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Evolving Institutions and Catching-up by the Candidate Countries of the EU

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Interim Report **IR-02-028/April**
**Evolving Institutions and Catching-up by the Candidate
Countries of the EU**

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April 2002

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Abstract

Since institutions include not only governmental and civic organizations and regulations, but also social customs and behavior, the post-transition development can not be analyzed or understood without the heritage of the past. All-encompassing state-ownership, monopolization and elimination of all kinds of competition reached unprecedented proportions in the Soviet-type economies, creating oligarchic organizations, mentalities, and behavioral patterns. The ruling communist elite enjoyed extreme privileges; citizens became much more alienated from the state than in democratic societies.

Experiences of the fastest growing countries proved that by reforming the institutional system and the policy-regime the growth potential of an economy can be much better exploited and catching-up with the more developed countries can be faster. Because of the “velvet” character of transition in East Central Europe, many of the old special interest organizations were not destroyed, thus creating obstacles to faster growth and structural change. In the catch-up process much depends on the openness of an economy, however its performance is basically determined endogenously, by the allocation of resources and their efficient use depending on the institutional structure.

The lack or weakness of the rule of the law is one of the main obstacles to the economic catching-up of the East Central European societies and their accession to the European Union. The share of the shadow economy in the transition countries increased very substantially and is about twice as big as in developed market economies. Increased criminal activities and large-scale tax-avoidance is closely related to corruption and is very damaging for the lawful and secure environment of growth. Corruption is strongly negatively associated with the investment rate, and through this it lowers the rate of growth. Clientelistic networks evolved around the political parties, creating a social network where political loyalty prevails against market relations, democratic decision making, and professionalism in public administration. In the political struggles, the question was not only which political group would govern the country, but also who would privatize the vast quantity of state assets, and to whom. In clientelist regimes corruption, favoritism, partiality, give-and-take, and nepotism abound, and thus democratic morale and the logic of the market is destroyed.

The analysis shows that the institutions in place in most of the East Central European countries are suitable to achieve a faster growth rate than the EU average, thus catching-up in the not too distant future seems probable after accession. However, the deficiencies in the rule of law are seriously hindering the full utilization of the growth potential of these economies.

Foreword

by János Gács

This paper is one of the results of a broad, multi-year research project of the Economic Transition and Integration Project of IIASA entitled “Catching Up and EU Accession – Prospects for First and Second Wave Countries”. The research was particularly encouraged by IIASA’s Swedish and Hungarian national member organizations, while financial support was provided by the (then) Swedish national member organization, the Swedish Council for Planning and Coordination of Research (FRN). Preparations for the project started in 1999. In addition to other forms of communication two workshops, one in Budapest in January 2000, and one in Stockholm in May 2001, helped to elaborate the research agenda, coordinate collaborative work and discuss results. Publication of the studies prepared in the framework of this projects started in September 2001.

The main ideas of the research project can be summarized as follows.

The accession of the Central and East European countries (CEECs) to the EU is likely to lead to conflicts between these countries and the incumbent members unless there is a rapid narrowing of the gap in per capita incomes between them. The CEECs are much poorer and have proportionately much larger agricultural sectors than the average EU country, and their combined populations make up between one-fourth and one-third of that of the current EU. Due to these characteristics there is concern in EU member states about a mass migration from the East following accession, about social and environmental “dumping” from CEECs, and about an increased demand by the CEECs on the EU’s Structural and Cohesion Funds, as well as on the funds provided under the Common Agricultural Policy.

These concerns, however, are counterbalanced to a large degree by a “catching up” predicted by both theory and experience: poorer countries, unless their development is impeded by institutional barriers, usually develop faster than richer ones, and there is a tendency toward convergence in levels of GDP per capita. In recent years, this catching up process seems to have started. In addition, trends in capital inflows and stock market developments suggest that the expected return on capital in the region is sufficiently high to support the buildup of stronger production capacities.

The research project on catching up studied the pattern according to which preparations for membership can trigger changes that will affect the growth process before and after membership. Special attention was paid to CEECs in different positions: those that started negotiations in 1998 and may reach membership first, and those that started negotiations in 2000. The effects on the sources of growth in both the pre-accession and post-accession periods were studied.

The following specific topics were investigated by the contributors of the project: the relevance of the export led East Asian development experience for CEECs; the forces of convergence and divergence that worked in the less developed EU member states (Spain, Portugal, Ireland and Greece) following their accession; the mixed experience of East Germany in catching up in a growth theoretic perspective; the role of domestic savings and savings behavior in the catch-up process; the likely pattern of the so-called Balassa-Samuelson process (real appreciation associated with the expected rapid productivity growth) in the course of the convergence; evaluation of the possible effects of EU structural aid on the candidate countries' development based on the experience of the cohesion countries of the EU; financial convergence of the candidate countries to the EU and the growth process; the role of institutions in the process of transition and catching up; and the relationship between the growth process and human development (health, education, standard of living, including inequality) in the context of EU accession.

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Evolving Institutions and Catching-up by the Candidate Countries of the EU

András Nagy

Introduction

The role of institutions and their evolution in the transition process of Central and Eastern Europe to a market economy has been a neglected subject, both in theoretical discussions and in the practice of economic policy. It was widely believed that adopting institutions similar to those found in developed market economies would be a relatively simple process and would solve the problems of technological backwardness and economic inefficiency in a short period of time. The past ten years have showed not only that these are by no means simple tasks, but also that the development and the significant structural changes in the transition countries have very divergent results. More attention seems to be focused recently on the role of institutions and their changes in explaining what really happened and why, and what should be done to accelerate the catching-up process and the European integration of the transition countries.

There is no break in history and especially not in economic development, and the transition from the communist one-party rule to a pluralistic democratic society, and from the non-competitive, planned economic system to a market economy did not start with a blank page. Past, present and future are linked by the evolution of institutions, by their creation and disappearance, by their changing motivations, by their conservative, adaptive or resilient features, which strongly influence the structural and productivity changes, the dynamics of economic and social development.

Most people understand institutions to be government agencies, private, or civil organizations, courts, etc. However, in fact, the scope of institutions is much larger¹. As North (1990, p. 3.) defined it: “Institutions are the rules of the game in a society, or more formally, are the humanly devised constraints that shape human interaction.” According to Schotter (1981, p. 11.) they include not only the legal and governmental structures and regulations, but the different interest organizations and the regularity in social behavior that specifies action in recurrent situations. Hare (2000, p. 5.) gave a definition of institutions by listing four characteristic features: “(a) they *regulate economic behavior* in ways which, in the short run, often conflict with individual preferences; (b) they are based on *shared expectations*, derived from custom, trust, legal provisions, etc.; (c) they make most sense if the economy is thought of as a “*repeated game*” in which most types of transaction occur many times; and (d) *anonymity*, in the sense that the functioning of a given institution should not be dependent upon the identity of the economic agents seeking to conduct the types of transaction to which this institution relates.”

¹ There are many definitions and interpretations of institutions and there is an ongoing debate about it. Without going into the details, I intend only to clarify briefly, in what sense this term will be used in this study.

Institutions can be formal or informal, as laws and regulations, or customs and conventions of behavior. They include both what citizens are prohibited from doing, as well as what they are permitted or compelled to undertake. These regulations strongly influence the performance of the economy, as they affect the costs of transaction and transformation. The state has an important and necessary role of creating institutions. If this is missing, or the institutions are weak to enforce regulations, private sector can intervene, but in such cases, they frequently serve special interests, like coercing debtors to pay or demanding “award for protection”.

While the existence of institutions (*versus* an anarchic situation) stabilizes human interaction both in economic, political and cultural sense, they are not constant: laws, regulations, contracts, codes of conduct, and the organizations, authorities they embody, are evolving, as they all are human creations. Institutional change has widely different forms: laws and regulations can suddenly be modified by judicial decisions, government departments can be invented or abolished, while customs and traditions change slowly in an incremental fashion. This characteristic is very important when the development of the transition countries is studied. As behavioral patterns are strongly and traditionally imbedded in the society, they change more incrementally than in a discontinuous way. This is true even in the case of sudden or radical change, such as revolutions or the collapse of political regimes. The continuity of informal constraints links the past to the future, and can explain many features of the development processes.

To catch-up the East Central European economies need well-functioning markets, but these are at least as much the outcome as the condition of economic development. As Lazonick (2001) pointed out, the society must first put in place the institutions that generate well functioning markets to reap the advantages of them. Then, additional institutions are needed to control the operation of markets to achieve stable and equitable economic growth.

1. Heritage of the past

It was a great surprise how fast and relatively peacefully the communist one-party rule and the non-competitive, planned economic system in Central and Eastern Europe collapsed. At the beginning, this created a widespread feeling of liberation and euphoria linked to great expectations of political democracy, pluralism and the introduction of an efficient market economy. Equally unexpectedly, the mood of the population significantly worsened in a short period, as general disillusionment resulted from unrealized expectations. Resistance to change became much stronger, as economic conditions deteriorated considerably. It is highly probable that the unforeseen character of the developments in these cases was closely related to the lack of understanding of the nature, interests and resilience of institutions.

It was generally recognized that a widespread and deep economic and social crisis preceded the sudden collapse of the Soviet-type system. The symptoms of this crisis were well known and discussed in literature: low efficiency, declining rates of productivity improvement, slow technical progress and adaptability, slowing growth or stagnation, deterioration of living conditions (especially of the environment), shortages of all kinds simultaneously with wastefulness and squandering, a strong decline in work morale, etc. However, the deeper causes, the more fundamental layer of reasons for the

conspicuous failure of the former system were not recognized, and the reasons why the reform efforts were unsuccessful were not well understood.

There was a long period of preparation for the collapse of the regimes in East Central Europe, during which nearly all the experts of socialist societies made a great error of judgment: confusing immobility, resistance to change with stability. The stubborn resistance to reforms, the conspicuous immobility of these regimes, was viewed as stability, while it created a self-destructive instability. The stronger the resistance to change became, the more stability declined. Institutions changed considerably over the decades, but even if the reforms introduced in certain countries brought improvements in many fields, much of this change, against the expectations of the party leaderships, went in the wrong direction: instead of curing the imperfections of the system, the reforms aggravated them².

Very unexpectedly, the Soviet-type systems collapsed relatively peacefully, in most cases without the bloodshed, civil wars, or violent revolutions associated with comparable radical changes in the past³. The political, economic, military and cultural elite of the old regime not only abstained in most cases from open and violent resistance, but a significant part of the "nomenklatura" actively co-operated in the demolition of the old system. This shows the importance of institutional and mentality changes within the communist leaderships. There were obviously many factors causing the fall of the East Central European regimes under Soviet domination. It can be rightly assumed, however, that transformation of the institutional structure, the system of incentives, interests and values of the dominating political and managerial elite played an important role in the collapse of the system⁴. Without understanding the process of this change, one can not explain the slowness and difficulties of the transition itself, much less the likely direction of it.

It seems evident that the communist organizations and their leaderships, which at the end of the 1980s helplessly and sometimes even willingly surrendered their power to the democratic opposition, bore little resemblance to those communists who had violently seized power forty years before. The communist elite evolved from the period of armed resistance against Nazism and occupation during World War II, through the short-lived democratic period when they monopolized power and overturned the legal parliamentary systems, to the period of Stalinist dictatorship and terrorist oppression of the population. During this time, they remained nevertheless, permeated by a revolutionary ideology, with hatred against all values and attitudes seen as "bourgeois".

² For the evaluation of the reforms see Chavance (1994), Kornai (1986), Nagy (1989, 1991).

³ There are a lot of different explanations of the collapse, a good review of them can be found in Lavigne (1995).

⁴ According to Csanádi (1997 p. 306.) "common features and their behavioral consequences in the functioning of party-state systems, while providing the structure's self-supporting mechanism, also simultaneously form the traps which eventually lead to their disintegration and collapse." According to Solnick (1998) institutional collapse was a consequence of the erosion of supervision within and above the organizations to such an extent that the individual decision-makers were not prevented in pursuing a behavior that internally undermined the credibility and functioning the institutions themselves.

Rise of interest organizations

In the late 1940s when the communists seized total control in Eastern Europe, their economic policy was very flexible. Central management quickly adapted to the new conditions of sudden, extreme expropriation and nationalization of private property, rapid industrialization and forcible modernization, the confiscation of recently distributed land from peasant farmers and its collectivization etc. Later, however, rigidity, conservatism, and resistance to change and adaptation gradually became prevalent. A significant part of this development can be explained by Olson's theory of interest groups⁵. In the first period after the war, with the destruction of the political structure of the pro-Nazi regimes, most former special-interest organizations and distributional coalitions were eliminated. Consequently, the new organizations had a strongly encompassing nature, representing a relatively large segment of the society. The weak or non-existent interest organizations could not resist the introduction of radical structural changes in the society and economy. Subsequently, however, a gradual change could be observed: economic and political organizations, state and local bureaucracies as well as political organizations, including the communist party itself, evolved more and more into special-interest organizations and collusions, losing their encompassing character. By eliminating competition monopolies were created to an unprecedented extent in industry and services, as it was the adequate organizational structure of central planning and management. Agricultural co-operatives lost their collective and democratic characteristics and merged in large land estates. A strongly protectionist, autarkic trade policy effectively subsidized both import substitution and certain exports. To get rid of the threat of competition was of course consistent with the interests of the remaining industrial, agricultural and service enterprises, as evidenced by the almost complete absence of resistance to these measures. The "smooth" transition to the Soviet-type system was of course the consequence of brutal intimidation and terror, but one should not underestimate the microeconomic interests linked to monopolization and protectionism.

As the distributional struggle for resources increased, these special-interest organizations became powerful lobbies, and more attention was paid to grabbing a larger slice of the pie than to enlarging the pie. By fighting for funds for unprofitable investments, by lobbying for subsidies, favorable prices, high wages, large bonuses for managers and big Soviet contracts for outdated, low-quality products, they could obtain a larger slice but at the cost of reducing the size of the pie (i.e. the GDP).

As the original hierarchical structure of the socialist economies evolved into a network of interest groups, a distributional struggle developed, showing the relative power of these groups. The strongest, the military lobby usually received first priority over resources, mining and heavy industry came second, followed by the other sectors of the economy — while education, health-care and environmental concerns were in most cases in a much weaker position⁶.

