments. However, active monetary policy has long been out of the question and the only danger for monetary stability rests with the state budget, hence the recommendation of fiscal discipline. It should be mentioned that the consensus was not considered a comprehensive reform programme, but rather that part of it which found general agreement among economists (in Washington). And secondly, it was not meant to be a blueprint for the transition from plan to market, but rather for the Latin-American problem of transition from a mixed to a full-fledged market economy. But in 1989-90, when the communist economic and political system collapsed, the ten commandments were gladly taken up by Western consultants as well as by Eastern reformers as a guideline for their policy design clearly not implying that the state, or what was left over from it, should engineer its own disappearance.

The consensus has come under heavy attack targeted at two different points. First, those, like the Keynesians and Post-Keynesians, who do not subscribe to the underlying economic theory, in particular the macro-theory, criticise the prescriptions in themselves (see, e.g., Laski and Bhaduri 1997). And second, those who are basically in agreement with the economic theory have an easy target in the limited scope of the consensus with respect to the transformation task. Several arguments are found in the literature (e.g. Stiglitz 1999a; Stiglitz 1999b; Ahrens 1999):

- the consensus disregards the initial situation,
- it disregards the fact that the method by which the market is introduced influences its operation (path dependency),
- it ignores the embeddedness of the economic system or the interdependence of economy, polity, and culture,
- it has nothing to say about institutions, in particular legal regulations and their enforcement mechanisms,
- the underlying neo-classical micro-theory overestimates the role of the market and underestimates market failures,
- the consensus is silent about the social costs of its implementation.

Indeed, the consensus prescribes economic policies without saying a word about the institutional - let alone the cultural - infrastructure which is necessary to implement the policies and make them work as expected. It may be assumed that the reformers and their advisors were aware of, for instance, the importance of an independent central bank for monetary stabilization. The statement about the neglect of institutions, however, says nothing in itself about the adequacy of the policy recommendations. They have been relativized by Rodrik (1997) in the context of the comparatively successful North-East Asian growth policy, or the Japanese development model, which complied with the first five commandments, while the second five were much more loosely followed. Development is among the ultimate objectives of transformation and competitive markets may be seen as only instrumental to that end. Yet if we follow Hayekian and other liberal thinking, competitive markets are an element of a free society and, as such, an end in themselves. Inasmuch as transformation aims at a transition from a totalitarian to a free society, policies have to be evaluated not only from a developmental point of view which prevails in the arguments pro and con the consensus.

Many of the incriminated „neo-liberal“ consultants, including Jeffrey Sachs, could claim that their transformation program embraced not only stabilization, liberalization, and privatization, but also institution building. It is true, however, that they have not made sufficiently clear that appropriate institutions are the precondition for competitive markets to work properly and even less so that a powerful state is at the core of these institutions. It should not remain unmentioned that, for neo-liberal thinking in the Freiburg tradition of Eucken (1990), the institutional implications of competitive markets and the role of the state were self-evident and central to their transformation advice.

The chief witness against the Washington consensus has recently become Joseph Stiglitz (1999a, 1999b). This is not the place to evaluate his arguments in depth (which has convincingly been done by Dabrowski, Gomulka and Rostowski 2000). He has many good points about path-dependency, sequencing, and the mechanical implementation of stabilization, liberalization, and privatization. But when he juxtaposes unsuccessful Russia and China as paragon of transformation success, he not only misses the successes of Central Eastern Europe, he also fails to take account of a free society as ultimate objective of transformation. This raises the interesting question whether China is a valid example of successful transition to a competitive market order in which the type of state governing the economic system does not matter as long as it conforms to the market order. Clearly, the rule of law belongs among these conformity conditions, but it is unclear whether there is a binding relation between the rule of law and political freedom (see, for instance, Przeworski and Limongi 1993) - which does not automatically imply that China already enjoys the rule of law. Alternatively, it could be held that what we see in China is not the establishment of a full-fledged market order, but the only successful attempt up to now to decentralize a socialist planned system yielding some kind of market socialism. Economic growth in China is undeniable, bringing the Lipset hypothesis (Barro 1997) to the fore: prosperity stimulates democracy. So we should be careful not to interpret the connection between state and economy as a one-way relationship.

Given the fact that the modern market order and the modern state co-evolved over the last four centuries, it looks rather strange to learn only recently from economists (e.g. Rodrik 1997, Stiglitz 1999a) that markets and governments are complements, not substitutes for each other. The explanation of this remarkable phenomenon lies in the history of economic theorizing. When the problem of theory became the Smithonian metaphor of the invisible hand, i.e. of analysing the conditions of existence and stability of a competitive equilibrium, and these conditions turned out to include perfect information and perfect competition, there was no economic role left for the visible hand - if not, as the Freiburg school has stressed, to create and protect the institutional prerequisites for perfect information and perfect competition. This theoretical puzzle, together with perfect information and perfect competition, has little in common with historical economic systems (it never claimed it did, as a matter of fact).

Historical and institutional approaches, on the other hand, always were interested in the economic role of the state. However, they lacked the ability to give a theoretical rationale for what they observed and described. By and large, this is still the state of the art (see the rather brief chapter on the new institutional economics of the state, on the one hand, and the recourse to G. Schmoller as ancestor of the new institutional economics, on the other, in Richter and Furubotn 1999).

