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State, Public Goods and Reform





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## *About*

Shortly after the end of the Kosovo war, the last of the Yugoslav dissolution wars, the Balkan Reconstruction Observatory was set up jointly by the Hellenic Observatory, the Centre for the Study of Global Governance, both institutes at the London School of Economics (LSE), and the Vienna Institute for International Economic Studies (wiiw). A brainstorming meeting on Reconstruction and Regional Co-operation in the Balkans was held in Vouliagmeni on 8-10 July 1999, covering the issues of security, democratisation, economic reconstruction and the role of civil society. It was attended by academics and policy makers from all the countries in the region, from a number of EU countries, from the European Commission, the USA and Russia. Based on ideas and discussions generated at this meeting, a policy paper on Balkan Reconstruction and European Integration was the product of a collaborative effort by the two LSE institutes and the wiiw. The paper was presented at a follow-up meeting on Reconstruction and Integration in Southeast Europe in Vienna on 12-13 November 1999, which focused on the economic aspects of the process of reconstruction in the Balkans. It is this policy paper that became the very first Working Paper of the wiiw Balkan Observatory Working Papers series. The Working Papers are published online at [www.balkan-observatory.net](http://www.balkan-observatory.net), the internet portal of the wiiw Balkan Observatory. It is a portal for research and communication in relation to economic developments in Southeast Europe maintained by the wiiw since 1999. Since 2000 it also serves as a forum for the Global Development Network Southeast Europe (GDN-SEE) project, which is based on an initiative by The World Bank with financial support from the Austrian Ministry of Finance and the Oesterreichische Nationalbank. The purpose of the GDN-SEE project is the creation of research networks throughout Southeast Europe in order to enhance the economic research capacity in Southeast Europe, to build new research capacities by mobilising young researchers, to promote knowledge transfer into the region, to facilitate networking between researchers within the region, and to assist in securing knowledge transfer from researchers to policy makers. The wiiw Balkan Observatory Working Papers series is one way to achieve these objectives.



# The wiiw Balkan Observatory

## Global Development Network Southeast Europe

*This study has been developed in the framework of research networks initiated and monitored by wiiw under the premises of the GDN–SEE partnership.*

The Global Development Network, initiated by The World Bank, is a global network of research and policy institutes working together to address the problems of national and regional development. It promotes the generation of local knowledge in developing and transition countries and aims at building research capacities in the different regions.

The Vienna Institute for International Economic Studies is a GDN Partner Institute and acts as a hub for Southeast Europe. The GDN–wiiw partnership aims to support the enhancement of economic research capacity in Southeast Europe, to promote knowledge transfer to SEE, to facilitate networking among researchers within SEE and to assist in securing knowledge transfer from researchers to policy makers.

The GDN–SEE programme is financed by the Global Development Network, the Austrian Ministry of Finance and the Jubiläumsfonds der Oesterreichischen Nationalbank.

For additional information see [www.balkan-observatory.net](http://www.balkan-observatory.net), [www.wiiw.ac.at](http://www.wiiw.ac.at) and [www.gdnet.org](http://www.gdnet.org)

# State, Public Goods and Reform

## General introduction

State plays the major role in any reform process. Because of that, a much wider concept has to be used than that of a provider of public goods, although that remains to be one of its crucial functions. Though there is a sense in which the state itself reforms as a consequence of the development in the markets and in the society,<sup>1</sup> and especially in the international environment,<sup>2</sup> it is still the case that the reform process has to be, at least partly, initiated and guided by the state as the central policy-making and policy-implementing institution. What goes on for reforms, goes for failures of reforms too. Though successful reforms are perhaps a more satisfying subject, it may even be true that more is learned from failures. Within these wider concepts of the nature of the state and reform the narrower approach to the role of the state as a provider of public goods can be discussed too. Our main aim here is to define concepts, survey some of the more important trends in the literature and suggest topics for research.