⁵ See Olson (1965), (1982), and (1991).

⁶ In Soviet-type societies the indicators of education and health-care were relatively high (compared to their economic development) for ideological and political reasons. However, the endowment and quality of these services was low because of the weaknesses of the institutions representing them.

The extremely rigid terrorist period of Stalin's rule ended in the middle of the 1950s, when a widespread discontent was expressed by uprisings and revolutions in East Central Europe as a reaction to foreign oppression and to the institutional structure forced upon them. This created a turning point in the evolution of these societies. In different degrees and forms, the extreme political rigidity was eased. To avoid popular uprisings a compromise was sought, both with the population and with the major western powers. The search for a compromise became manifest in the mid-sixties in the interaction of the changing institutional structure and the mentalities of the top administrators and managers. The excessive centralization and monopolization soon created its antidote: the necessity of decentralization. Both "rationality" and the convenience of planning has required the elimination of parallelisms and competition. However, these huge centralized institutions soon started to live according to their own rules and interests; they realized their strength and indispensability and became reluctant to accept the orders "from above". With the gradual strengthening of these monopolies, central planning and management evolved more into a bargaining process, aimed at compromise between the central authorities, the monopolies and other (cultural, military, health, regional etc.) institutions.

Institutional changes strongly affected the attitude of those representing them: the managers of big state-owned firms, for example, stopped regarding themselves as obedient executors of central orders, and started to present and defend the interest of their enterprises, both against the central authorities and against each other. Top managers started to grab more and more rights, including certain features of property rights⁷. The changes in mentality and growing consciousness influenced and strengthened the institutional changes, which in turn had repercussions in the attitude of the representatives of the institutions. This interaction between mentality changes and institutional changes was self-reinforcing. The changing attitudes of managerial circles later, after transition started played a very important role to support the managers shaping the privatization process, economic policies and the regulatory and legal environment for their own advantage.

These gradual transformations during the communist era were closely related to the successes and failures of the economic and institutional reforms. Looking back at what have been, and what have not been implemented among the reform proposals, it seems that it was not rational considerations, but rather the interests and influence of top managers that prevailed. Beside the resistance of the political establishment, the willingness of top managers to change certain aspects of centralized planning and management, and resist to others, can explain the destiny of partial reforms and the final failure of "market socialism". The managers favored the reduction of central interventions and detailed mandatory planning, and the extension of enterprises' autonomy, without losing their protection both from domestic and foreign competition. They knew well the weak competitiveness of their firms and products and resisted to be forced to increase productivity, improve the quality of their products or to better satisfy their customers.

⁷ The right to use property by the managers gradually was extended to get certain benefits from the assets and the right to transform them. However, to sell or to buy assets was not granted to them before the transition started. See Pejovich (1990) and Major (1993).

Privileges and changing mentalities

In the process of decentralization and monopolization of the Central Eastern European economies, one could observe the first signs of significant mentality changes: a wider acceptance of so-called middle-class values was gradually taking place. The demands to replace dictatorial rule, the hierarchical dependence on the powers „above” with more independence for the firms and with their mutual interdependence were signs of these. These were linked to the demand to replace the centrally regulated egalitarian income policy with salaries and bonuses based on economic performance, both for the managers and for the employees. Influential groups of economic managers used their increased autonomy to extend their power and wealth. Their values and attitudes differed more and more from the revolutionaries fighting for communist ideas; the managers paid lip-service to Marxism-Leninism, and showed loyalty to the communist party, but in fact their motivations were very different. Income differences between the managers and top bureaucrats on the one hand, and other employees, on the other, were growing fast, and fringe benefits were increasing even faster⁸. The privileges of the nomenklatura were extended to special import licenses, foreign travels, scholarships and work permits in western countries, etc.

The top leaders of the communist regimes always enjoyed extreme privileges, but at the beginning, only a relatively small circle was lavishly favored. With the institutional changes mentioned above, the privileged nomenklatura was significantly extended and the income differences considerably increased. As ideological conviction and commitment diminished, communist party leaders realized that loyalty could be bought for money and power. This led to the development of clientelistic networks linking managers of large enterprises and collective farms, as well as officials of regional authorities supporting each-other in power and career building.

In the last two decades of communist rule, in several of these countries, significant personal wealth could be legally accumulated. In addition to the fast growing salaries and fringe benefits of the nomenklatura, the opportunities for enrichment by corruption, speculation, and stealing became widespread. Legal persecution of these crimes diminished and mutual indulgence increased among members of the higher echelon of the nomenklatura.

Private rent seeking was one of the main sources of accumulation of personal wealth under communism. As Dobrinsky (2001) pointed out: “since all productive assets were nominally owned by the anonymous state while control was always specific and individualized, there was ample room for extraction of private rents in the state-owned enterprise sector”. Rent seeking was widespread in the allocation of benefits or in access to goods and services in short supply.

Legally, and illegally accumulated wealth could be multiplied when and where certain private economic activities were authorized. Licenses for private shops, restaurants and other profitable small businesses were obtainable through "good connections", which meant more or less open corruption on the one hand, and profitable investment possibilities on the other. As these private businesses needed capital, and could not obtain it on the non-existent financial market, the savings of the nomenklatura could be profitably laundered in the more or less legal businesses.

⁸ See Kertesi and Galasi (1987).

Another important aspect of the privileges the communist rulers and party members enjoyed was that they were in many cases beyond the rule of the law. While there were extremely severe punishments for ordinary citizens for minor thefts of “state property”, party members, and especially higher-ranking officials were not, or very rarely condemned for corruption or fraud. Even criminal cases, such as killing a pedestrian in a car accident, were covered up and the offender was not brought to trial if he/she happened to be a minister or politburo member or a relative of these. Police officers, attorneys, and judges learned that they had to make a distinction according to party membership, or the rank of officials, both in the process of investigation and judgment. The fact that even after transition, politicians and higher-ranking civil servants are treated differently by the police and the courts is an unfortunate heritage of the past. Equality of rights and the indisputable rule of the law are not evident in the East Central European countries; it has to be learned and enforced.

One should not forget that in most of these countries, pluralistic democratic traditions could never develop, and there was no tradition of equal rights. On the contrary, respect and even submission to authority, servility was widespread, a traditional and rational choice for a large part of the population. While it was expected that citizens respect the law, the wealthy, the powerful and the state could violate it without consequence long before the communist regimes. It is no surprise that following the collapse of such unequal and hierarchical systems, unlawful, Mafia-type organizations developed much more easily than democratic organizations and behavior based on the respect of law.

Corruption and enrichment of a significant part of the nomenklatura can be morally condemned, and could have been legally prosecuted, but it did have a positive side that made the system more supportable. The dictatorial rule of fanatic communists was far crueler for the population than the more liberal rule of those who cared for their own comfort and wealth, or who were corrupt. Changes in mentality and in behavior were closely related to a generation change within the nomenklatura as the "old guard" communists gradually retired and a new generation with a craving for power replaced them. They were pragmatic, regarded themselves as technocrats and reformists, and started to question fundamental dogmas of the socialist system, including those regarding property rights⁹.

If middle-class values impregnated the communist leaders, it was even more prevalent in the society at large. The prescribed model of restraint from private consumption and wealth holding went against the very nature of human behavior. Hence it could be noted that in the final days of communism, “bourgeois” behavior prevailed in a great part of the society, especially among the growing quasi-middle class.

The fact that the collapse of the communist regimes happened relatively peacefully was strongly related to the changes in mentality and attitude mentioned. The need for a capitalist transformation emerged within the socialist system, and not only in the private sector or on the lower levels of the society, but at the ruling levels too. Managers of state-owned firms and other members of the nomenklatura with entrepreneurial spirit realized that their status, position, knowledge, and network enable

⁹ See Olson (1992).

them to keep or extend their leading role in business and politics, and to increase their wealth.

Alienation from the state

A paradoxical phenomenon could be observed in the first half of the twentieth century: while the role and spending of the state had increased very significantly and the authorities with their regulations pried more and more into the lives of the citizens, the state became more alienated from the citizens. This was a general tendency in Europe, but it was much more the case in the East Central European countries, where state ownership and control extended not only to the units of production and services, but also to every other field of life: education, health care, pensions, culture, trade unions, professional, social and even religious activity. It may seem rather peculiar: the more a state spreads its power and controlling activity, the more alien and remote it becomes for its own citizens and taxpayers.

The "paternalistic" socialist states of East Central Europe of the 1970s and 1980s developed from Stalin's totalitarian party-state of the pre-war period. Its peculiarity is that nothing can restrain or control its power. The totalitarian party state can confiscate or nationalize any assets, arrest or execute anyone without explanation, collect as much tax as it wants, enact laws and violate them without consequence, regroup investments, control all information, support or ban different scientific or artistic endeavors, etc. As most of the East Central European countries were militarily occupied by the Soviet Army, the state authorities were regarded by a great part of the population as the agents of a foreign oppressive power. It was well known that these despotic regimes could control and dictate all aspects of life. All but one: it could not deprive humans of their inner freedom; there was no way to force love and devotion toward the totalitarian party-state.

In the last three decades, the development of the East Central European countries can be described as their gradual relinquishing of several characteristics of the totalitarian state. Decentralization of power, rise and strengthening of special interest groups, increasing role of the market, granting of some human rights and legal security, acknowledgement of a limited autonomy of consumers, and more liberal cultural politics, all meant the gradual relinquishing of the totalitarian state. In this sense, state authorities became more tolerable for the citizens. Nevertheless, the alienation remained; the majority of the population still did not regard the state as their own. The citizens rejoiced in every little easing of the dictatorial hold, every step that reduced their defenselessness, increased legal security, human rights, and the autonomy of consumers. However, even if the state became somewhat less hostile and oppressive, it was well known that in the communist one-party regime no liberalization, decentralization or law extension was irreversible; the system could easily become unmerciful again, as it did several times.

With free parliamentary elections and the establishment of democratic political institutions, the disposition toward the state changed significantly; at least for a while. With liberation from the Soviet rule, regaining independence and self-government, the support of institutional change prevailed. However, as the consolidation of the new regimes did not meet the expectations of the citizens, for it brought previously unknown large unemployment and real-wage decline, the alienation toward the state returned.

Another important factor contributed to this development, something usually called “state desertion”. Partly due to a naïve belief in market automatism (strengthened by Western mainstream policy advisers), the inevitable reduction of the role of state was realized as an abrupt and drastic withdrawal of the state from the protection and support of a large segment of the society. State institutions are still regarded as external or superior authorities, and it is generally not expected that they serve the common interest or the well being of the population. The citizens slowly learn that they have rights, and how to use them, but trust towards the state has not really developed.

The ingredients of this process were not only the experiences of the past, the slowness of changes in mentalities, and the self-defense of the overgrown authorities, but presumably also the intentions of the political leaders. They do not encourage voters, taxpayers and consumers, the civil society, to take part in decision making. It is a particular feature of the dictatorial systems that, not only in the ruling circle, but also in the elite of the opposition, an “enlightened” view emerges. According to this, the elite knows better what is best for the “masses”, than the citizens do themselves, because the “consciousness of the masses is underdeveloped”, or the population has previously been “manipulated” by the dictatorial rule. This world-redeeming view of the “enlightened” politicians did not deter them from thinking of themselves as great democrats, but did hold them back from truly striving to get to know and consider the desires and will of the citizens.

The long run increase of the share of state budget in the GDP is a world-wide phenomenon. It increased on average from 8 per cent to 20 per cent between 1870 and 1960 - mainly in association with the two World Wars¹⁰. In the following 34 years, it grew to 40%. In the ex-communist countries, the proportion of state redistribution was comparable only to that of the Scandinavian countries, which have the highest welfare expenditure. A great difference between the two groups of countries was that the level of GDP per capita in the communist world was only a small fraction of the level in the Scandinavian countries¹¹. This redistribution reached an impassable level, the tax level could not be increased, and the budget deficit became large and enduring.

As was mentioned above, the strongly centralized hierarchical system slowly changed into a complex combination of monopolized special interest groups, but this process did not ease the alienation of the state. However, the only shield the citizens or consumers could count on against the ruthless behavior of the monopolies were the central authorities. No interest group represented their rights, only the central authorities raised barriers eventually to price increases, deterioration in quality, and pollution. The growing power of state monopolies significantly reduced the efficiency of the economy. When neither the central authorities nor the market has a strong influence on the management, it is the best solution for the enterprises, and the worst for the consumers. As the state was the proprietor of all assets, it was reluctant to be “harsh” with “its” enterprises; it was difficult to harden their budget constraints, or decrease the subsidies to them. However, if the state were “soft” with its enterprises, it inevitably needed to be

¹⁰ See Tanzi, V. and Schuknecht, L. (1995).

¹¹ The share of state redistribution is, in fact, not directly comparable due to differences in the statistical systems, and because of various kinds of subsidies (price subsidies, support to loss-making enterprises) in the socialist system.

“harsh” with the consumers, who suffered from shortage, poor quality, and inferior services.

The majority of the population, probably in part unconsciously, understood this problem. This may be the reason why, following the start of the transition process, the population, without fully knowing the consequences, accepted the idea of privatization, or at least did not resist it. If they had regarded the state’s property to be their own, or the community’s, they would have surely protested against the dispossession of “their” assets. They realized that they had no right to the state’s property, and saw how inefficiently and wastefully the state dealt with it. The will to be freed from the rule and political power of the communist party therefore became intertwined with the will to be freed from the alienated totalitarian state and its property.

It was a very important, but little analyzed feature of the Soviet-type systems that the extremely large-scale taxation seemingly didn’t exist, or at least stayed invisible to the population. There was no, or very little, personal income tax. Invoices did not show the size of sales tax, contributions to the pension and health care systems were paid by the employers, and their size was unknown to the beneficiaries. This was a perfectly adequate system for a dictatorship: the state could tax as much as it wanted, while the taxes remained “invisible”. Thus tax payments were not linked to state expenditures and social insurance benefits. This produced the impression that the employees do not give anything, while they, and their family members, received a lot: education, housing, police protection, health care, courts, hospitals, pensions, holiday resorts, subsidized consumer goods, etc. Where the state got the money from to cover all these expenses remained obscure. This seemed to be a real “provident state”, which generously offered many things, and asked little or no payment in return.