So when we try to look a bit more closely at the relation of state and economy in the rest of the chapter, there will be a lot of *ad hoc* observation and *ad hoc* theorizing, which is typical for the treatment of the economic role of the state. The following paragraphs first briefly treat the state and the rule of law, second some more and some less accepted economic roles ascribed to the state, third the age-old fact that the economy thrives only under a regime of good governance, and finally the question whether there is a specific role for the state in the process of transformation. The aim of the exercise is to find out whether or not any state would do for a well-functioning market order and whether transformation assigns the state specific tasks.

2. The state, government, and the rule of law

The friendly request for the state to wither away is targeted at a specific type of state, not at the state as such. For Marx, this was the class-state, to be substituted by rational public administration. For transformation, this was the totalitarian communist state which Marxist-Leninist theory saw as an instrument for rebuilding society according to the well-understood laws of history. As long as different interests prevailed in society, thus ran the argument, the dictatorship of the proletariat was deemed necessary to promote the unity of state and society. As soon as there was harmony of interests, the state would express and carry out the collective will of all. In both cases, the ultimate decision-making power rests with the state, there is no separation of the private and the public spheres. Yet in theory there is no conflict between power and consent, i.e., between markets and hierarchies, because of the assumed harmony of interests: democratic centralism can be perfectly democratic and perfectly centralistic. In practice, the ensuing state turned out to exercise universal petty tutelage and all-pervasive highly incompetent intervention, thus blocking individual freedom. In addition, it failed to live up to its promise, namely to provide an ever-increasing level of welfare. To abolish the communist state and to de-etatise the economy was the logical consequence of the anamnesis of the economic catastrophe to which it had led.

Abolishing the totalitarian communist state did not imply abolishing state activity altogether, nor did it imply introducing Western-type democratic states whose economic role is not clearly defined, anyway. Yet to cut a long argument and a long history short, we may assume that most transformation countries aimed at such Western-type democratic societies. From this it follows that the private sphere and the public sphere ought to be neatly separated and the former protected against arbitrary intervention from the latter. The separation of private and public spheres requires the introduction of private property rights. The protection of their free use requires the rule of law, which by its very nature is the antithesis of arbitrariness. Let us already mention here that predictability of law and of government policy is considered conducive to economic performance (and enumerated among the core institutional elements of a competitive order by Eucken 1990: 285).

Up to here, I have equated the state and the public sphere. Even if it is not in line with juridical definitions, it could be a workable definition. However, such a definition disregards the non-state domain of the public sphere, non government organisations or the organisations of the civil community (in contrast to firms that are meant to operate in the private sphere, NGOs are meant to operate in the public sphere). Since Putnam (1993), this part of the public sphere has attracted new attention, for he was able to show its importance for the functioning of the statist part of the public sphere. Already Marxist-Leninist doctrine was deeply convinced thereof, which made the Party monopolise practically all NGOs in communist society: the unity of state and society resulting in the fact that in the end the domain of non-government organisations was almost an empty set - the church being the most conspicuous exception in some countries that was regarded with highest suspicion by Party and State.

Among economists (for instance, Stiglitz 1989: 21; Richter and Furubotn 1999: 301) it is common to think that the state is all about authority and coercion, i.e., to define it, following Max Weber, as the part of the public sphere with the monopoly of legitimate power. Surely, the state is the only societal subject to use coercive power legitimately. But this does not imply that it can use compulsion at any time and on any occasion. However, we have to be very careful to differentiate positive from normative statements. For, looking back at totalitarian rule, the state can use compulsion deliberately there being no exit option for its citizens (just remember Trotzky's idea of the militarization of labour, a feasible mode of regulation as many war economies show). When we distinguish with Hayek (1960; see also Kläver 2000) state action with and without coercive power, we do so in the normative context of the rule of law.

The state with coercive power legitimately uses power to enforce general laws. The constitution and the material definition of the rule of law - as distinguished from the formal definition of legality - delimits what is *ultra vires* of legislation and government, for instance in the relationship between the government, the market, and the individual citizen. Where the authorization of state action does not have to be confirmed constitutionally, as is mandatory in the United States, it is at least bound to well-understood criteria such as legal security, prohibition of excessive action, and liability. To test for these criteria is the task of administrative jurisdiction, a branch of jurisdiction which, by the way, was introduced in Eastern Europe only in the very last days of communist rule. The state without coercive power takes care of certain tasks which, in principle, could be handled by other organizations, non-government organizations or commercial organizations with whom the state competes in this domain. A public school cannot use coercive power to enroll all pupils of a given district, whereas government, on the basis of an appropriate law, may control compulsory schooling.

In short, in the public sphere we find the state as „state“ and the state as ordinary institutional consumer and producer. The two activities are motivated and legitimized differently, the first by the guarantee of liberty and freedom from private coercion, the second by considerations of efficiency (which does not rule out that a public police may also be more efficient than a private one). Between the legal state - the English language places the rule of law above the state, whereas in German it *is* the *Rechtsstaat* (the legal state), both having similar material intentions - and the productive state (*Leistungsstaat*) we may place a third domain of state activity, the social state, which is motivated by considerations of equity. It is more controversial than the other two and some, such as Hayek and other liberals, even regard it with greatest suspicion. Its task can be normatively determined in very different ways ranging from the Zorro model (the state as defender of the poor) to the Caterpillar model (creating a level playing field of equal opportunity). The rule of law requires that the social state be based on general laws, and the state can use its coercive power to tax to finance it. This brings the social state into close proximity with the legal state.