In this paper, we look at the state from a number of different angles, discuss in particular cases where it is weak or has failed, and use the examples from the Balkans to elucidate topics that could be useful for further research in this general area. We rely on the recent experience of the political and economic developments of the Balkans to illustrate the more general claims we make. The reliance on the Balkan experience is justified by the fact that in a relatively small region a great variety of processes of state-formation, reform programmes and international involvement can be found. Rather than relying on cross-country analyses, which tend to be removed both from general theoretical considerations and from particular cases, the reliance on a specific, though rather representative, regional cases can have certain methodological advantages.<sup>3</sup>

The very varied experiences and range of initial conditions one sees in the Balkans make them almost a laboratory generating relevant generalizations for a wide variety of economies and allowing comparisons of policies and outcomes. Thus this relatively small region provides important lessons for all economies facing extensive institutional restructuring and capacity building, changing role of the state and provision of public goods as well as those seeking policies aimed at generating modern economic growth. But above all the experiences of the Balkan economies are especially interesting because of their history of varied failures, repeated attempts of reform, meandering non-linear policies and dashed great expectations. Since many economies exhibit one or, alas, more than one of

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<sup>1</sup> Which is mainly the topic dealt with in the theories of modernization and sociology of development in general.

<sup>2</sup> On this see a very interesting new major treatment in Bobbitt, 2002.

<sup>3</sup> More on the difference between the methodology used in cross-country studies and those in case studies see Rodrik, 2002.

these features using the Balkan as area for drawing examples of the more general statements seems justified.

The paper is divided into three parts. In the first, the general role of the state and its relation to reforms are discussed with the special reference to the issue of legitimacy. In the second, the concepts of failed and weak states are discussed in greater detail with special reference to the provision of public goods under such circumstances. In the third and shortest section, the relation between the state, public goods and economic growth is explored. We conclude with a discussion of some of the issue that we think would be most useful for future research.

## **1 State, legitimacy and reform**

### **Introduction**

Economic justification for state action is based on the concept of market failure. For reasons of symmetry, it would be useful if the political justification of the autonomy of the markets is based on the concept of state failure. The notion of state failure, however, can have a different meaning, or rather significance, than that of market failure. It can imply the need to extend the working of the market to areas of public concern as it can mean that the public sector is not functioning in the way that is in accordance with the idea of the state or with that of good public governance. In particular, a state may fail to provide certain public goods, it may compete for the supply of public goods with the private sector, or the supply of public goods may be completely privatized, as in the case of the capture of a state by special interest groups.

There is of course a difference between a failed state and a state failure, but there are also some similarities. Here, in the first part of this paper, the concept of the state will be discussed first, the issue of state-failure will be tackled parallel with that, and then some specific issue about the role of public governance in development and reform will be analysed. Then, in the second part of this paper, these ideas will be developed further and applied to the states in the Balkans.

### **Defining the state**

Max Weber defined the state as the monopoly of the legitimate use of force. All the three characteristics – monopoly, legitimacy, force or power – are of importance.

There is only one government in a state, i.e., there is a monopoly in the provision of public governance.<sup>4</sup>

The state governs unconditionally, which means that it coerces its citizens into behaving in certain ways.<sup>5</sup>

The use of coercive force has to be legitimate, which means that it has to be either legal or accepted in some way by the citizens.

The idea of legitimacy is crucial not only for Weber's concept of state, but in general. The notion refers to the paradox of public governance best seen in a democracy. Legitimacy means that state coercion is somehow accepted, in the case of democracy even voluntarily accepted. There are a number of ways to conceptualize this relationship between the government and the governed, but there is no doubt that the idea of legitimacy captures the essential characteristic of public governance. States can obviously provide public and other goods without being legitimate. Those that do, may not be considered to be failed states, even though they fail to be legitimate. Legitimate states, on the other hand, can also be failed ones, their legitimacy notwithstanding. Thus, there are three independent notions: that of legitimacy, that of efficiency and that of the specific ways in which both are or are not supplied.

This definition of the state does not refer directly to what it is that a state does. However, given that it monopolizes the legitimate use of force, that implies that the state at least supplies security. Of course, if its monopoly is not legitimate, it may be a source of insecurity, indeed of repression for its citizens, as clearly totalitarian states were and are. The reference to legitimacy does indirectly point to legality, so that it could be assumed that a state would be supplying legal goods, which in the first place would mean justice. Simply supplying rules and order would not necessarily satisfy the demands for legitimacy, as again was and is the case with totalitarian states. In order for the legal order to be considered to be legitimate, it has to be related in some way to the idea of justice, though what is meant by that may be very different in different states.