If the citizens do not pay taxes, it is obvious that they have no right to intervene in how the state spends “its” money. They should only praise, and not criticize the state and its leaders. The seemingly invisible tax system had – over a long period – created a mentality which is very different from democratic societies where the citizens may know how much tax and social insurance contributions they have to pay, and consequently have a high stake in how it is spent. One should add that even after the transition, many politicians and civil servants prefer a system where neither the citizens nor their different interest groups influence or decide the level of taxation or the state budget. This is partly because they think they know better how money should be spent, and partly since this would reduce their power.

After reviewing the heritage of several aspects of the dictatorial one-party systems and centralized planned economies, let us see now how the inherited and newly created institutions influence the catching-up process of the transition countries.

2. Institutions and catching-up

There is a large and fast expanding literature on how institutions help or hinder growth in general, and the catching-up process in particular. In this section we intend to review what can be learnt from previous investigations from the point of view of the East Central European countries’ EU accession. First, we discuss some aspects of the historical precedents and then the findings of empirical investigations of the effect of institutions and governance on economic integration and growth.

The post war growth miracle

The catch-up problem of the East Central European economies shows certain similarities to the post World War II situation of the West-European countries, when a wide gap had opened, in comparison both with the US and with Europe's pre-war development patterns. After the nearly two decades of depression and war efforts, between the two World Wars, starting with 1950 a quarter century of Golden Age appeared in Western Europe, when economic growth was nearly twice as rapid as over any comparable period before or since¹². There are of course a number of explanations for this spectacular catch-up experience and it is intriguing to find out what their implications are for the transition economies.

One of the first theoretical explanations of the fast growth rate of the post war period was offered by Jánosy (1966), who stressed that rapid economic development is not finished with reconstruction, when the pre-war level is reached. It continues until the long-term trend is attained, corresponding to the level of development which could have been achieved without the intervention of the war. He assumed a significant stability and smoothness of the growth process, linked to the expanding knowledge and adaptability of the work force.

According to Eichengreen (1996), one of the main causes of Europe's post-war growth miracle was the exceptionally high rate of investment, which was nearly twice as big in the fifties and sixties as before the war¹³. According to the author, the conditions for this was provided by wage moderation and fast export growth. Wage moderation stimulated both the demand for and the supply of investment: demand - by making investments profitable, supply - by making profits available to finance those investments. The fast developing openness of European economies increased the growth of trade, which was more than eight per cent a year in the 1950s and 1960s. Rapidly growing investment and trade allowed capital to be allocated to the sectors where its contribution to productivity was the greatest.

Both of these characteristics were in direct opposition to the experiences of the inter-war period, when exports stagnated and wage pressure was intense. The question is: what kind of institutional structure developed and made it possible that wage moderation and the expansion of international trade could take place?

In Eichengreen's opinion, what happened in Western Europe was similar to the dynamic game model of Lancaster (1973) and van der Ploeg (1987), where welfare is maximized when capital and labor agree to defer current compensation in return for future gains. Workers moderate their wage claims in order to let enterprises make profits and invest in capacity modernization and expansion with a view of future profitability. Capitalists restrain dividend payout in order to increase investments, which stimulates growth, raising future incomes.

¹² According to Eichengreen's (1966) calculations [based on Crafts (1992) and Boltho (1982)] the unweighted average growth rate for eight European countries was 4.4 per cent in 1950-73, but only 2.4 per cent in 1922-37 and 2.3 per cent in 1979-88.

¹³ Maddison (1976) estimated the rate of investment in Western Europe rising from 9.6 per cent of GDP in 1920-38 to 16.8 per cent in 1950-70.

The cooperative equilibrium can be maintained, however, only if there are credible institutional arrangements which bind capitalists to invest and workers to exercise wage restraint. The social and economic institutions developed in Western Europe after World War II, the welfare state, can be regarded as a mechanism to enforce such an agreement¹⁴. Institutions were developed to monitor the compliance of capitalists and to disseminate evidence of non-cooperation. Social contracts between labor, management, and government — including wage and price controls, unemployment, health-care, and retirement programmes — were used to pre-commit unions to wage moderation.

The expansion of trade required new international institutions to further coordination and commitment. It was essential for the European governments in the post-war catch-up process to be convinced that their partners' commitment of gradual trade liberalization was permanent¹⁵. An important factor of export oriented development was that both governments and business executives had to be convinced that import tariffs would be gradually lowered, and no return to protectionism would take place.

There were great differences between countries in how similar “social partnership” agreements were attained in the fifties. The North-European countries — including Germany and Austria — were more successful in establishing such cooperative arrangements, which included linking wage demands to productivity increases in return for a management pledge to stimulate the latter. In several countries, profit taxation encouraged investments, and in return for wage restraint, full employment and higher future incomes were offered. In France, the UK and Italy, labor militancy and wage pressure remained strong in the fifties, and therefore efforts to cut similar bargains succeeded only in the subsequent decade. Consequently, higher investment and growth rates could be observed with a delay.

What was new in these cooperative institutional arrangements was that unions and employers' associations exchanged information on wage and investment decisions to monitor and disseminate evidence of compliance or non-compliance with the terms of the agreement. In certain countries, they included the compulsory representation of labor unions on advisory and administrative committees of industry and government.

Destruction of special interest organizations

Another theory offering an explanation of the great differences in economic performance in different countries and historical periods is Olson's model of collective choice already outlined in section 1. According to this theory, organizations for collective action with narrow constituencies have uniquely perverse incentives, and in stable societies, many such organizations accumulate, over time, decreasing economic

¹⁴ Such an arrangement is called “class compromise” by Przeworski and Wallerstein (1982), where some institutions make it reasonably certain that wages increase as a function of profits. In Boyer's (1988) definition, this is “Fordism”, a cooperative structure of industrial relations, in which an equitable division of productivity gains is reached with a prominent role of government intervention.

¹⁵ The European Coal and Steel Community and the European Payments Union, by creating an efficient monitoring system, contributed significantly to a credible commitment mechanism.

efficiency and dynamism. Revolutionary upheavals, totalitarian repression, and foreign occupation destroy organizations for collective action. If such a catastrophe has destroyed many of the special interest organizations, economic growth will be, for a time, extraordinarily rapid.

The most remarkable examples of economic growth in previous centuries justify in certain respects this theory. The growth of Germany in the period of the Zollverein and the unification of the country was extremely fast. The same thing can be said of Japan after the Meiji Restoration, the growth of the United States in the nineteenth century, of Holland during its Golden Age in the seventeenth century, and of Britain during the Industrial Revolution between 1760 and 1840. In all these cases, a jurisdictional integration took place, with a wider market, within which internal free trade developed, and very rapid economic growth could be observed. The establishment of new jurisdictions or governments undercut the guilds and other parochial lobbies, and it took a long time until larger scale interest organization influencing legislation could develop.

The contrast between the economic development of Great Britain, Germany and Japan in the post World War II period underlines the validity of Olson's theory¹⁶. While Great Britain produced the poorest economic performance of the major developed countries, Germany and Japan showed spectacular economic miracles. According to Olson, this was in great part due to the fact that Britain had the longest period of stability and immunity from invasion and institutional destruction, while the old organizational structures in the two defeated countries were almost totally eliminated. In the 1950s and 1960s, real per-capita income in Germany and Japan grew more than three times as fast as in the UK and USA.

The creation of the European Common Market by the original six countries destroyed much of the distributional coalitions of the previously protectionist economies, providing a growth advantage as a consequence of integration. Per-capita income in France, Italy, and the Benelux countries grew at more than 4 per cent a year in the sixties, much faster than in the other OECD countries.

An important message of Olson's theory is that societies are not defenseless against the gradual development of the growing influence and power of lobbies and monopolies in stable conditions. Not only wars, foreign occupations, or revolutions can eliminate them. Since narrow special-interest organizations represent only a tiny minority of the population, in democratic societies, in principle, they can be outvoted. They can achieve their aims only because the majority does not notice or understand the harm they are causing to them. The last few decades in several countries have shown that market-opening and deregulatory reforms can greatly weaken the influence of cartels from both the business and the labor side. Deregulation of lobby-intensive industries such as airlines, telephone, trucking, railroads, and communications could remove much of the economic irrationalities of these industries, which damaged the interests of the consumers. The harmful influence and power of tiny minorities can be defeated if the public wises up. Or as Olson has said: "No historical process that is understood, is inevitable"¹⁷.

¹⁶ See Olson (1996).

¹⁷ Ibid p. 92.

Quality of governance and catching up

One of the most striking characteristics of economic development in the last decades was that while the underdeveloped countries as a whole have been falling further behind, a few of them have grown much faster than the developed countries. The three fastest growing countries between 1985 and 1995 were all developing countries (China, Korea, and Thailand) and they grew on average more than twelve times as fast as the three countries with the highest per capita income (Canada, Switzerland, and the US)¹⁸.

Factual world development thus contradicted the expectations of both neoclassical and endogenous growth theories. The neoclassical model assumes that there are diminishing returns to investment in physical and human capital, and predicts a general convergence of incomes and growth rates. The characteristic of endogenous growth models is, by contrast, constant or increasing returns to capital, and therefore the prediction of these models is consistent with underdeveloped economies remaining poor and with the observed divergence in per capita incomes. One explanation of why both the neoclassical and the endogenous growth theories are unable to account for the fact that the fastest growing countries are developing countries, and at the same time there is no tendency for general convergence, is that the quality of governance has been left out of both of them. This becomes particularly important in a more and more globalized economy, where capital flows and particularly FDI are favoring economies with competent governance.

If economic performance depends strongly on differences in governance, then the utilization of opportunities will vary forcefully in different countries and in different periods. It can be assumed that poor countries achieve only a small fraction of their economic potential and they do not converge because of deficiencies in their governance. Institutions and policies usually change slowly, but they differ significantly between countries. Some of them, however, by radically reforming their institutional system and their economic policy regimes, i.e. with better governance, can exploit their exceptional growth opportunities for catching-up and grow much more rapidly than rich countries can.

The results of both Keefer and Knack (1993, 1995) and Olson, Sarna and Swamy (1998) showed that better governance leads to higher rates of investment and is closely related to productivity growth¹⁹. They found that secure property rights not only encourage investments, but also the efficient allocation of factors of inputs. In response to threats of expropriation or repudiation of government contracts, entrepreneurs reduce investments, or invest in less specialized capital. Beyond the unfavorable static effects, this discourages dynamic gains from innovation, because innovations are most likely to thrive when specialization is encouraged.

In the studies mentioned above the measures of governance quality were taken from ICRG (1982), and in the case of Keefer and Knack also from BERI (1972), prepared by private firms to advise enterprises in foreign investment. They include the

¹⁸ Source of data: WDR (1997).

¹⁹ See also: Knack (1996), Olson (1993), and Barro (1997).

risks of confiscation or forced nationalization; unilateral repudiation or change of the terms of contracts by governments; contract enforceability; the expertise of government administrations and their insulation from political pressures; the level of corruption; the authority of courts in implementing laws and adjudicating disputes; and the quality of infrastructure. The results of the regression analyses supported the hypothesis that the structure of incentives reflecting the institutions and economic policy regimes of a given country is a major determinant of the rate of growth in productivity and economic performance in general in the country. The studies concluded that political and civil liberties are insufficient proxies for the quality of the institutions that protect property rights. More direct indicators, however, proved to be crucial in explaining economic growth, the magnitude of investments, and the efficiency with which inputs are allocated and used.

It can be concluded that low-income countries can catch up only if they have a sufficiently efficient institutional system and sound economic policy. The studies mentioned all inferred that convergence, or the lack thereof, could not be explained without considering the quality of institutions. There seems to be a general agreement that poor countries have a significant growth potential unused, but the tendency for them to grow faster holds only under certain conditions, depending especially on the level of governance.

Theoretically it is possible to argue — along the line of the simultaneity bias of regression analysis — that the quality of governance is the result, rather than the cause, of productivity growth. However, the direction of causation is evident if we look into some of the major changes, or differences in economic growth. Comparing the performance of East and West Germany, North and South Korea, Mainland China and Hong Kong can not be attributed to preceding differences in income. Similarly, it was not prior growth of productivity, which led to the institutional and policy changes occurring in China with the leadership of Deng Xiaoping, or when president Park Chung Hee replaced president Rhee Syngman in South Korea, or the changes of Kuomintang's economic policy in Taiwan.

Considerations of institutional development in East Central Europe

Let us see now what conclusions can we draw from the theories and investigations mentioned above on the relations of institutions and the catching-up process for the East Central European countries preparing for their accession to the EU.

Even if theoretically it would be possible, it seems to be far-fetched — following Jánosy's arguments — to interpret the catching-up process of the transition economies as a “reconstruction” period until the level of development is attained which would have been achieved without the detour of the planned economy era.

The conditions for a cooperative equilibrium between wage moderation by labor and commitment to invest their profits by capitalists are not existing in the East Central Europe countries, even if the concept of “social market economy” and “social partnership” got much publicity in political programs and debates. On the one hand, traditional trade unions lost much of their credibility as they served obediently the communist regimes, and have not found their new roles in the changing circumstances. The newly created democratic unions were in most cases (with the exception of Polish

Solidarity) too weak to make credible commitments. On the other hand, in the process of privatization, neither the employers' associations nor the state were willing to reach, and even less to enforce, such an agreement.

However, economic conditions in the transition countries in the early 1990s were not totally dissimilar from the post-war situation of Western Europe, and not only due to the relatively weak economic performance in both regions in the respective periods. In the transition countries, the level of wages (measured in US dollar or DEM) remained low, not because of labor restraining their claims, but mainly because of recession and widespread unemployment, and because of the devaluation of domestic currencies. Low wages contributed significantly to the attraction of foreign investments²⁰ and to the successes of export growth, the two most important factors promoting the recovery of transition economies. Institutional changes such as privatization, and the liberalization of trade and capital flows were important factors of structural change (involving temporary unemployment), a necessary condition of economic growth. There is a lot to learn from the social compromise of the West European countries and of the role of the governments in reaching and keeping the agreements of the social partners. This is particularly important because the hardships of structural change, foreign competition, and gradual integration into the European markets may strengthen populist and protectionist tendencies and wage pressures, which can become serious obstacles to faster growth and catching-up.