The political economy of the state has been interpreted as a market, with politicians as entrepreneurs supplying government services and the public, or any given rent-seeking group of it, as consumers exercising demand. It can, as well, be viewed as a game over government policies between multiple

principals, the people, and multiple agents, the politicians. The difference is hierarchy, but the concept of consumer sovereignty makes it clear that there is no essential difference - the consumers ideally being principals of the producers. This view underlines the proposition that the power of compulsion is a public good as much as any other demanded by the public. Although the state can, within given constitutional limits, exercise certain monopolies, there is competition in the market for politics, competition between governments - the internal exit option to vote a government out of power and the external exit option to leave the country. And there is the voice option with all its instruments of the public media to remind government of public demand, lest it be confronted with the exit options. It is typical of the totalitarian state, to be substituted by such a democratic state in transformation, that it reverted the roles of principal and agent. It prohibited the voice option by censorship and competition between governments by banning opposition parties and setting up the Iron Curtain. Not only the economic system, but also the political system of socialism was supply- and not demand- driven, which means for the consumer or the general public: take it, you can't leave it.

3. The economic role of the state

The question about the economic role of the state can be now formulated in various ways:

- what has been the role of the state?
- what should be the role of the state? and
- what can be the role of the state?

„What has been the economic role of the state?“ implies the empirical-historical aspect. Economic history and comparative economics show quite different national approaches even within the competitive capitalist paradigm (see, for instance, Crouch and Streek 1997). The cooperation of market and state is shaped according to divergent national traditions and cultures without necessarily resulting in significant differences in performance. Globalization, that is intensified competition, will lead, it can be conjectured, to convergence in certain fields, in particular outcomes, but there is no compelling reason why it should destroy the plurality of organisational solutions that bring about the outcomes. As a measure of state influence, the relative size of the government budget is only one indicator, reflecting predominantly the weight of the social state. In this respect Japan, for instance, scores rather low while the Japanese government plays an important role in development and industrial policy. In industrial relations and wage policy the Japanese government, again, has very little influence (see Hayami 1998). Therefore, distinguishing a market-oriented (Anglo-American countries), a corporatist (Germany, Japan), a statist (France, Italy), and a social democrat (Sweden, Austria) model (Boyer 1997: 90) reflects certain tendencies, but cannot fully render the actual diversity of market - state relations. These relations are by no means stable over time within particular national economic systems. The failure of Keynesianism confronted with stagflation or the wave of liberalisation and privatisation in the wake of increased international competition and technical innovation has certainly changed, but not necessarily diminished, the role of the state in the economy.

„What should be the economic role of the state?“ implies the normative-theoretical aspect. Here we can discern two extreme positions of political-economic theory and vision: the liberal, with the „nightwatchman-state“ as its caricature, and the Marxist-Leninist, with Lenin's idea of the whole society organised like a huge German post office as its caricature. Closer to reality is the liberal vision of the state's responsibility for law and order and the economy being driven by individual decision and coordinated by voluntary contract, and the socialist vision of the state's responsibility for modernisation and development and the economy guided and coordinated by state governance and planning. Between the two we may position the social-democratic vision ascribing to the state a responsibility for social fairness or equity as well as for law and order. Both extreme views share the conviction that the market and the state are substitutes for each other. This conviction is neither historically nor theoretically compelling.

Economic theory has for long maintained neutrality between the two extremes. The neo-classical model was able to show that both, the market and the plan, could attain the same equilibrium under similar conditions, in particular perfect competition or perfect planning, full information, and no transaction costs. Starting from here, Western economists developed a predilection for the market and postulated a kind of subsidiarity principle: the state should come into the picture only where the market fails. Since the subsidiarity principle derives from a holistic vision of society, market and state are no longer considered substitutes for each other, but complements with a primary responsibility for economic decision-making in the private sphere and an over-all responsibility for systemic stability (law and order is only part of it) in the public sphere. The holistic vision goes back to Althusius‘ (1995) *Politica* of 1603, which „presented a theory of polity-building based on the polity as a compound political association established by its citizens through their primary associations on the basis of consent rather than a reified state imposed by a ruler or an elite“ (Elazar 1995: xxxv). The gradual transition from the private to the public sphere and their organic, non-antagonistic relation are important in this context.

There can be consensus about this principle, its operationalisation is controversial: the instances of market failure, in particular when social justice is an argument. However, economic theory has found the trick to keep the state off the market in the latter case or, phrased more positively, to organise the cooperation of market and state. The second fundamental theorem of welfare economics - any desired market equilibrium can be attained by an appropriate distribution of initial endowments - leaves the state with the distributional task to implement fair initial endowments while the market can fulfill its allocational task (Stiglitz 1989: 37-40). Very concretely, this theorem can be applied to social security systems: pension funds and health insurance can be supplied by the private sphere, the public sphere need do only two things: ensure that everybody takes the necessary provisions (regulation) and put the indigent in a state to pay for it (redistribution which, of course, affects allocation in other parts of the economy). The provision of systemic stability is no less controversial. For it can be argued that markets stabilise automatically and that there is no need of a lender of last resort, prudent regulator, or competition guard. A long history of crises in the market economy, however, has proven these functions to be essential for the smooth working of the system.