Except by implying that the state supplies security and obliquely referring to justice, this definition of the state does not indicate what would be the economic functions of the state? The idea of justice suggests the role of distribution, as it is hard to conceptualize the idea of justice that does not imply some kind of distribution, and that is certainly an economic

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<sup>4</sup> This does not mean that the state has to be centralized. It can be a federation or even a confederation. However, competitive supply of force or power is excluded.

<sup>5</sup> That, again, does not mean that it cannot enter into contractual relations with its citizens or with firms and other organizations. However, laws and the whole legal system apply to the citizens and all the other legal persons unconditionally.

function too. But, a state will also be regulating the economic as well as every other behaviour, which means that it will also have an allocative function. It will also be using resources and the way it will do that will have consequences for the general economic developments, which means that the state will have a stabilizing role, if it chooses to exercise it (it can also have a destabilizing role as is well known). And these indeed are the three main economic functions of the state as identified in the public finance literature.<sup>6</sup>

To fulfil them, the state relies on regulation and trade, fiscal and monetary policies, though some or all of them can be shared with other states or delegated to shared or even international institutions. These are highly complex functions and policies and cannot be treated in any detail here. But it is certainly true that the level of involvement of states in economic activities has grown dramatically over the course of the last hundred years or so. How these functions are performed and what are their main consequences is the central subject of public economics and also of political economy and development economics.

Thus, at a minimum, state supplies two public goods: security and perhaps justice. In addition, it affects the allocation and distribution of resources and the stability and growth of their supply. For that, it relies on laws and other regulations and uses economic policy instruments that come down to trade, fiscal and monetary ones. As an agent, it is a monopoly that uses coercion. All of the above it can do in a legitimate or illegitimate ways. It is assumed that legitimacy is useful for the efficiency of a state and especially for its ability to reform the way it governs the society.

### **State failures**

A state may fail to meet one or all of the three Weberian requirements. Its monopoly may be contested in a more or less violent manner. It may not be able to implement its decisions even by force and may have to negotiate its authority with the citizens or with their organizations and associations. It may have a monopoly over the use of force, but it may not be legitimate. Or it may not satisfy all three of these criteria at the same time. These failures will give rise to different types of failed states.<sup>7</sup>

The lack of legitimacy was sometimes seen as the least troublesome from the point of view of the efficiency of public governance. An authoritarian government may lack legitimacy, but it may be able to make decisions and to rule. It may be argued that the important thing is whether the decisions it is taking are right and whether it can be expected to evolve into a legitimate government in time. As a rule, however, the lack of legitimacy has to be

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<sup>6</sup> The classical formulation is in Musgrave...

<sup>7</sup> Here only some most general comments on state failures will be given. More on failed states will be found in the comments in the second part of this paper. Also, some aspects of state failure, like corruption and state capture will be treated in other places in this paper.

compensated for with the increased use of force and coercion. Which then does not guarantee that the decisions taken will be the right ones and that the transition to some form of a legitimate government will be a smooth one. In any case, the issue of the demand and supply of legitimacy is certainly the crucial one.<sup>8</sup>

The state may fail to be forceful or powerful. In fact, the use of force is only one way to insure the unconditional implementation of government's decisions. More than on force, governments rely on laws and administrative measures. That is, they rely on the functioning of the judiciary and on the efficiency of its bureaucracy. The fact that the government has to be obeyed means that force can be used to coerce people into behaving in the desired way, but the less it is actually used the better the functioning of the public governance actually is. The failure of government's power is thus twofold. It can fail to elicit routine compliance and it can fail to have power to enforce its decisions.

The latter may be because it does not have the monopoly over public governance. It has been argued that this monopoly is important from the point of view of efficiency. The so-called stationary bandit, i.e., a ruler with the monopoly of the use of force on certain territory is going to deliver higher welfare to his or her subjects than the so-called roving bandit, which is the one that is competing with other bandits over the power to extract rents from the ever changing territories and population.<sup>9</sup> Whether the competition is better than monopoly is a somewhat more complicated issue, however. The costs of both, of course, have to be taken into account.

The contest over state's monopoly of power can have quite a number of causes, some of which have been analysed within the dichotomy between greed and grievance.<sup>10</sup> Some states lose authority because they are not just. Some fall victim to the greed of fighting factions, especially over the control of natural resources. Clearly, some of the failed states are those that disintegrate into the war of all roving bandits against each other.