Due to the “velvet” character of East European transition many of the interest organizations that usually create obstacles to faster growth and structural change were not destroyed²¹. With the inflow of foreign capital and the growing role of multinational firms in East Central European economies, powerful new lobbies and pressure groups appeared and started to influence legislation and economic policies. Several of the multinational companies came to the East European markets and took part in the privatization process, not to compete with local or foreign firms, but to occupy and monopolies the local markets, resisting the development of competition. Governments were neither prepared to resist such monopolistic tendencies or to split the previous state-owned monopolies. In many cases, the buyers preferred to acquire local monopolies, moreover splitting, and selling these monopolies in pieces would have meant a surplus activity for the privatization agencies. Antitrust legislation was lacking, and it took time to develop institutions defending consumers' interests.

In contrast to the post second world war period, with the destruction and transformation of the communist political structure, many of the special interest organizations were not destroyed. In certain cases — most conspicuously in Russia — some of the monopolies actually became stronger and less restrained, as the state authorities were destroyed, and a power vacuum arose.

The idea that monopolies are in most cases harmful, and competition is advantageous for the consumers, is in many respects new in Eastern Europe, which

²⁰ Relatively low wages are a necessary but not sufficient condition of FDI inflow. The ability to accommodate foreign capital is also a decisive factor, according to Hamar (2001).

²¹ As we will show below, a notable exception here were organizations that could have hindered the liberalization of trade: at the beginning of transition they were not existing or powerless, that is why trade liberalization in most countries could be accomplished relatively fast.

experienced a long period of excessive monopolization. A lot of effort is needed to understand that low productivity, misallocation, and misuse of resources is linked to monopolization of the markets. The defense of the interests of consumers, or the majority, needs not only the transformation of the role of government, but the development of civic organizations, the involvement of the media, as in many cases the consumers can not count on the support of the political parties. As we shall discuss later, widespread corruption both in legislation and in administration enables lobbies to resist the implementation of antitrust laws, or even to make loopholes in the laws themselves.

The most important lesson, however, can be derived from the close relationship of the quality of governance and economic growth. The rule of law in general, and property rights, in particular, seem to be the cornerstone of the catching-up process and the integration of the East Central European countries. The implementation of the institutional changes needed in this respect is more difficult and time consuming than the necessary macroeconomic changes, like stabilization, liberalization, or the reduction of inflation²².

Initial conditions

Several research projects have found that the great variety of the results of the transition process from a planned to a market economy is closely related to their inherited and initial conditions from which they started. The path they follow depends strongly on the policies they choose, but this choice is also forcefully influenced by the past. There can be little doubt that the future of catching-up will be affected both by the initial conditions of institutions and the policies of institution creation and institutional change pursued in the last ten years.

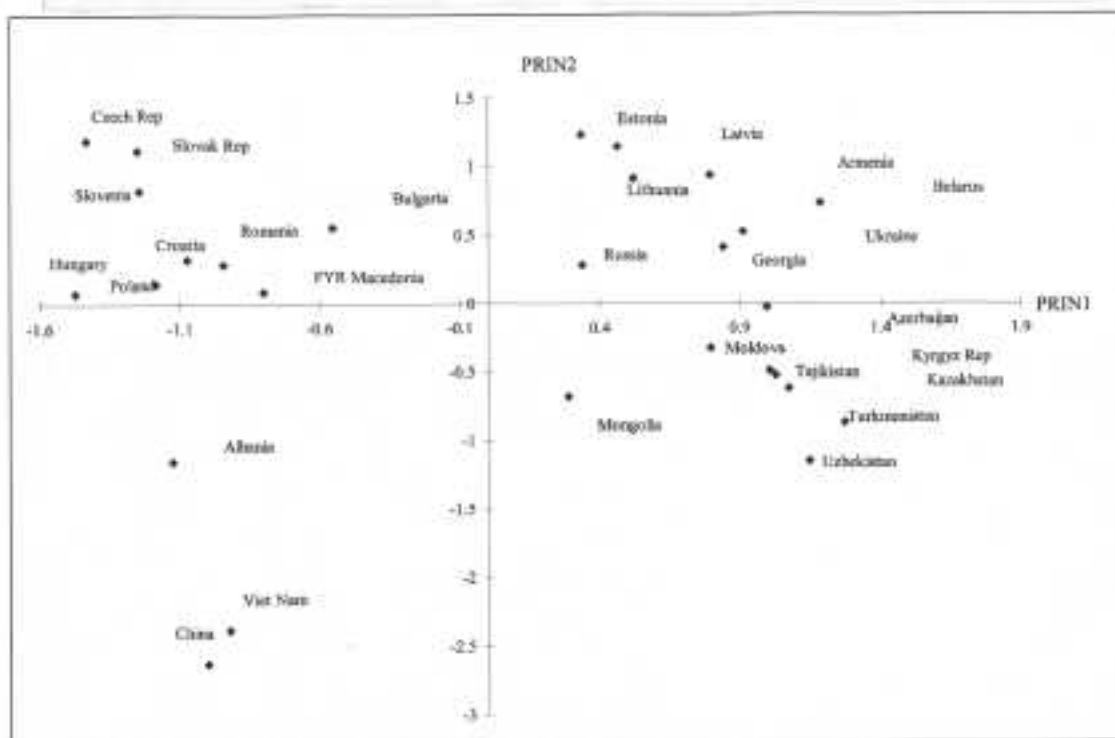
de Melo et al. (1997) studied in detail the role of initial conditions in the transition economies. They followed several previous studies focusing on the effects of policies, comparing the results of “big-bang” versus gradualism, and finding that the outcome is largely dependent on how macroeconomic stability was attained, and how fast the factors of production were transferred to efficient use. The unique feature of this research project was, however, a systematic attempt to analyze the interaction of factors, like initial conditions, political change and reforms in a unified framework comprising East Central Europe, the CIS countries, China and Vietnam. One group of indicators for initial conditions captured the different levels of development, resources and growth: such as urbanization, over-industrialization (i.e. repressed shares of trade, financial and consumer services) and abundance in natural resources. Another group of indicators intended to represent economic distortions and institutional characteristics. These were: repressed inflation, concentration of trade in the CMEA area, black market exchange rate premium, the familiarity with market institutions.

The results of the authors showed the importance of initial conditions. Most of the characteristic initial conditions were strongly correlated and could be summed up in

²² Section 3 will be devoted to these problems: the shadow economy, corruption, and clientelism.

two principal components. These two components explained between 64-75 per cent of the variability of the initial conditions.

Figure 1
Ranking of Transition Economies by the First Two Components of Initial Conditions



Source: de Melo et al. (1997).

The two principal components are:

PRIN1: Macroeconomic distortions at the beginning of transition and unfamiliarity with market processes;

PRIN2 Level of development and structural distortions.

Figure 1 shows the values of the two principal components for the transition economies. One can see that the East Central European countries cluster in the first quadrant, while the ex-Soviet economies are high in the first component. A high level of structural imbalance, but relatively low macroeconomic distortions was found in the case of the Czech Republic and Slovakia. Due to earlier reforms a higher level of openness and marketization in Hungary, Poland and Croatia resulted in relatively low values of both macroeconomic and structural distortions.

The authors also found that adverse initial conditions were associated with slower economic liberalization, however, the effectiveness of reforms was not reduced once they were implemented. The relationship of liberalization and improvement of performance turned out highly non-linear over time. Another important result of this research is that policy was found the most important factor determining growth differences since both the speed and comprehensiveness of economic liberalization depends on it. The influence of initial conditions diminishes over time: monetary overhangs are dissipated through inflation, structural distortions are eroded as inefficient plants shut down, and familiarity with markets can be acquired through experience.

It is obvious from the de Melo et. al study how difficult it is to capture the institutional characteristics and differences by quantitative methods in a model with many countries. For example, the familiarity with market institutions (or the lack of it) was represented by a proxy variable of the number of years under central planning. It was naturally much larger for ex-Soviet countries (71) than for East Central European countries (42), expressing the difference of having, or not having a generation in the society with prior experience with a market economy. For a more accurate analysis, however, this is obviously not sufficient. The difference, for example, between Czechoslovakia and East Germany on one hand, and Poland and Hungary, on the other, has been very great in terms of how much liberalization the people were exposed to during the last decades of socialism.

Initial conditions strongly influenced production and productivity changes in agriculture also. As Macours and Swinnen (2000) has shown, the decline in agrarian production depended on pre-transition development and distortions, while reform policies had an important impact on subsequent productivity changes. The authors drew attention to the problem that one should be careful using output as an indicator of success. The fall of previously subsidized production, in fact, can be valued positively, since it indicates improved allocation of resources. In contrast to the volume of production, productivity increase following reform measures is a better indicator of success.

There were great differences among the ex-Socialist economies in the power relations of the central authorities (i.e. the Planning Commissions) and the special-interest organizations and monopolies. These differences strongly affected all aspects of the reform processes after the political changes took place, the speed, and scope of liberalization, privatization, the attraction of, or resistance to foreign direct investments and structural change. Even if it is very difficult, or in some cases perhaps impossible to quantify these aspects of the initial conditions, one should not lose sight of the fact that they are very important factors of how transition took place in the different countries, and what its outcome became.

Institutions matter

After the first shocks of the transition process, as recovery slowly started in several of the transition countries, the analysis extended from macroeconomic variables, structural characteristics, and initial conditions to the importance of institutions and their development. As was mentioned, the effects of adverse initial conditions diminish over time as the economy is gradually transformed into a market economy.

It is now widely accepted that economic growth and the attainment of prosperity depends in great part on the institutional framework of the rule of law and property rights protection. North (1990) showed how institutional development contributes to the effective working of markets, Murrell (1992, 1996) discussed the sequencing problem of liberalization policy and institutional development in the transition process. It can be expected that the establishment and implementation of strong legal institutions become increasingly important for achieving sustainable growth. This may take more time than, for example, trade liberalization, but delaying the creation of a market-friendly environment can be very risky, as it may reverse the reform process and stabilization.

Havrylyshyn and Rooden (2000) were among the first who tested how much explanatory value is added by institutional indicators in growth regressions in transition economies. They used two categories of market-friendly institutions with separate effects on performance:

- a. the legal framework of economic activity, including property rights, contract and bankruptcy law, and enforcing them even-handedly and transparently.
- b. political and civic freedom, including freedom of assembly, speech and the equal treatment of political and judicial bodies.

They used the “Economic Freedom” index of the Heritage Foundation²³, the “Nations in Transit” reports from Freedom House, the transition indicators of EBRD, the World Bank survey of 1998 on institutional environment and the country risk ratings published by Euromoney. They covered many institutional factors, such as trade, taxation, government intervention, democratic and economic freedom, the effectiveness of the legal system, foreign investment, property rights, the enforcement of contracts, black market, corruption, etc. Up till now, this is one of the most wide-ranging quantitative studies of the relationship of institutions and economic performance.

Havrylyshyn and Rooden found a surprisingly consistent and high degree of correlation between the ranking of countries’ level of institutional development. Their results were in accordance with previous investigations, when showing that macroeconomic policies and structural reforms are the two most important factors explaining output developments in transition economies. Their other interesting finding was that not only is economic liberalization determined by legal and political institutions, but the impact of good policies on growth is likely to be greater, the stronger and more developed these institutions are. Concluding the results of their investigation, Havrylyshyn and Rooden assert that the statistical value added to econometric explanations of growth by indicators of institutional development is significant, but not overwhelming.

A special case of how institutional change affected growth can be observed in agriculture, where different methods of land reform and farm restructuring led to strongly divergent productivity changes. Lerman (2000) analyzed how land privatization methods (restitution or distribution), restructuring (of corporate farms), and the economic policy environment led to even greater differences in East Central

²³ We shall come back to the problem of reliability of the subjective rankings of different agencies based on expert outside opinion.

European countries in the agriculture than in industry. The successes and failures in agricultural reforms depended in great part on market-type institution building and on how land property and its use was regulated.

Dewatripont and Roland (1996) pointed out that, as the systemic change from a socialist planned economy to capitalism is a historically unique event, economic theory has little to say on the problems and solution alternatives of the transition process²⁴. The theories that western experts were relatively well-equipped with concerned macroeconomic stabilization, but it was obvious from the beginning that this is a necessary but insufficient condition of transition. What is really needed is large-scale institutional change. The problem is that these changes — like the creation of markets, privatization, restructuring, enforcement of property rights — need to take place without creating unmanageable disturbances, because the political support of reforms have to be maintained.

The lack of prior knowledge and a significant amount of wishful thinking led to an underestimation of the difficulties and hardships of transition. Consequently, there was less precaution in policy implementation and less care for the social consequences than necessary, all of which aggravated the burden of the process. The astonishment, such as the unexpected size of the fall in output, and increase in unemployment, and the political backlash after the first significant changes, showed to what extent policy makers, advisers and theorists were unprepared for this unprecedented endeavor.

One of the basic institutional changes relates to the role of the government. It was obvious that it has to differ fundamentally from the dictatorial state of planned economies, but views differed strongly on what are adequate government institutions for a market economy. There is consensus, however, that political and institutional stability is in great need, private property has to be protected from encroachment both by criminals and by the government, and consumers and taxpayers have to be sheltered from the rent-seeking of pressure groups.

Since so little was known about transition, the outcome was strongly uncertain. Capitalism is a vast concept including very divergent systems and regimes. The economic and social experience gained by the different transition countries in the last decade did not diminish the amount of uncertainty concerning further progress in transition. It was rightly suggested by Dewatripont and Roland that the theory and modeling of the transition process must integrate this relative ignorance and learning-by-doing in reforming the institutions.

This ignorance was, and in many respects still is, related to the complementarities and interactions between the necessary steps in reform and institution building, including the effects of their timing and sequencing. Institutional change is seriously constrained by the political aspects of it: even if in the long run aggregate welfare is enhanced, beside the gainers, there are large groups of losers, and in the first period the majority may belong to them.

²⁴ They referred to the “Murphy’s law of Economic Policy” of Blinder (1987 p. 1.): „Economists have the least influence on policy where they know the most and most agree; they have the most influence on policy where they know the least and disagree vehemently.” In their opinion, this is especially valid for the economics of transition.