When economic theory left its ideal world of perfect competition, full information, and no transaction costs, things became much more difficult. Once it is realised that neither the market nor the state operate without cost and that information, if available at all, is not costless either, the cooperation of market and state may become especially fruitful, but the assignment of tasks to one or the other is contingent upon the specific place and time. To return to the above example: the costs of running a public social security system may be much lower than the up-keep of markets for health insurance and old-age retirement pensions. No *a priori* statements are possible.

The non perfect world of costly and limited information, imperfect competition, and, eventually, bounded rationality made clear that allocational efficiency and distributional justice are heavily dependent upon the institutional infrastructure of the economic order. But in order to function properly even the most perfect market economy needs a number of institutions, in the sense of behaviour-constraining rules, and of organisations supporting them. Core elements of a well-functioning market system are secure private property rights, freedom of trade and freedom of contract, hard budget constraints or clear liability obligations, and stable money. In addition, the market system will be protected against degeneration by competition control, provision of consumer protection and of public goods, regulation of externalities, and a basic fairness. It is by no means clear to what extent all this has to be supplied and administered by the state. The fact, however, that contract enforcement, for instance, is quite often controlled by private arbitration, is no argument against state legislation and its judiciary. For the latter determine the opportunity costs of the former and thus limit their arbitrariness and cost. This becomes quite obvious in countries where the public legal system does not function well. On the other hand, the fact that the market is not well prepared to provide public goods does not automatically imply that the state has to produce them. The only thing government has to do in this case is to specify demand and to organise the financing. What societies consider public goods, by the way, is more often than not a matter of public preference, rather than of objective criteria (non-rivalry and non-exclusion) of the respective goods.

„What can be the role of the state?" implies a theoretical-practical aspect. The socialist ambition to govern the entire economic system by central administration has clearly turned out to be impossible. In similar fashion, the Keynesian ambition to fine-tune economic activity and to guarantee full employment could not be realized. The market is obviously better suited to the first task, but not to the second. Economic theory should be able to show why this is so. There are many more instances in which the market fails and in which the state does not fare better, because of imperfect information, equally high transaction costs, a lack of price signals, and moral hazard. The state is not run by a benevolent dictator nor by impartial Weberian bureaucrats, but rather by opportunistic administrators. This entails the dangers of state capture, rent seeking, and the diversion of public funds and assets. All these are arguments in favour of the aforementioned subsidiarity principle. Nevertheless, it cannot be denied that modern economic growth was accompanied by an increasing economic role of the state, that successful development models, like the East Asian, were characterized by close cooperation between the public and the private sphere, and that high levels of productivity correlate strongly with high levels of social infrastructure. It is only recently that economic theory has tried to identify the specific factors and relations which lie behind these facts. When we know them, the answer to the question „What can be the role of the state?“ will perhaps be more positive.

4. Social infrastructure and good governance

Not every state is a good state, and not every government does a good job in terms of economic development and provision of welfare. The more economists look into it, the more they find that here we may find answers to questions such as „Why don't poor countries catch up?“ (Keefer and Knack 1997) or „Why do some countries produce so much more output per worker than others?“ (Hall and Jones 1999). The puzzle „Why growth rates differ?“ (Denison 1967) is an old one. It was treated by growth accounting in the context of growth theory with capital, labour, and „technical progress“ as explanatory variables and with the result that the greater part of the variation was explained by exogenous factors or remained unexplained. The „catching-up effect“ was theoretically deduced from the assumption of diminishing returns to capital and empirically confirmed for Western Europe and Japan vis-à-vis the United States. It was not asked, however, what made the catching-up effect operative. New in present attempts is that convergence is put in the conditional mode and that explanations of actual growth performance are also sought in the institutional environment of private economic activity (Barro 1997). And here the state plays a predominant role.

The basic idea holds that social infrastructure lowers transaction costs and gets the prices right, to the effect that individuals capture the major share of social returns to their economic activity (production and investment) as private returns (Hall and Jones 1999: 84). In an unfriendly environment, a sizeable share of the returns will be diverted by people who do not contribute to the result. In the long run, this will induce the producers to cut back their efforts. Uncertainty is the major brake to investment in physical capital as well as in human capital. From this it follows that investment in social infrastructure is a *sine qua non* for economic development and welfare production. This idea is known as the Hobbes hypothesis: comparing the state of nature (unregulated competition) with the civic state, it is in the well-understood interest of each to consent to collective action (the implementation of which, then, may be preferable along the lines of Althusius rather than of Hobbes).

One of the most efficient instruments for the diversion of returns, it can hardly be denied, has been the state. Confiscatory taxation, expropriation, and government corruption are examples of direct public diversion. In an indirect way, government can yield to rent-seeking activities of the private sphere and install regulations which unduly benefit particular individuals or groups. In other words, the role of the state is ambivalent: it is responsible for the social infrastructure and it can exploit its position and power of compulsion for predatory purposes. Apparently, the visible hand can be a helping or a grabbing hand. Hence the importance of good governance. That good governance (*buon governo*) makes the economy thrive is already illustrated in Ambrogio Lorenzetti's famous 14th century frescoes in the city hall of Siena.

Governance can be understood as „the traditions and institutions by which authority in a country is exercised. This includes (1) the process by which governments are selected, monitored and replaced, (2) the capacity of the government to effectively formulate and implement sound policies, and (3) the respect of citizens and the state for the institutions that govern economic and social interactions among them" (Kaufmann, Kraay and Zoido-Lobatón 1999:1). So broadly speaking we may equate good governance and a high level of social infrastructure. The basic institutions that are needed derive from the aforementioned core elements of a market system: secure and stable property rights, freedom of trade and of contract, enforceability of contracts, clear liability rules, stable money, and well-defined and predictable administrative and judicial procedures as well as policy regimes. Secure property rights and a credible government inhibit diversion of income from production and investment, and they lower transaction costs through high transparency and reduce the risk of unexpected policy change. Thus, entrepreneurs face lower costs, inducing them to higher investments, and commercial success depends only upon static and dynamic efficiency. On the other hand, „where institutions are inadequate, entrepreneurs succeed on the basis of political rather than economic criteria: inefficient entrepreneurs survive who happen to have the personal ties with state officials that are necessary to protect against expropriation" (Keefer and Knack 1997: 591). The Russian „oligarch" Beresovsky is reported to have said: the best investment at present is in politics. The Russian growth statistics of investment in construction and equipment, negative for the last decade, seem to corroborate his view.

Good governance is not big government. Barro (1997: 26) has confirmed the old liberal hypothesis that „big government is bad for growth" where he measures government size by government consumption, excluding expenses for education and defence as productive government spending. This, of course, is a typical example of ad hoc theorizing. To determine the necessary institutions for good governance is one thing, to assess their existence and measure their functioning is a different one. It is important to note that there is a great diversity of established institutions in countries which are held to exhibit good governance. Just compare Europe and the US or Singapore and Sweden. So it is hard to imagine that there is an optimal set of institutions. It is rather the local mix adapted to the cultural traditions of the individual country and accepted by public officials and the people which makes for security and credibility of policy. Yet the fundamental aspects of governance, like the rule of law, bureaucratic quality, and corruption are of general importance. In their recent studies, Kaufmann, Kraay and Zuido-Lobatón (1999, 2000) have attempted to identify a set of governance indicators and to aggregate them into a data set fit for testing. These indicators, whose representation, probably unwittingly, follows Lorenzetti's model of confronting *buon governo* with *mal governo*, may serve here as an example (Kaufmann, Kraay, Zoido-Lobatón 1999: 8-10).

In a first cluster of indicators called „voice and accountability", the political process is assessed, i.e. the selection and replacement of those in authority, public participation, and political rights, in particular the independence of media. The second cluster is, so to speak, the mirror image of the first, labelled „political instability and violence". The chance that a government may be overthrown by unconstitutional means contributes to insecurity and discontinuity. The third cluster „government effectiveness" should cover the state's ability to formulate and implement sound policies and to have transparent administrative procedures. The credibility of the government's commitment to its declared policies is an important element in this context. The civil service will tend to act arbitrarily when exposed to political pressure if it has no clear institutional framework, if there is no effective judicial control, and, of course, if the quality of the administrative personnel is poor (see also Keefer and Knack 1997: 594). Again as a kind of mirror image, a cluster „regulatory burden" is introduced. It measures excessive regulation and market-unfriendly policies. The final two sets of indicators should reflect the state - citizen relation, in particular the respect and acceptance - let it be clear by both sides - of constitutionally established institutions. The cluster „rule of law" captures the predictability of the courts and the enforceability of contracts. Obviously, the rule of law is strengthened by sound political institutions, to which may be added a clear division of powers, in particular an independent judiciary. The mirror cluster „graft" measures the perceived extent of corruption, defined as the abuse of public power for private gain. Corruption can take many different forms. In the state - economy relation it is above all state-capture and public-procurement corruption which make for bad governance. State-capture can be defined „as the capacity to influence the formation of the basic rules of the game (i.e. laws, rules, decrees and regulation) through private payments to public officials", and public-procurement corruption is „the efforts to alter the implementation of government policy through high-level kickbacks" (Hellman, Jones, and Kaufmann 2000: 2). In both cases, the firms engaging in these activities seek to extract rents that they would be unable to obtain by ordinary market transactions.

It should be rather obvious that the variables of good governance are hard to measure. In many cases, it is only the subjective perception of foreign investors aggregated into country risk and business risk indicators which sheds some light. Nevertheless, it is astonishing that all mentioned studies are unanimous about the result: governance matters. Hall and Jones (1999) are quite sure the can explain much of the variation in economic performance by differences in social infrastructure, and they show that the countries most influenced by Europeans over the past centuries have social infrastructures that are conducive to high levels of output. Barro's (1997: 75) similar regression of economic growth on previous colonial status did not yield significant results. Social infrastructure triggers high capital intensity (investment in physical capital), high human capital, and high labour productivity. Keefer and Knack (1997) focus on the ability of backward countries to benefit from the advantage of the latecomer or catching-up effect. They find strong support for what may be called a generalized Gerschenkron hypothesis. According to Gerschenkron (1962), the state had a beneficial effect on the catching-up of backward countries. In Keefer and Knack, institutions in general or institutional quality, mostly through government action, produce this result. Kaufmann, Kraay and Zoido-Lobatón (1999) find that strong institutions and good governance have a very large payoff in economic development. There may be a problem of the chicken and the egg. Putnam (1993) has suggested that strong institutions are the result of very long periods of cultural history, so we may assume a virtuous circle of good governance and economic welfare. Barro (1997: 86) has confirmed the aforementioned Lipset hypothesis that there is a positive relation between democracy and prior measures of prosperity. The finding of Hall and Jones concerning European influence indicates that part of the tradition can be transplanted. If the result turns out to be robust, this sheds a new light on colonial history. However, the „warning“ of Barro (1997: 59) should be also mentioned: too much democracy is bad for growth. He has found an inverted U-shaped relationship between democracy and growth: the increase of liberalisation and the rule of law enhances investment and growth, but because of popular redistribution claims, full-fledged democracies reduce their growth potential. Right now, there seems to be a lot of measurement and a comparative lack of theory. But there can be little doubt that institutions matter.