One of the reasons why the reforms lost much of their popular support so quickly was the unexpected and fast growth in income differences. This was especially conspicuous, as egalitarian income distribution was a characteristic feature of the Soviet-type systems. The current actual income gaps in the transition countries resemble more to the Latin American and Asian developing countries, than to the West-European welfare states. The relatively small, well-organized interest groups, like executives of financial institutions, members of parliament, local managers of multinational firms and lawyers could attain very strong increases in their incomes, while weakly organized state-employed doctors and teachers, pensioners, small farmers and the unemployed had to suffer great reductions in their real-incomes.

In a democratic system reforms can not start if the majority of voters are not convinced of their advantages, and the reform process may stop, or be reversed, if they lose trust in it. Uncertainty and the danger of reversal were largely neglected in the early period of transition and by the advisers advocating the “big bang” strategy. Gradual and partial changes are preferable to avoid larger scale reversals, as the reactions to the reform steps are better observable. One would guess that taking into account uncertainties slows the transition process. Bertocchi and Spagat (1993) produced a learning model showing that under certain assumptions, the opposite is the case. They studied the effect of the removal of subsidies in the state sector on unemployment. In the presence of uncertainty, the subsidy removal can be relatively fast, as it allows learning about the rate of job creation in the private sector. If the absorption of labor is low, the state can increase subsidies to reabsorb some part of the unemployed. This kind of fine-tuning in reform implementation can in fact maintain or accelerate the transition process, compared to the case of more radical measures, which can lead to partial or total reversal of them.

Some of the serious incentive problems characteristic of the Soviet-type economies survive in the transition period and beyond, depending on how large the state-owned sector remains and how government-firm relationship develops. One of the crucial incentive problems is the soft budget constraint²⁵ when the planner regularly bails out loss incurring firms. Saving firms that showed deficit induced planners to shift resources from good firms to bad ones, leading to lower efficiency in both of them.

Incentive distortions do not disappear fast. They remain, or change slowly in the state sector and remain in many cases even in the private sector if they are financially linked to state-owned banks²⁶. Hardening the budget constraint of enterprises is a necessary condition of stabilization, but handling the great inherited stock of bad loans by the decentralized system of financial institutions is a serious problem for all transition countries. Banks in many cases can not be too hard with enterprises, because to initiate bankruptcy may reveal the weakness of the banks’ financial situation, which would make their pending privatization difficult or impossible. This is the reason why banks burdened with a lot of bad loans put pressure on the governments for bailout subsidies to refinance bad firms, so that they themselves can escape hardening the budget constraint, or failures of the enterprises linked to them. In certain cases, it is preferable for banks to help the restructuring of firms with bad loans, rather than closing

²⁵ See Kornai (1979) (1980).

²⁶ This could be well observed in the case of the Czech Republic.

them. Considerations such as these explain the difficulties and slowness of the disappearance of soft budget constraints.

Liberalization of trade and protectionist pressures

Trade liberalization was very comprehensive and happened suddenly, or within a very short period in East Central European countries as part of the reform package of stabilization, marketization, and restructuring²⁷. It was partly the result of strong pressure from the IMF and the World Bank, and the advisers following their “liberal orthodoxy”²⁸. The other reason was the weak resistance to liberalization²⁹. The first reactions to import liberalization were very positive; a feeling of satisfaction characterized both the consumers and the business community; or in some countries it was part of the euphoria following the regained independence and the end of Soviet and communist domination. After the long period of isolation from the western markets, the disappearance of shortages and the inflow of fashionable, good-quality import goods contributed to the satisfaction and general acceptance of the advantages of trade liberalization.

However, this positive attitude did not last long, and as output declined and unemployment grew, the demand for protection of domestic production strongly increased. It caused some surprise among policy makers and economists that the first firms aggressively claiming protection were foreign-owned enterprises and joint ventures. They were more skilled in lobbying and had stronger arms blackmailing the authorities. They asked for tariff increases for competing products and tariff reductions on their inputs, tax exemptions, and the extension of non-tariff barriers, like administrative and procedural protection: special health, environmental, quality and trade-mark requirements. The mood of domestic businesses changed also, the demand for protection by the state against competition fast increased. Courses were organized to teach domestic firms how to prepare and present complaints of anti-dumping and market-disruption procedures. In government procurement processes and decisions, the neutrality requirement was in many cases neglected and domestic firms were preferred.

The farmers’ organizations and the lobbies of food industries developed strong resistance against trade liberalization. While they lost much of their previous subsidies and eastern markets, they had to face strong agrarian protection in the West. These pressure groups succeeded in keeping or reintroducing quantitative restrictions on many food products.

²⁷ See in more detail: Gács (1994), Rosati (1994), Nagy (1994).

²⁸ In the case of the Baltic countries it was the consequence of winning suddenly their independence without having custom authorities, officers or tariff laws.

²⁹ As explained by Gács (1994, pp.137-8): “the usual pressure groups resisting economic reforms were either non-existent or virtually ineffective... After the changes of 1989, the party-state did not exist any more and the behavior of the state was dominated by pro-liberalization policies of the government. Earlier, managers had traditionally derived their power from their close relation to the communist parties. With the disappearance of this background, most managers felt themselves discredited and for the sake of survival in their old positions, they did not attempt at making any noise, even when the interest of their enterprises became seriously endangered. Old trade unions were also discredited and the new ones were either supporters of the new government, or were too immature to act efficiently.”

Due to protectionist pressures, a significant portion of the trade liberalization measures were revoked, and the fact that many of them could remain in place was due mostly to the membership in the WTO and to the efforts to join the EU. The idea that protectionist restriction is in most cases good only for small producing minorities and harmful to the majority of consumers and many businesses is still not generally accepted and disseminated.

One should not forget that there is no tradition of liberalized trade (and very little of liberalism in general) in Eastern Europe. Protectionist teaching and thinking have prevailed for more than a century since the time when many of the nation-states were created in the region, as well as during the Nazi and Communist regimes. Economic protectionism was blended with nationalism, in some periods with chauvinistic jingoism or anti-imperialist hostility. In the ten years of transition, much of this has changed, but xenophobic and protectionist ideas are still lingering in the background and can surface any time.

From the point of view of the catching-up process of the East Central European economies, any further retreat in trade liberalization would be extremely dangerous. On the contrary, a gradual dismantling of existing restrictions is necessary. In the globalized world of today all the arguments of previous successful experiences of export-led growth combined with protectionism became obsolete or out of place. The consequences of retaliations by the main trading partners and the international financial and trade organizations following any significant protectionist measures could retard or break the fragile tendency of economic growth in the transition countries.

Liberalization of capital flows and the role of multinational firms

It is becoming more and more evident that the catching-up of the smaller transition countries depends on their integration into the global economy and consequently on how their relations with the multinational companies are developing. This was not evident at the beginning of the transition process, in the early nineties. It was clear that privatization is necessary to get rid of the inefficiencies of state ownership and central planning, but many policy makers and academic advisers thought that by replacing the bureaucratic incentives with profit-oriented ones would result in a significant productivity increase³⁰. The view at the time was influenced also by the privatization experiences of the West-European countries, where government downsizing, and replacing state property with “real” owners and bureaucratic direction with good corporate governance was the major aim.

The question of how to deal with foreign investors, and especially with multinational firms, became a problem for the new governments. A conflict of interest emerged among and within the political parties. On the one hand, it was obvious that foreign investments were much needed by the transition economies because of a great and long-standing shortage of capital, the huge technological gap, and lack of

³⁰ A typical view was expressed by Blommerstein et al. (1991) at an OECD conference: “Under more competitive market structures, privatization coupled with appropriate incentives would also promote a general increase in the effort of workers and managers to improve organizational and technological conditions”.

managerial skills. On the other hand, selling state assets to foreigners was counter to the interests of the clients of the ruling political parties, who aspired to purchase these assets but did not have the financial means to compete with foreign investors. The inherited managerial staff of the large state-owned companies, who were afraid that the new private owners, especially if they were foreigners, would fire them, contributed to the resistance. In many cases the employees and workers who worried about keeping their jobs have also sided with the managers. It was not difficult to find popular support with nationalistic slogans against the “selling out of national wealth”. However, the political and economic elite was divided on the question of foreign ownership. A certain part of it saw great opportunities not only to keep their positions and influence, but also to increase it by associating with foreign investors and by accepting CEO positions in local affiliates of multinational firms. The great differences across the transition countries concerning the influx of FDI was in great part due to the different outcomes of the political power struggle on the issue of how much foreign investors should be attracted or warded off.

There was not only local opposition to foreign investments, but many transition experts expressed skepticism concerning them³¹. They thought that legal reform, market institution building and stabilization of the post-socialist economies were preconditions of a significant foreign capital inflow. The investment “push effect” of multinational firms was strongly underestimated. Blanchard et al. (1991) and Kornai (1989) expected, for example, that foreign investors would be cautious, waiting until favorable conditions for the security of property rights developed. The Economic Commission for Europe warned that fast privatization to foreigners may “simply transform a public monopoly into a private one”³².

The experiences of the catching-up of Ireland and the new South-European members of the EU were conspicuously not taken into account. Privatization and foreign direct investments were the major factors of accelerated growth for Spain, Portugal and Ireland after their European integration, and FDI contributed considerably to their economic stability, and reduction of debt and inflation³³. In the case of Ireland, for example, Barry and Bradley (1997) have shown that even though only 15 per cent of the firms are foreign owned, they employ 45 per cent of labor and produce 60 per cent of output. Foreign owned firms are not only bigger, but they are significantly more productive, more export-oriented and profitable than domestic owned ones. For this reason, foreign owned enterprises (in great part multinationals) became the cutting edge of faster than average growth of the South-European economies.

In the ten years’ experience of the East Central European transition countries, it became clear that FDI acted as a very important agent of change and catching-up. Recent research results have shown that the more open and institutionally attractive the transition countries were to foreign investments, the faster their growth became after the decline at the early stage of systemic change³⁴. Micro-level analyses indicated that the reason for this was that FDI provided the indispensable change of governance structure

³¹ E.g. Blanchard (1991), Brabant (1992), Kornai (1989), Crane (1991), Eatwell et al. (1995). A detailed discussion of it can be found in Mihályi (2000).

³² UN ECE (1990) p. 16.

³³ See in more detail: Bliss and Macedo (1990), Larre and Torres (1991), Nagy (1999).

³⁴ See Landesmann (2000), Carlin et al. (1997) and (1999).

needed for “active restructuring”. Landesmann (2000), comparing the transition countries, found that those economies are growing fastest which attracted the largest shares of FDI. Firms with foreign involvement are more capital-intensive, invest more, show higher productivity levels, and are more export-oriented than the domestically owned enterprises.

In Table 1 some measures are presented about the characteristic features of the so called foreign investment enterprises in manufacturing in relation to these features in all enterprises in the manufacturing industry³⁵. The selected indicators are: equity capital, employment, investment, sales or output, and exports. It can be seen that foreign-owned firms have higher than average labor productivity levels (sales and output shares are greater than employment). Their investment intensities are also higher than average (investment/sales and investment/employee ratios are higher than unity) and so are the capital intensities as measured by equity capital per employee. In addition, they are more export-intensive than other firms are (export shares are higher than sales or output shares)³⁶.

Table 1
Share of foreign investment enterprises
by main indicators of manufacturing companies, 1996, 1997, per cent

	Equity capital	Employment	Investments	Sales or output	Export sales
Czech Republic ¹	21.5 ²	13.1	33.5	22.6	
Czech R. 1997 ³		16.0	31.2	26.3	42.0
Hungary	67.4 ⁴	36.1	82.5	61.4	77.5
Hungary 1997	71.8 ⁴	42.8	79.8 ⁵	66.7	75.4
Poland ⁶	30.4	15.0	43.1	30.3	33.8
Slovakia ³	19.4	13.0	24.7	21.6	
Slovenia	15.6	10.1	20.3	19.6	25.8

Notes: 1) Companies with 100 and more employees. – 2) Own capital. – 3) companies with 25 and more employees. – 4) Nominal capital in cash. – 5) Compared to the whole industry; corresponding figure for 1996: 68.6%; – 6) Corporate sector

Source: Hunya (1999).

These are clear indications of the pre-eminent role foreign investments and foreign firms play in the acceleration of growth in the transition countries. Gomulka (2000 p. 78.) summed this up the following way: “the negative experience of the Czech Republic [with voucher-type privatization] and the much better growth performance of Poland, Estonia and, more recently, Hungary, which has led to the »new wisdom«,

³⁵ The data used by Hunya (2000) was compiled from company level balance sheets, where foreign investment enterprises are defined as companies with some degree of foreign ownership involvement. However, it was found that foreign ownership means in most cases a decisive influence on the governance structure.

³⁶ A part of the difference between foreign and domestic owned firms may be due to the variance in the accuracy of their reporting. It may be assumed that tax-avoiding and profit-hiding is more frequent in domestic firms.

namely that the success of transition depends above all on a rapid creation of conditions – institutional, legal, microeconomic and macroeconomic – which are conducive to the development and growth of a new private sector (including FDI)”.

There are of course very divergent motives for foreign capital to get involved in different branches; there is no sign that FDI in East Central European countries would have been oriented mostly towards labor-intensive, low-skill, or domestic market oriented manufacturing. Comparative research mentioned above has shown that foreign involvement is strong in a number of capital-intensive, skill-intensive and export-intensive industries (particularly transport goods, electrical and optical equipment). In domestic market-oriented industries such as food, dairy products, beverages, or tobacco, foreign firms are also strongly represented.

The distribution of foreign investments across manufacturing branches does not follow the traditional comparative advantages of these countries, they are motivated more by increasing returns³⁷, where the multinational firms have significant advantages (concentrated R&D, economies of scale in component production, sales and repair services).

The experiences of the last ten years’ development clearly indicate that resistance to foreign capital inflow — like resistance to trade liberalization — is detrimental to growth, and the best results in restructuring, modernization and export growth were achieved by countries which attracted more foreign investment. The effect of FDI and especially of the increased presence of multinationals on the rule of law is more ambiguous. There are indications that some of these investors, the more aggressive ones, frequently used bribery to obtain favorable conditions and protection, contributing to the decline of public morality. In other cases, it could be observed that the more conservative and well-established foreign firms, that have longer business perspectives in the country, carefully avoided the use of illegal methods and refused to take sides in the political struggles, even if they were invited to do so. Thus, they showed a good example and encouraged the development of an efficient and law-abiding institutional system.