All these studies work with large samples of countries all over the world. Hellman, Jones and Kaufmann (2000) concentrate on transformation countries. Here they get the result that state capture pays only in a favourable environment, i.e. where there is a market for it. In low capture environments, the efforts are a dead weight loss for firms that nevertheless try, in contrast to public-procurement corruption, which always pays in the short run, since it is a much more direct *quid pro quo*. Low-capture countries are typically those where transformation of the political and economic system has either not really started yet (like Uzbekistan and Belarus) or where it has already progressed very far (Estonia, Poland, Czech Republic, Hungary, Slovenia). These are also the countries which either have had no dramatic transformation crisis yet or which have already overcome it. This prompts the conclusion that good governance may sooner be found in the pure system types, rule-of-law democracies or rule-of-party autocracies, than in transitory mixed forms. High-capture countries are those which have started economic reforms (liberalisation and privatisation), but which did not succeed in implementing correspondingly far-reaching reforms in the political and judicial systems. These are also the countries which are still in a deep economic depression. Evidently, where a weak state and strong entrepreneurs come together, the risk of state capture must be greatest. This is the danger of partial reforms or gradualism. To design and implement reforms of the political and economic system as well as policy reforms is the genuine task of government, which brings us to our last point, the role of the state in transformation.

But before turning to it, we should mention the somewhat puzzling „paradox of the successful state“ stated by Rodrik (1997: 427-8). He summarizes four rules of thumb for good governance, which certainly will meet with the broadest approval:

- apply simple and uniform rules, rather than selective and differentiated ones,
- endow bureaucrats with few discretionary powers,
- incorporate safeguards against frequent, unpredictable alteration of rules,
- keep firms at arms' length from policy formulation and implementation.

„[T]hese rules were almost perfectly negatively correlated with actual outcomes“ (ibid.: 428). The empirical test ground in this case was East Asia, where there has been economic development with an active state and close cooperation between industry and administration. The solution to the puzzle, in my eyes, lies not in discarding the rules as simplistic, but rather in their lack of cultural embeddedness. If there is a high culture of civil service, then discretionary bureaucratic power, differentiated rules and regulations, and close personal links between managers and government officials may not end up in excessive corruption or, at least, not in suffocating protection. For Russia, on the other hand, I would surmise that the four rules of thumb are highly advisable. Generalisations which start from the theoretical assumption of opportunistic behaviour may be valid, but not necessarily applicable in societies that have developed forceful institutional and cultural checks against myopic opportunism.

5. The role of the state in economic transformation

Transformation is a multi-faceted process. It aims at many different levels of the politico-economic architecture of society. As far as the transformation of the economic order from plan to market is concerned, stabilisation, liberalisation, and privatisation describe the most important steps to be taken. What our introductory paragraph called the „Washington consensus“ reflected these steps and did, in fact, enjoy an even broader consensus in the region. However, stabilisation, liberalisation, and privatisation do not occur by mere fiat, they are the result of purposeful and well-balanced government policies. And the newly established private firms, whether they came into existence *de novo* or are privatised formerly state-owned enterprises, together with their clients, the consumers, need a legal and institutional environment that allows for uncomplicated, stable and reliable private transactions. These structures and reform policies will not develop spontaneously from the bottom up, but are generated by a political authority that designs and implements them.

There can be little question about it: transformation is a fundamental challenge for any government; for a post-communist government it is a Herculean task. Such a government must transform not only the economic, the legal and the administrative system, but also the political system which supports the very government. The paradox of the state in transformation is that it is supposed to retreat from the dominant position it held under communist rule and at the same time be the prime actor in the transition. In this, government is helped by two circumstances, by what is called period of extraordinary politics (Balcerowicz 1995: 160), i.e., the public‘s expectation that radical, even painful, measures have to be taken, and by the organisational void left by the old system which means that not all potentially powerful interests are already organised and politically represented. Both circumstances, however, are ambivalent in their effect upon policy. For if politicians behave opportunistically, the period of extraordinary politics allows for extraordinary private gains and the organisational void leaves the field to those who happen to be organised or in power. We might also conclude that successful transformation, the reaching of a good institutional equilibrium, is a highly improbable event.

The transition from big government to a strong state lies at the core of transforming the economic system in former communist countries. Apart from a market-friendly and effective legal system, the good equilibrium, i.e., the strong state, has a government and administration with clearly defined and limited tasks. Government and administration together are autonomous and at the same time accountable, and work under conditions of executive authority. Even if the Washington consensus is accepted as a promising policy program, it needs leadership to be put on the rails and it needs good governance to be credibly implemented and carried through. Both requirements have a political and an administrative aspect. The formulation and launching of reforms is the task of the reform team, which ideally comprises the whole government, but mostly is only a subset of it. However, the strength of the reformers within government and the strength of government within the newly emerging political system are decisive for the coherence of the reform package, its comprehensiveness, and its timing. Risk aversion and short time horizons make for impatience, whereas system transformation is an operation with long-term effects. Commitment to reform has to be independent of changing government coalitions.