3. The rule of law

The transition from centrally-planned dictatorships to democratic market economies in Eastern Europe was a historically unique, unprecedented process, producing much astonishment compared to expectations. Most experts and advisers did not foresee, for example, the size of the decline of economic activities and the consequent unemployment³⁸. Another unexpected concomitant result was the breakdown of the rule of law, with a strong increase in criminality and all kinds of

³⁷ This is very similar to what Pratten (1988) and O’Malley (1992) have found in the case of Irish FDI.

³⁸ This is mainly true for the Western advisers and their reformist local partners at the time when the systemic changes started. However, during the debates on the introduction of market-type reforms in the previous decades, their conservative Marxist-Leninist opponents argued with threats that liberalization of trade and prices and the introduction of profitability requirements could lead to bankruptcies and large unemployment in the majority of the socialist enterprises. They probably exaggerated this danger, but the reformers certainly underestimated it.

illegal activities. It was, in a sense, a natural consequence of liberation from the (more or less) strict dictatorial rule of the communist parties and their police state system. It was an expression of the measure of the alienation of the citizens from the totalitarian state and from its laws and rules, which did not, and could not suddenly change with free elections and the vacuum of power following it.

The astonishment caused by the widespread lawlessness was partly due to the — already mentioned — confusion: interpreting the self-destructive immobility of the communist system as stability. Autocratic regimes are more fragile, in fact, than they seem to be, or they try to lead us to believe. As they are based not on popular consensus or support, but on coercion and intimidation, their stability depends on the incentives of the officials and the repressive forces. If the rewards offered to these forces do not seem sufficient, or their fear of punishment is diminished, the dictatorial system can collapse more easily than expected, and a chaotic situation can emerge³⁹.

Even if subsequently valuable reasons can be found, it was surprising for most observers how fast and to what extent lawlessness spread in all transition countries after the collapse of the communist regimes. One could of course argue that in a despotic system there is no rule of the law, but a rule of lawlessness. The rulers, i.e. the nomenklatura, were always above the law; they could commit crimes, accept bribes, and enrich themselves by illegal means, as long as they remained in their powerful positions. In this sense there was not, and could not be, equality before the law in the Soviet-type systems⁴⁰.

Nevertheless, for the vast majority of the population there was an enormous number of laws, regulations and restrictions which had to be followed to avoid severe punishment. Dictatorial rule also meant efficient law enforcement agencies, reducing revealed criminality below the level of many liberal democratic countries. The combination of overwhelming regulations on the one hand, and lawlessness on the other, led to a constant feeling of insecurity, fear and distrust of the authorities. Freedom and democratic change meant liberation from the huge amount of restrictions and from fear of non-obedience. The double standards of lawlessness above, and expecting strict law-abiding behavior below severely corroded public morality.

The lack or weakness of the rule of the law is one of the main obstacles to the economic catching-up of the East Central European societies and of their accession to the European Union. We shall discuss this in some detail in the following.

³⁹ Olson (1991) pointed out that : “If a government’s operatives, and especially those in the police and the military, believe that they will be punished if they fail to carry out their orders and rewarded if they do, an autocracy is secure...Since even the most awesome despotisms often rest on nothing more than a shared perception of their guards and administrators, they are, paradoxically, close to disorder and even to anarchy.” (pp.13-14.)

⁴⁰ Lawlessness in this region goes further back in history than the socialist period. One can hardly speak of the rule of law in the nationalistic military dictatorships between the two World Wars or in the royalist and tsarist autocracies before in most of the East Central European countries.

Spread of the shadow economy

Black or shadow economy usually means the unregistered (and consequently untaxed) economic activities. It can be found at all times in all societies, and there are strong indications that it has an increasing tendency⁴¹. The shadow economy existed and expanded in the Soviet-type economies too, its size being different depending on the more or less liberal character of economic policies and periods. It was mostly the consequence of the acute shortages in socialist economies, and in some countries (e.g. in Hungary and Poland) it became a more or less tolerated supplement to the state-owned sector. In the 1990s, in the transition countries, the huge decline in production, rapid increase of the deficit in the state budgets and large-scale tax avoidance directed the attention to the problems of illegal economic activities.

It is difficult to gather information about and measure the size of the shadow economy, as in most cases it is illegal, and punishable if identified. It is typically a reaction of the economic agents who feel overburdened by the size of taxes and social security contributions. The cross-country analysis of Johnson et al. (1999 p. 19.) found that: "Hidden economy is larger in countries where tax rates are higher, where managers are more likely to pay bribes, where managers pay for Mafia-type protection and where managers have less faith in the legal system".

There is a large literature on the different methods of measurement of the shadow economy, a good review and criticism of them can be found in Lackó (1999) and Schneider and Enste (2000). The estimated size of the shadow economy and its growth can be seen on Table 2 where the results of the physical input method by Johnson et al. and Lackó are presented.

Table 2
Shadow Economies in Transition Countries
(size of shadow economy as per cent of GDP)

Countries	Average 1989-1990		Average 1994-1995	
	Johnson et al.	Lackó	Johnson et al.	Lackó
Bulgaria	24.0	26.1	32.7	35.0
Croatia	22.8*		28.5*	38.2
Czech Republic	6.4	23.0	14.5	23.2
Hungary	27.5	25.1	28.4	30.5
Macedonia				46.5
Poland	17.7	27.2	13.9	25.9
Romania	18.0	20.9	18.3	31.3
Slovakia	6.9	23.0	10.2	30.2
Slovenia		26.8		24.0
Average	17.6	17.6	20.9	31.6

Sources: Schneider and Enste (2000) calculations using values of Johnson et al. (1998) and Lackó (1999).

* For Croatia: Madzarevic and Milkulic (1997), using the discrepancy method.

⁴¹ See Schneider and Enste (2000).

The estimated average share of the shadow economy in percentages of GDP increased in the East Central European countries from 17.6 per cent to 20.9 and 31.6 per cent⁴², respectively in the first five years of the transition period. This can be compared to similar calculation on the OECD countries⁴³, showing an average of 15.1 per cent of estimated shadow economy in 1990. While at the beginning of the transition the unofficial economy was relatively low e.g. in Czechoslovakia, it increased significantly in all East Central European countries, and the differences among them diminished.

Without going into the details of the different methods and problems of estimations, and taking into account the large uncertainties of the data used, the results show clearly two things. One is that the share of the shadow economy is large in the transition countries, about twice as big as in developed market economies, and second, that its size increased very substantially in the first period of the transition process.

The significant rise of the shadow economy is obviously linked to the decline of production and income, which increased the tendency of tax evasion. Many firms preferred not to pay taxes and social security contributions in order to avoid deficit and bankruptcy, especially when the danger of detection and penalty diminished.

Decentralization and privatization of state owned firms gave birth to many new small-size enterprises, while increased unemployment, in many cases, led to self-employment. Due to these developments the number of entities with potential to join the shadow economy increased and contributed significantly to the rise of unregistered and untaxed activities.

The choice to go underground was linked to the general decline of the rule of law and of the loyalty towards public authorities, an expression of the longstanding alienation from the state. As Vihanto (2000) pointed out, people have learned in the Soviet-type systems that laws are arbitrary decrees of the non-representative governments, so they are not meant to be generally enforced. Consequently, people in these states have difficulties, and need to get used to the idea that universal compliance is a prerequisite for a sustained working of the legal system. Even if opting for illegality may be a favorable decision in the short term, it hinders the transition to a free market economy.

The significant extension of tax avoidance is obviously linked with the declining efficiency of the administration in transition countries and with the increasing amount of bribery and corruption. Friedman et al. (1999) found in a large cross-country investigation that entrepreneurs go underground not only to avoid taxes but also to reduce the burden of bureaucracy and corruption. According to Johnson et al. (1999 p. 18.) “Either firms hide their activities in order to reduce the bribes they need to pay, or they pay bribes in order to be able to hide their activities”. There is a strong correlation between the amount and complexity of regulation and the size of the shadow

⁴² The difference may be due to the numerous differences in the methodology used by Johnson et al. and Lackó.

⁴³ See Schneider and Enste (2000) p. 102.

economy⁴⁴. The increasing frequency of unofficial economic activities in the transition countries was a consequence of the resilience of large-scale regulations, while the enforcement of tax laws declined.

It is questionable how sincere politicians and administrators are when they call for a substantial reduction of the shadow economy. High taxes and complex regulations lead to increased power of the bureaucrats and, for some, more chances for corruption⁴⁵. Both entrepreneurs and administrators know well that in certain cases it is more advantageous to pay bribes than taxes. As many voters gain from unofficial activities and lax legislation of taxes, for re-election purposes, politicians may find it preferable to only talk about “law and order” and do little for stricter collection of taxes and social security payments.

The East Central European countries inherited a relatively developed welfare system compared to their general level of development, necessitating a high level of public expenditures. A large shadow economy means relatively low tax and social security income, which may lead to a vicious circle: the larger the burden on firms, the more they opt for exit (illegality), increasing the pressure on public finance, resulting in higher nominal tax rates, and so on.

It is not evident what the effect of the shadow economy is on the official economy. Schneider and Enste, after reviewing the literature on the subject, found that its “effects on economic growth remain ambiguous”. Several investigations concluded that the two economies move together, and there is a positive relationship between their growth. Others⁴⁶ concluded that the activities of the informal sector have a negative impact on economic growth, because of the negative correlation of the informal sector and public infrastructure, which in turn is a key element of economic growth. Untaxed economic activities reduce the income of the state and are evidently unfair for the law-abiding citizens and firms, but from the point of view of the general growth of the economy, they are not necessarily harmful. The question is how they use the resources withheld from taxation. Are the resources better allocated with regard to general welfare than under state allocation? This ambiguity is a consequence of the difficulty of answering this question.

There can be little doubt that in the transition countries the informal sector of the economy contributed significantly to the muddling through the difficulties of the transitional crisis. It gave work to many unemployed people and helped the survival of small and medium size firms. It was in the shadow economy that new business-persons have learned the entrepreneurial spirit and dynamism, contributing to competition and increasing the efficiency of the economy. However, working in the shadow economy

⁴⁴ According to the estimated model of Friedman et al. (1999) a one point increase in the index of regulation (ranging from 1–5) is associated with a 10 per cent increase in the shadow economy for 69 countries.

⁴⁵ This depends, of course, on how severely the bureaucrats’ activities are controlled. The level of corruption and tax-avoidance, in this sense, is a consequence of the leniency of the political power and the judiciary.

⁴⁶ Loayza (1996) found empirical evidence for Latin American countries that a one percentage increase in the ratio of shadow economy in the GDP results a 1.2 per cent decrease in the growth rate of official real GDP per capita.

can be disadvantageous for the work force, for there is usually no work contract, and in many cases employees have no access to social security or legal protection.

A great disadvantage of the hidden economy is that, after a certain time, it becomes an impediment to private sector development, and consequently to economic growth. Firms usually can remain in the shadow while they are small; the bigger they become the more difficult it is to hide activities, sell their products, hire labor, or to get credit. Moreover, hidden firms have none or minimal access to debt and equity markets to raise new capital. For this reason, many of them prefer to remain small and hidden, even if they have the opportunity to grow.

An important part of the growth of the shadow economy was the sudden explosion of such criminal activities as drug and arms trafficking, prostitution, gambling and extortion. This contributed much more than other unregistered activities to the breaking down of the rule of law and to a widespread feeling of insecurity. In such conditions security guards and private police forces are mushrooming, sometimes fighting each-other, deteriorating even more public security. The unofficial enterprises are in many instances financed by and even intertwined with criminal activities, which help them launder their money. The increase of criminal activities is damaging for the lawful and secure environment, necessary conditions for attracting foreign investment, progress with EU integration, and catching-up⁴⁷.

The greater the shadow economy, the bigger the discrepancy between the registered economy and the real economy. Statistical data of output, employment, income, consumption, etc will be less reliable. Policy makers have to face the fact that much of their information on the economy is deficient, and they have to consider how their policy decisions will influence the unregistered part of the economy.

As a greater size of the shadow economy is a sign of the lower level of the rule of law, there can be little surprise that a positive relationship was found between the extent of corruption and the unregistered economic activities. After investigating 49 countries, Friedman et al. (1999. p. 20.) concluded: “In summary, the relationship between the share of unofficial economy and rule of law (including corruption) is strong and consistent across eight measures provided by six distinct organizations. All eight of the indices suggest that countries with more corruption have a higher share of unofficial economy.” However, the causal relationship of corruption and illegal economic activities can go both ways: if corruption is widespread and bribes are an important part of the fixed costs of firms, these firms can go underground to avoid the pressure of corruption⁴⁸. On the other hand, entrepreneurs may find it advantageous to bribe officials in order to avoid tax and social security expenditures. In this way more corruption and larger shadow economy are complementary⁴⁹.

While the contribution of the shadow economy to growth of the registered economy is doubtful, it is not questionable that it has a negative effect on the fairness and the equality of sacrifice in the society, and consequently on the rule of law. The more the society and the authorities find acceptable the activities in the informal sector,

⁴⁷ Referring to Yugoslavia Ash (2000) concluded: “A crucial test – this we learned from other transitions – is whether they can establish the rule of law in a highly criminalized society.”

⁴⁸ Rose-Ackermann (1997).

⁴⁹ Johnson et al. (1998).

the more they damage public morality. Informal activities naturally reduce public income and are especially harmful to tax compliance. It is not merely the loss of tax revenues or resource allocation problems that are the result of the shadow economy. Their negative impact on the rules, norms and institutions of a healthy economy can be even more corrosive. A large and growing shadow economy shows not only that the tax and social security payments and state regulations are high and hardly tolerable, but also that the legitimacy of the social order is endangered.

Corruption and State Capture

Similar factors causing the decline of the rule of law in the context of the shadow economy could be observed in the spreading and strengthening of corruption. There are many types of corruption, which can come under the same definition of “the abuse of public power for private benefit”⁵⁰. They include bribe paid for obtaining licenses, access to publicly-provided goods and services, procurement of public investment contracts, influencing tax regulations, obtaining jobs, or promotion in the public sector, etc. A distinction should be made between “small” and “grand” corruption, the latter being in many cases politically motivated and often tied to capital investment projects.