Bönker (2001) has analysed in Central Eastern Europe the political economy of fiscal reform, i.e., one central element of the ten Washington commandments, and found that these factors play an important role. Tightening the fiscal regime, beneficial for long-term stability as it may be, is well known to have embarrassing transitory social costs. In any political context, this constitutes a problem, but in the context of transformation the problem must be immense, given the transitory social costs of all other measures, like restructuring, for instance. Correspondingly strong and determined must be the position of the reform team and the government that wants to implement fiscal and monetary stabilisation. It might be thought that the social costs of transition will be satisfactorily taken care of by the remains of the socialist welfare state. Such a proposition would be utterly erroneous. Even if health reform and pension reform can be considered second-phase transformation tasks, there is an immediate need for state action (see Wagener 1999). The socialist welfare system was organised around the firm. People with no firm or other organisational affiliation were in a difficult or underprivileged position. If this system is not changed, that is to say made independent of the firm, resistance against necessary restructuring measures will be particularly strong.

Looking at transformation performance, it is pretty obvious that there are transformation successes like Poland and poor transformers like Russia. All European and post-Soviet transformation countries were initially hit hard by the transitional crisis. However, while Poland's GNP reached about 125 percent of its initial value at the end of the 1990s, Russian GNP is approaching the 50 percent level. Recovery is by no means automatic. Structural reform policies are a necessary precondition, i.e. liberalisation, privatisation, and the build-up of monetary and legal institutions. But the main driving force is the supply reaction: entrepreneurs engaging in production and investment. The immediate explanation of the difference between the Polish success and the Russian failure is to be found in reform policies and the supply reaction (see also Dabrowski, Gomulka and Rostowski 2000). Careful research on the conditions of recovery and self-sustained growth in transformation countries corroborates the importance of comprehensive and rapid reform measures (de Melo et al.1997 and Berg et al. 1999). Comparing the performance of the former Soviet Union, in particular Russia, with Central Eastern Europe, in particular Poland, the analysis boils down to the conclusion that the former had slightly worse initial conditions, making the initial decline more dramatic. But the lack of recovery is mainly due to a lack of consistent reform policy. Frye and Shleifer (1997 and Shleifer 1997) experienced this at the grassroots. They interviewed Moscow and Warsaw shopkeepers about how they were helped or hindered by government in their daily business. The result was that the Russian government is less effective than the Polish in serving the market. Moscow shopkeepers feel a more severe tax and regulatory burden, a greater legal vulnerability, and a greater burden of corruption. „[T]he Polish shop keepers have their rents extracted by competitors, while the Russian ones by the bureaucrats" (Shleifer 1997: 394).There is no better way of saying that Poland has succeeded in establishing a market economy and Russia has not.

The failure of Russia is a policy failure, or, more correctly, a governance failure, in that the reform policies were not carried out consistently and decidedly, and a failure to give space to new men with new ideas. What is lacking is a strong state and entrepreneurial activity. The Russian state is weak: physical and social security is poor, the economy is demonetised and the rule of law is not credible. The universal quest for a *krysha*, a cover or protection, shows that the state and its law cannot fulfil this function. Where the vital institutions of a market economy are lacking, enterprise has neither incentive nor confidence and trust to produce and invest with a long-term perspective. The only behaviour to be expected is „grab and run“.

Governance and the emergence of new entrepreneurs explain the divergent performance of Poland and Russia. The latter is secondary, in that it may be the consequence of the former: bad governance deters entrepreneurial activity. Good governance in the context of transformation - implicitly, we have seen this already - means among others:

- a clear vision of the intended new system and recognition of its constitutive elements,
- commitment to this vision even under changing parliamentary conditions,
- implementation of the necessary reforms as soon and as decidedly as possible, and
- introduction of a sober, impartial, and predictable administration, a Weberian instead of the Leninist or, even worse, a patrimonial bureaucracy.

But why was Russia not able to establish a regime of good governance, while Poland, starting from a similar communist regime, apparently was? Several explanations have been offered: a less radical change in government structure and government personnel, different degrees of identification with the Soviet model, the historical and the prospective distance from the European Union, the constitutional history of the country, different attitudes towards legality and bureaucracy, different traditions of civil community or social capital, and religious attitudes (Shleifer 1997; Wagener 2000). These explanations are not mutually exclusive. This is not the place to assess their validity. What is important in our context is the suggestion that the relation between the private and the public sphere differs largely among countries for geographical, cultural, and historical reasons. Certain elements of good governance may be created in the short run by vigorous leadership and sound administration, but credibility and trust in continuity, or the supporting social infrastructure in general, will emerge only over time - as it seems, very long periods of time. Bad governance is not an accident that may or may not happen, it is, once entrenched in habits, attitudes, and expectations, a kind of bad equilibrium that requires special long-term efforts to be overcome.