If it is difficult to measure the size of the shadow economy, it is much more difficult to measure corruption, as in the latter case both the private and public parties are interested in hiding the facts. To measure corruption, it is not possible to use objective variables as for the hidden economy, such as the currency demand or electricity utilization. For the quantification of corruption indices of private rating agencies are used that rely on replies to questionnaires by consultants and experts⁵¹. They all have the drawback of being subjective, therefore contain a serious risk of reverse causation: performance perception may bias ratings by experts⁵². However, since the correlation of corruption indices prepared with different methods, and based on data received from different consultants is very high, and especially since the ranking of countries according to the corruption indices is very similar, with the necessary reservations one can have a certain amount of confidence in the reliability of such measures of corruption⁵³.

In a recent publication Kaminski (2001) presented a comparison of different estimations of corruption in the transition countries, of which the East Central European countries' indices are presented in Table 3. Two kinds of corrupt behavior are distinguished: *administrative corruption* as revealed in illegitimate payments to public officials, and *state capture* measured by the percentage of firms directly affected by the ‘purchase’ of laws and regulations.

⁵⁰ Tanzi (1998).

⁵¹ As Wei (2001) succinctly remarked “Like pornography, corruption is difficult to quantify, but you know when you see it”.

⁵² See Havrylyshyn and Rooden (2000).

⁵³ The methods of measuring corruption by the perception of experts are strongly criticized by Sík (2000), who argues that „independent information is highly unlikely from a self-selected, small and closed circle of experts”. He proposes a direct method of investigating actual cases of corruption.

The level of estimated corruption in the first five countries (the so called “Luxembourg Group” of the candidate countries) is lower than in the last five countries (the “Helsinki Group”). State “capture” is remarkably high in Latvia, Romania, Bulgaria and Slovakia. There seems to be a close relationship between the different measures of corruption. When both administrative corruption and state capture is on a high level, it suggests that the system acts deliberately to set the rules of game in ways maximizing rent-seeking behavior for those enjoying political power. “Under these circumstances, corruption feeds on itself by fuelling counterproductive, corruption-generating regulations” — remarks Kaminski (2001, p.7).

Table 3
Measures of corruption in East Central European countries

	EBRD (2000): progress in transition ^{1/}	Corruption Perception 2000 ^{2/}	State Capture ^{3/}	Administrative corruption ^{4/}
Czech Republic	100	35	27	44
Estonia	90	26	24	28
Hungary	98	29	17	30
Poland	94	37	29	28
Slovenia	85	27	17	25
Bulgaria	79	43	68	37
Latvia	82	44	73	25
Lithuania	82	44	27	49
Slovakia	89	43	59	44
Romania	73	52	74	56

Sources: Kaminski (2001) derived from data in EBRD (2000), World Bank (2000), Transparency International (2001), World Bank (2001).

Notes:

^{1/} Indices of progress in transition in East Central European countries derived from EBRD 2000. For each country, eight “grades” (ranging between 1 and 4+) of the progress in creating foundations for competitive markets were summed with “pluses” and “minuses” treated as plus or minus 0.5. For each assessed area the maximum grade (4+) reflects the standards typical of advanced industrial economies. The index was normalized in terms of a most advanced country among transition economies. The higher the value of the index the more advanced a country is in terms of transition to mature market economy

^{2/} Corruption Perception Indices (CPI) as reported by Transparency International multiplied by 10 and inverted. The value of the index equals to 100 for a country with the highest perception of corruption.

^{3/} State capture data derived from Hellman et al. (2000/a) inverted and multiplied by 100 and standardized in terms of the most “corrupt” country. The closer the value of index is to 100, the more corrupt a country is in relation to other East Central European economies.

^{4/} The measure of administrative corruption (bribes as a share of the annual revenue of the firms) as reported in World Bank (2000).

As long as corruption could not be measured and compared, some authors assumed that corruption might increase economic growth, as bribes may speed up decisions by the authorities, and bureaucrats may work harder if they can expect such a

reward⁵⁴. However, all of the empirical studies done in the field recently refute this “bribery-as-grease” hypothesis, and agree that corruption tends to lower economic growth⁵⁵. Mauro (1995) used the country risk indicators of Business International (1981, 1984) to measure institutional efficiency and political stability. He found that the indices related to the judiciary system, red tape, and corruption are closely related and can be regarded as good indices of the degree of bureaucratic efficiency in a country. There is a strong association between bureaucratic efficiency and political stability, richer countries tend to have better institutions than poorer countries, and fast-growing countries have a higher bureaucratic efficiency index than slow-growing ones. Legal systems obviously have a strong influence on corruption, but their effectiveness depends on the political and cultural setting in which they work. Triesman (1999) found that a system where the judiciary is not independent and judges have a broad discretion can even stimulate corruption, increasing the toll of bribery.

As far as the effect on growth is concerned it was found that bureaucratic inefficiency in general, and corruption, in particular, are strongly negatively associated with the investment rate. One can state with high probability that institutional inefficiency and corruption cause low investment, and this is the main channel through which bad institutions lower growth rates⁵⁶. If corruption results in more tax-avoidance, as is the case in transition countries, it reduces public income and expenditures, including public investments. Public procurement contracts influenced by corruption can lead to exaggerated costs of construction⁵⁷, inferior services, or to the use of cheap, low-quality materials. Consequently, the loss caused by corruption is much higher than the bribe itself. Moreover, in the case of transition economies the major disadvantage of corruption can be the worsening reputation of the country and the loss of confidence of foreign investors.

Most of these effects are indirect, but corruption can directly affect the growth performance by leading to misallocation of the investment among sectors. The reason for this is that corrupt government officials prefer those expenditures where they can collect bribes and if possible huge ones. This is frequent in large capital investment projects such as the construction of bridges, hospitals, airfields, purchase of medical equipments, etc. In a cross-country analysis Mauro (1997) found strong evidence that government expenditures on education and health are negatively and significantly correlated with higher levels of corruption, while both of them play a determining role in economic development. It is more difficult to prove, but is very likely, that corruption leads to high capital expenditures on useless (so called “white elephant”) projects.

⁵⁴ E. g. Leff (1964) and Huntington (1968).

⁵⁵ See Shleifer and Vishny (1993), Rose-Ackerman (1978), Mauro (1995) and (1997), Tanzi and Davoodi (1997), Kaufmann and Wei (1999).

⁵⁶ According to Mauro (1995 p. 700.) a one-standard-deviation improvement in the corruption index is significantly associated with an increase in the average investment rate by 3.3 per cent of GDP.

⁵⁷ Tanzi (1997) is quoting a report of Transparency International on the city of Milan, where after a great corruption scandal broke out, within the space of two years “the cost of city rail links fell by 52 per cent, the cost of one kilometer of subway fell by 57 per cent, and the budget for the new airport terminal was reduced by 59 per cent.”

Tanzi (1997) found strong evidence that corruption reduces growth by increasing public investment while at the same time reducing its productivity. It was found also that in a corrupt environment, periodic current expenditures (so called “operation and maintenance” costs) are not accompanied by adequate level of investments, thus reducing the efficiency of such expenditures. Reduction of growth is induced by the deterioration of the quality of infrastructure, which, in turn, is frequently caused by corruption, increasing the costs of doing business.

Distortions in the sectoral or local allocation of government spending are frequently politically motivated, and corruption is intertwined with political pressure or favors. Politicians frequently steer the approval of infrastructure projects towards certain locations where domestic or foreign firms are planning investments in exchange for bribes. Alternatively, they may offer “free” infrastructure facilities (roads, electricity, communication, etc.) to attract investors toward their home districts.

Wei (1997) studied the effect of corruption on the countries’ ability to attract foreign investment and found strong evidence that corruption in the host countries is negatively associated with FDI. As corruption is inherently secretive and arbitrary, the implicit contract between the briber and the person to be bribed can not be enforced. The consequent uncertainty deters many potential investors. The experiences of the transition countries conspicuously support the negative relationship between corruption and foreign investment.

In the East Central European countries the state sector was, and in some cases still is, very large. Privatization in trade and industry has developed relatively fast, while privatization in infrastructure is lagging behind. The more so, as it is not clear and decided what should remain in the possession of central and municipal governments, and what should be privatized? It is well known also, that during the socialist period, infrastructural investments of various kinds, were strongly neglected, and in most cases were of inferior quality. Consequently, in the transition period there is a need for a lot of new investment projects in all these fields, offering lucrative opportunities to private contractors. Managers of these firms are frequently prepared to pay a “commission” to government officials for helping them win a contract, the “commission” being calculated as a percentage of the total costs of the project. In such cases, it is obviously not in the interest of the official to favor a low-cost project. Needless to say, that “commission” in many such cases is only a euphemism for what is essentially a bribe.

Privatization by foreign investors and the influx of foreign capital in the transition countries turned out not to be accompanied with the importation of fair business morals; on the contrary, the managers of foreign firms have learned fast how to corrupt officials and politicians. In many cases the foreign firms offered lucrative jobs to local advisers with “good connections” to teach them whom and how to bribe or to be a go-between with the corrupt officials. There are widespread rumors about what “price” (i.e. bribe) tax-exemptions, preferential credits, low-priced land for investments, etc. can be obtained, or that generally what percentage of kick-back is offered and expected for a government contract. It is, of course, difficult or in most cases impossible to obtain reliable information on such arrangements, especially when the judiciary is not willing or able to reveal the information and prosecute those involved in such deals.

The exact boundaries of what is considered “corruption” depend on culture: some people regard permissible what others consider liable to be persecuted. However,

in the East Central European countries public opinion polls showed that an overwhelming majority favors the reduction of corruption and in many cases, it is regarded as public enemy number one⁵⁸.

Experiences confirm the finding of Triesman (1999) that societies with longer periods of democratic rule, free press, and more education, where the separation of “public” and “private” is clearer, have less corruption⁵⁹. Let us finally remark that even if there are a number of reasons why corruption is impeding growth, it does not mean that it prevents it entirely. Other factors may be more conducive to growth, and outweigh the negative effect of corruption.

State capture is an even greater danger in the transition economies for the rule of the law than the shadow economy and corruption. It was defined by Hellman et al. (2000/b), as “shaping the formation of the rules of the game (i.e. laws, rules, decrees and regulations) through illicit and non-transparent private payments to public officials”. Firms with various methods can not only circumvent laws and regulation, but can exert influence on their formation, on the design of economic and political institutions, eventually on the quality of governance. What is observed, in different degrees, in the transition process is that powerful firms could collude with public officials to extract rents through manipulation of state power, i.e. to capture the state.

In a survey by the World Bank and the European Bank for Reconstruction and Development⁶⁰, it was found that in certain countries, public officials created a private market for the provision of the security of property and contract rights and rent-seeking opportunities, which a relatively small share of firms can obtain. In their analysis of state capture Hellmann et al. (2000/b) differentiated between *influential* and *captor firms*. The first group of firms consists of large state-owned enterprises with a large market share, secure property rights and close ties with the authorities. Captor firms are usually newly created enterprises, with less secure property rights and weaker ties to the state, facing stronger competitive pressures from incumbent firms. Influential firms exert their request without recourse to private payments, while captor firms pay for influencing the law-making behavior of public officials.

In the investigation, firms were asked to assess the extent to which activities such as the sale of parliamentary legislation, decrees, court decisions, financing political parties, etc. had a direct impact on their business. The survey showed that the purchase of such activities is present across all transition countries, in varying degrees. State capture in the former Soviet states and in some of the East Central European countries was found to be high, while in the majority of the latter economies, it was relatively low. Captor firms grew much faster than other firms in the economies where state capture environment was strong, while this could not be observed where states provide a broader range of public goods for the market and the legislative process is more subject to political competition.

⁵⁸ See Wei (2001).

⁵⁹ Recently revealed cases of corruption in Italy, Belgium, France, or Germany showed that there are great differences in this respect among firmly established democracies.

⁶⁰ The Business Environment and Enterprise Performance Survey of 1999 assessed obstacles in business environment across 22 transition economies. For a full description, see Hellman et al. (2000/a).

The privatization process and the possibility of new entry created firms with higher insecurity in their property and contract rights, and displayed a greater demand for strengthening their security. Through private payments to public officials captor firms have succeeded in gaining greater protection, what most new entrants and privatized firms have been unable to achieve. The real danger in this respect is when corruption goes beyond the administration and reaches the level of the members of parliament. One can not expect severe anti-corruption legislation and its implementation from corrupt legislators. The many times futile efforts made in order to introduce transparency in the wealth status of legislators and high-level officials show that this danger is real.

The development of the transition countries in this respect has shown that the initial introduction of civil liberties and checks on abuse of power were often insufficient to counterbalance the loss of control from the dismantling of the communist regime. This situation helped the emergence of state capture. It could be observed e.g. in mega privatization deals, like telecommunication, energy production, or purchases of military equipment. In such cases the partners of the state sought to determine the rules of the game to secure monopoly positions, favorable pricing arrangements, state guarantees.

By increasing the oversight by the civil society, freedom of press and independence of the judiciary a certain threshold of democratic reforms have to be reached to channel the strategies of firms away from state capture. Gradual demonopolization, supporting competition, and helping entry can direct firms to more legitimate means of influencing the decisions of the state. However, in several East Central European countries, it was observed that when the grasp of political power of the ruling parties weakened, they tried to reduce the transparency of the dealings of the state, and by attacking the freedom of the press and the independent decisions of the judiciary. The danger of a situation when capture of the state may emerge is not yet over.

Clientelism and the creation of the “new middle class”

One of the main causes of the weakening and breaking down of the rule of law in East Central Europe is strongly linked to the political and social processes of the introduction of democratic pluralism. The transformation of the socialist system to a market economy obviously entailed privatization, selling state assets to real owners, i.e. the creation or emergence of a new capitalist class, which could not have existed in the Soviet-type systems. There was a general political agreement among practically all political parties that privatization is necessary; the question was how fast and how much to privatize and who will be its beneficiaries, the new owners of privatized assets. In the election campaigns and the political struggles all the parties proclaimed that a “new middle class” had to be created, which was an euphemism for the capitalist class, even if it meant a larger social strata of entrepreneurs, self-employed professionals, and higher level bureaucrats.

The creation of the “new middle class” signified on the one hand the governmental redistribution of assets, land and services, and on the other the legal and administrative frameworks of this redistribution. In the political power struggles in Eastern Europe, especially at the beginning of the transition, there was much more at

stake than is usual in western democracies. The question was not only which political group or coalition would govern the country in the next period, but also who will privatize the state assets worth billions of dollars, and to whom. Clientelistic networks evolved around the political parties and groupings eager to participate in the distribution of state-owned firms, in the redistribution of land and in obtaining profitable state contracts⁶¹. The slogan of “creating the new middle class” covered in fact a power struggle of the clients demonstrating strong party loyalties⁶².

The eagerness of the client groups of the ruling political forces to get as much as possible of the redistributed wealth may be one of the reasons why there was too much emphasis on privatization and too little on marketization at the early phase of transition. Even if privatization is a necessary condition of a well functioning market economy, as Bromley (2000) pointed out, it is not sufficient, as in the absence of adequate institutions, a coherent factor and product market can not develop which would flaw the incentive structure.

According to Sajo (1998), clientelism in contemporary political science means “a network of social relations where personal loyalty to the patron prevails against the modern alternatives of market relations, democratic decision making, and professionalism in public bureaucracies”. Even if clientelistic corruption pervades all areas of public life, clientelism is different from corruption: it is a form of social organization, while corruption is an individual social behavior. Clientelism inherited much from the nomenklatura legacy of the socialist period and became a more or less stable form of social organization in the East Central European societies⁶³. This is a consequence of the specific circumstances of the birth of the democratic regimes.

When the Communist parties lost their grip on power, the only surviving, all-encompassing organized force that remained active was the state, with its huge and in great part incompetent bureaucracy. The parties winning the elections first offered high public service positions to their clients, and later opportunities to participate in the privatization process with favorable conditions. As it frequently happened, the party or coalition in power lost the next election, the clients of the different political tendencies had the opportunity to occupy high-level government positions or had their share in privatization, or both. This is how a great part of the “new middle class” has been created, involving enormous income differences separating them from the impoverished and partly unemployed “lower classes”, who are the majority of the society.

Participation in the privatization process and in the redistribution of capital, to become capitalists, was one of the major aims of many clients of the different political parties. Managers of enterprises and agricultural co-operatives, enriched nomenklatura

⁶¹ In the clientelist networks many small-size firms can be found, which, lacking sufficient capital, are dependent on favorable contracts with the central and local governments.

⁶² Dobrinsky (2001) rightly pointed out that the largest part of the “middle class” developed in the communist period, including petty entrepreneurs, farmers, owners of a house or car, etc. which strongly supported political and economic change, suffered a heavy loss both in its wealth and in social status.

⁶³ In fact, clientelism or the patronage system has much deeper roots in Eastern Europe, partly going back to western feudalism and eastern Ottoman tradition, and meant that the political faction in power controlled all contracts and administration appointments at whatever level of government.

members, as well as victims of previous injustices and other enterprising persons, used their good connections and party-loyalty to get inside information on the opportunities and favors in the privatization process. As most of them did not have the necessary funds to buy state assets, they used their good connections to get loans from the state-owned banks on favorable conditions. Many of these loans were never repaid and contributed to the bad portfolios of the banks⁶⁴. The consolidation of the banks in the mid-nineties in nearly all East Central European countries, which demanding billions of dollars of taxpayers money, became necessary due to other reasons too, but a significant part of it was the consequence of politically motivated lending of money without the necessary prudential considerations.

The moral dilemma created by large-scale restitution and privatization of state assets goes beyond the problem of lawfulness. The different methods of privatization can be rationally justified on the ground that the resources privately owned will be more efficiently used, while the distribution of these resources could be legalized by freely elected parliaments. However, this redistribution could hardly be accepted by the public as just and fair. The sudden creation of extreme richness was regarded by a great part of the society as questionably legal, and certainly unjust. But if it is done on political grounds, avoiding transparency and competitive bidding, many times favoring not the best offer, then it contributes substantially to the decline of the rule of law and public morality.

As the privatization process is coming to its end, clientelist networks are concentrating on government procurement and investment contracts, and well-paid leading positions in state institutions or state-sponsored projects. As the state sector is still large in all transition countries and goes much beyond the government administration (including railways, airlines, the military, education, health services, the judiciary, arts) there is a great number of lucrative leading positions which can be filled and re-filled with each switch of government. This happens in all democratic societies, the difference with the newly emerging democracies is how wide-scale these replacements are and how far they are based on political loyalty rather than on professional qualities. The result is disruption of the activities of the different institutions, reducing their efficiency, and spreading insecurity.

The success of the catching-up process depends very much on how freely and fast the entry of new firms, on the one hand, and exit and restructuring of incumbent firms, on the other, evolve⁶⁵. If a government, instead of enhancing these market-friendly processes, intervenes with special subsidies, preferential taxation, advantages provided in government procurements or credit relief for the businesses of its clients, it will obviously reduce the structural and productivity improvement of the economy.

The clientelist networks are evidently corrupt, where favoritism, political partiality, give-and-take, nepotism abound and much of the morale of democracy and the logic of the market is destroyed. A clientelist regime is more open to state capture by firms supporting the actual political administration, and it is alien to an independent judiciary and to a free press. It is strongly interested in maintaining the lack of transparency in connection with government activities, the use of public funds, the

⁶⁴ On the consolidation of banks see Várhegyi (2000).

⁶⁵ See in more detail Aghion and Schankerman (2000).

conditions of privatization and state contracts, the tax exemptions and other favors given to investors. Consequently, even if scandals are frequent, one can rarely find cases of serious and persistent criminal investigations in corruption, embezzlement, misuse of public funds, or even in Mafia-type activities. If corruption is not punished, if powerful politicians can avoid or stifle prosecution, it is not only ruinous for the rule of law due to the impunity of the crimes themselves, but creates public resignation which is harmful for the emerging democratic regimes and the development of civic society.

Ten years' history of the East Central European societies revealed that political freedom, pluralism and democratic elections are not sufficient in themselves to evolve a dynamic political equilibrium with the necessary mechanisms of checks and balances. If clientelist networks develop, for example, in a two-party system, then following the electoral campaigns the adversaries can cooperate in illegal deals, as both of them know enough "dirt" on the other to feel safe. The "dirt collection mechanism" — as Kaminski (2001) aptly called it — works not only among political parties, but also in the selection of the officers, or the staff of authorities: to trust someone, one must have "dirt" on him or her. Such a political cooperation is also a system of checks and balances, but it is based on mutual concealing and leniency of the shames and crimes. If it is combined with limitation of the freedom of the press and the independence of the judiciary, it can be very damaging for the development of a truly democratic system.

Politically disruptive clientelist regimes are disadvantageous for the extension and empowering of the market forces and for economic growth. If the choice between the privatization offers, state contracts, tenders etc. is politically motivated, and clients are offered inside information and are favored, the best offer will rarely win. In clientelist rule, an impartial and honest professional civil service, which is guided only by the law and the public interest, can not develop. But it can use very well the officials, judges, journalists, police officers, inherited from the communist regime, who have learned to obey politicians by all means and to implement laws to suit their bosses' whims. In such conditions, the administration likes to extend secrecy of government's dealings beyond all limits, following the tradition of the paranoid non-disclosure in the communist regimes.

4. Summary and conclusions

Since institutions include not only governmental and civic organizations and regulations, but also social customs and behavior, the latter being strongly imbedded in the society, the post-transition development can not be analyzed or understood without the heritage of the past. All-encompassing state-ownership, monopolization and elimination of all kinds of competition reached unprecedented proportions in the Soviet-type economies, creating oligarchic organizations, mentalities, and behavioral patterns. The ruling communist elite enjoyed extreme privileges and was beyond the rule of the law; corruption gradually became widespread and generally unpunished. In these dictatorial regimes, especially where communist power was combined with military occupation and foreign oppression, citizens became much more alienated from the state and its regulations than in democratic societies. This heritage in both the organizational and the behavioral patterns will take a long time to change, and strongly influences the institutions emerging in the new democratic market-economy systems.

Recent experiences in the catching-up process of the fastest growing countries could not be explained without taking into consideration the quality of governance — including both institutions and economic policy. The fastest growing economies — among both the developing and the South-European countries — proved that by reforming the institutional system and the policy-regimes, the growth potential can be much better exploited and the catching-up can be fast.

In the last ten years, several of the countries belonging to the first wave of EU accession practically finished their transition: they are now stable democracies with sufficiently well-functioning market institutions, and have started to grow faster than the average of the EU countries. Their relatively low wage-level contributed significantly to the attraction of foreign investments and to the successes of export growth, the two most important factors promoting their recovery. Institutional changes, such as privatization, the liberalization of trade and capital flows were important factors of structural change, a necessary condition of economic growth. However, there is a lot to learn from the social compromise of the West European countries and of the role of the governments in co-coordinating and keeping the agreements of the social partners. The hardships of structural change and foreign competition may strengthen populist and protectionist tendencies and wage pressures, may rouse anti-European, or anti-globalization passions which can become serious obstacles to faster growth and catching-up.

With the “velvet” character of systemic change, the transition did not destroy many of the previous special interest organizations that create obstacles to faster growth and structural change. With the inflow of foreign capital and the growing role of multinational firms, powerful new lobbies and pressure groups emerged and started to influence legislation and economic policies, occupy and monopolies the local markets and exclude competition. The governments were not prepared to resist such monopolization tendencies, antitrust legislation was lacking, and it took time to develop institutions defending consumers’ interests.

The great variation in the economic performance of the transition countries was in significant part due to the inherited initial conditions. The path they followed depended heavily on the policies they have chosen, but this choice was strongly influenced by the past also. Adverse initial conditions were associated with slower economic liberalization; however, once the reforms were implemented, their effectiveness was not impeded. It is remarkable that the influence of initial conditions diminished and the importance of institution creation increased over time.

There is a wide consensus that sustainable economic growth and the attainment of prosperity depends in great part on the institutional framework of the rule of law and property rights protection, since these are indispensable to the efficient working of the markets. However, changes of such magnitude that took place of East Central Europe — like the creation of markets, privatization, restructuring, enforcement of property rights — need to be managed without excessive disturbances, otherwise the political support of reforms can not be maintained. This involves a great deal of uncertainty; therefore, the process of institution building must integrate the risks concerning the outcomes and the learning-by-doing character of the reforms.

Early and fast trade liberalization was one of the success stories in the East Central European transition countries. Still, as protectionist thinking and practice has prevailed for a long time, starting more than a century ago when many of the nation-

states were created in the region, a retreat from the openness of these economies — which is clamored for over and over again both by domestic business organizations and foreign investors — would be extremely dangerous from the point of view of growth and EU accession.

Experience has shown that the catching-up of smaller transition countries depends on their integration into the global economy and consequently on how their relations with foreign investors and multinational companies are developing. Foreign investments are much needed in these economies because of the shortage of local capital, of the huge technological gap and lack of managerial skills. On the other hand, selling state assets to foreigners is against the interests of domestic investors (including the influential clients of the ruling political parties), who are in many instances unable to compete with their foreign rivals. The outcome of this economic power struggle is decisive for the catching-up process, as it became evident that the more open the transition countries were to foreign investments, the faster the restructuring in production was carried out and higher export growth was achieved following the decline of their output in the early 1990s.

While liberalization of trade and capital flows are vital conditions of catching-up, one should not forget — as Abramovitz (1986) reminded us — that these are basically endogenous processes. Even if much depends on the openness and the changing external conditions of an economy, its performance is basically determined by the allocation of resources and their efficient use influenced by the evolution of the institutional structure.

The general breakdown of the rule of law and increased criminality were unexpected consequences of the collapse of communist rule. It was the consequence of liberation from dictatorship and police state and the expression of the alienation of the citizens from the totalitarian state. However, the lack or weakness of the rule of the law is one of the main obstacles to the economic catching-up of the East Central European societies and their accession to the European Union.

The share of the shadow economy in the transition countries increased very substantially in the first period of transition and is now about twice as big as in developed market economies. When both production and state control suddenly declined, firms tried to avoid bankruptcies by going underground. While large-scale tax-avoidance is closely related to corruption and the decline of the rule of law, their effect on economic growth is not obviously negative. In contrast, the significant increase in criminal activity is very damaging for the lawful and secure environment of growth.

Even if measurement of corruption is very difficult, all investigations found a relatively high level of it in the transition countries. Corruption is generally found to be strongly negatively associated with the investment rate, and this is the main channel through which it lowers the rate of growth. Corruption usually helps tax-avoidance, and reduces public income and expenditures, including public investments. Public procurement contracts in a corrupt environment lead to exaggerated costs of construction, lower productivity, inferior services, and poor quality. All of these are very harmful for economic growth, especially in the transition countries where infrastructural investments were strongly neglected during the communist period.

The danger for the rule of law is even greater when firms can influence the formation of laws and regulations through illicit private payments to public officials or

legislators than when they can circumvent them by going underground or by bribery. In several cases it could be observed in the transition process that powerful firms could collude with public officials to extract rents through manipulation of state power, i.e. the capture of the state.

At the time of the democratic change in the East Central European countries practically all political parties agreed on the necessity of privatization and the creation of a “new middle class”, which was in many cases an euphemism for the capitalist class. In the early stage of the political struggle, the question was not only which political group would govern the country, but also who would privatize the vast quantity of state assets, and to whom. Clientelistic networks evolved around the political parties, creating a social network where political loyalty prevails against market relations, democratic decision making, and professionalism in public administration. Clientelism is different from individual corruption: it is a form of corrupt social organization and group-behavior offering members of the clientele high public service positions without the necessary qualifications, and also opportunities to participate in the privatization process with favorable conditions.

In politically disruptive clientelist regimes corruption, favoritism, partiality, give-and-take, and nepotism abound, and thus democratic morale and the logic of the market is destroyed. All this is obviously very harmful for the extension and empowering of the market forces, for economic growth and for the development of an impartial and honest professional civil service guided only by law and the interest of the public.

This paper concentrated on how institutional development in the East Central European countries contributes to and hinders the catching-up process of future EU members. The essence of what comes out of this analysis is that the institutions in place in most of these countries are suitable to achieve a faster growth rate than the EU average. Consequently, the catching-up in the not too distant future seems very probable after accession. However, the deficiencies in the rule of the law are seriously hindering the full utilization of the growth potential of these economies. Therefore, very much depends on when and to what degree the rule of law and the credibility of governments in this respect can and will be restored.

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