6. Conclusions

The public sphere exhibits a multiplicity of organisational forms, and it performs a multiplicity of different tasks across countries and times. In many instances, it cooperates successfully with a private sphere that is integrated by competitive markets. Are we to conclude from this fact that size, function, and organisation of the state do not matter for the good functioning of the market? This is obviously not the case. There are good states delivering good governance and there are bad states delivering bad governance, whatever activities that may imply in the concrete case, and the two seem to be the result of rather lengthy evolutionary processes. The properties of good governance with respect to a private sphere integrated by the market are more or less known. Foremost stands the rule of law, binding the state not to interfere with the private incentives that promote economic activity and guaranteeing private property rights and the fulfilment of contracts between economic subjects. The welfare benefit of the rule of law derives from uniformity, transparency, and predictability. Equally well known are the properties of bad governance, prominently featuring arbitrariness, intransparent and selective treatment, diversion of private gains, corruption, and state capture. The welfare loss of bad governance derives from uncertainty, high transaction costs, and social injustice. Next to bad governance, there is market-incongruous governance, like the all-pervasive political control of the communist party-state, disregarding the separation of the public and the private sphere. It is open to question whether constitutional provisions, rather than political practice, can secure good governance for the community.

This said, the implications for the organisation of the public sphere and for the delimitation of its tasks are entirely unclear. We have seen that the market and the state are not substitutes for each other, but rather complements: where one fails, the other may step in, with some tasks where apparently both fail. The market does not function in an institutional vacuum. On the contrary, each single market needs a tailored framework of regulations, and if it is a sensitive market, like the money market, of prudent regulations. But a glance at the different national banking systems shows that many roads lead to Rome. There is no optimal set of institutions, but rather a list of common problems which can be solved in different ways. Complementarity is enhanced by the widely accepted principle of subsidiarity, which envisages a continuum from the individual to the commonwealth, giving pride of place to private economic activity. But here the consensus ends. For it is not equally clear in every case which are market failures and which are state failures. This depends in addition upon the shared views about the objectives, which may differ particularly with respect to social justice or fairness. Redistributive measures, eventually deemed necessary for fairness considerations, conflict with non-interference with private incentives. The possible solution, a change of initial endowments, is only adopted in the context of human capital, the education state, but rarely in the context of physical capital, since it seems to be in conflict with the protection of property rights.

The separation of the public and the private sphere, one of the major tasks of transformation, implies only a relative autonomy of the private sphere, which, for the purpose of certainty and reliability, has to be legally well established. Apart from that, the market model of politics makes it clear that size, scope, organisation, and tasks of the public sphere depend, in fact, upon the demand from the citizens, the private sphere. This has several consequences for the economic system. One is the possibility of bundling interests and lobbying for special treatment. Another is imprudent consumption habits. Just as demand for drugs creates drug markets, demand for subsidies creates subsidy markets (rent seeking), which may be detrimental to efficiency. A third is beggar-my-neighbour policies. In other words, an uncontrolled market for policies may degenerate the market order. Although there is, of course, no demand for bad governance, good governance is in permanent danger of deteriorating. This idea haunted Eucken and the Freiburg liberals. Their solution, a class of educated politicians dedicated to the good order and good governance, looks rather Platonic. However, there is the problem of how constitution *cum* culture can protect the good institutional equilibrium, which seems to be much more delicate than the bad one.

Transformation, finally, does not ease the task of the state, on the contrary the state is burdened with a task much more difficult than in normal times. The emergence of a market economy, the intended aim of the operation, is by no means a spontaneous act after the removal of the planning state's restrictions. A comprehensive program of economic policies and institutional reforms has to be designed, politically decided , and consistently implemented to bring the change about. The reform of the political system need not stay at the beginning of the process which, after the collapse of the old regime, increased the burden of the state and most probably aggravated the transitional crisis in Eastern Europe. The example of China shows that any government dedicated to reform can get far in economic transformation. It remains to be seen whether it can avoid political reform. For, after all, China's type of governance is market-incongruous. The stability of Chinese government perhaps made possible a very gradual process of reform that started in 1978 and is still not accomplished. Under less stable conditions, partial reform steps create the danger of state capture and other features of bad governance. The two attractors good governance and bad governance are at work particularly under conditions of transformation, with bad governance having special power, since neither the rule of law nor stabilising political practice are firmly grounded. Those countries which succeeded in transforming their economic and political order at the same time must have operated, it seems, under particularly advantageous conditions.

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9/00	Bernik, Ivan	Political Culture in Post-Socialist Transition: Radical Cultural Change or Adaptation on the Basis of Old Cultural Patterns?, 40 S.
10/00	Nuissl, Henning	Dimensionen des Vertrauens: Kategoriale Bausteine einer Ressource ökonomischen Handelns (im Transformationskontext), 38 S.
11/00	Schwarz, Anna	Diverging patterns of informalization between endogenous and exogenous economic actors in the East German transformation process - Results from a case-study in the IT-branch in Berlin-Brandenburg, 22 S.
12/00	Eger, Thomas	Systemtransformation als umfassender institutioneller Wandel: Die fünf Dimensionen der Transformationsprozesse in Osteuropa, 44 S.
13/00	Pollack, Detlef/ Pickel, Gert	The Vitality of Religion-Church Integration and Politics in Eastern and Western Europe in Comparison, 18 S.
14/00	Wagener, Hans-Jürgen	On the Relationship Between State and Economy in Transforma-tion, 22 S.