### **Public and other goods**

These are areas in which major types of state failures can occur. Others have to do not so much with the sources and strengths of state's authority but with the content of state's actions. In a very broad sense, the state provides for basic security and justice, as is almost implied in the Weberian definition. These two public goods are not unrelated.

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<sup>8</sup> In the mainstream political philosophy, the emergence of a state is explained within the theory of social contract. In that context, the legitimacy of a state is derived from the fact that it is based on the original social contract. Though this is methodologically useful, it has limited usefulness in empirical explanations. A very interesting recent literature on that is the one which discusses the so-called "political Coase theorem". For a recent paper see Acemoglu (2002).

<sup>9</sup> The idea was introduced by Mancur Olsen. The foundational analysis is probably the one to be found in Nozick (1994)

<sup>10</sup> See Paul Collier and much of the work done within World Bank's programme on civil wars and ethnic conflicts.



Security can be threatened if there is no justice and justice can hardly be expected to be delivered if basic security is not provided for. The very fact that there is a monopoly on the use of force and especially if that use is legitimate, may be seen as a guarantee to a certain extent that there will be some basic security. Of course, if the state does not use its powers against its citizens. Legitimacy is precisely what should constrain the behaviour of the state.

The supply of legitimacy in recent history has been connected with the constitutionality of state power. The key difference between constitutional and unconstitutional governments is not whether they have written constitutions or not. Max Weber wrote on the first Russian constitution as providing a “façade constitution”. Not only because it did not look as if there was any intention to implement it, but also primarily because it did not conform to the modern idea of constitutionality. Which is that of constraining the state power over its citizens. This takes the form of the respect and protection of basic individual rights. Also, it allows for the autonomy of the civil society. Only within these constraints, the government can expect the routine compliance of the people with its exercise of state’s power. Which is to say, its use of power will be legitimate. Weber identified other types of legitimate authority, but it is clear today that the constitutionally based legal system is the only sustainable source of legitimacy.

Apart from the basic political functions of a state, its economic functions are usually classified to encompass those of allocation, distribution and stabilization. Allocation is affected mostly by the regulatory powers of the state, which include those of setting up firms and agencies that supply public or private or other goods and services. Distribution is affected mainly through the fiscal function of the state. While economic activity is stabilized through the use of practically all of the economic functions of the state, but more specifically by its monetary policy.

The justification for the existence of these public functions is based, in the final analysis, on the idea of market failures. Markets may fail to supply certain goods, among them especially the so-called public goods. Without going into the details of the theory of public goods, which is anyway standard nowadays, it suffices here to say that markets may clearly fail to supply certain goods, which justifies the allocative function of the government. They may fail to distribute income in socially desirable way, which may necessitate the distributive role of a government. And they may not provide stability and especially sustainable growth, which again justifies the stabilizing role of governments. In one way or another, all these goods that markets do not supply or do not supply in the desired way, can be subsumed under the supply and demand of public goods. Thus, apart from security and justice, which a state supplies, or fails to supply, equality and stability are also goods that a state supplies or fails to supply.

Within that context, the state can be seen as having a developmental function, i.e., the function of supplying the public good called development. In exercising this function, by among other things supplying public and other goods and services, the state can act as an entrepreneur, a manager, an owner and a provider of those goods and services. Some major changes in the thinking on these roles of the state have taken place since the collapse of socialism, however. The most important one perhaps being the increased role that the rule of law plays in development.

### **Legitimacy and reform**

The state is of course the one agency that can supply the rule of law. Theoretically, the value of the rule of law can be questioned. It can also be argued that it can be supplied privately. This is not the prevalent opinion, however. In fact, the opinion has moved very much into the opposite direction. It has become increasingly accepted that the rule of law plays a very important part in the initiation and the implementation of reforms. In fact, it is now believed that the reforms should start with the strengthening of the rule of law.

The other reason is that the state has to initiate and implement reforms and thus the issue of legitimacy of what it is doing becomes quite essential. How is legitimacy acquired is of course the crucial issue. There are, in principle, two approaches to that issue. The one is procedural and the other is substantive. The most important example of the procedural legitimacy is the one that is acquired in democracy. A government in a democracy gets the mandate to introduce certain reforms. Of course, this is not really a very simple matter, and the political economy of reforms in democratic states is a very important one.<sup>11</sup> However, in principle, the issue of legitimacy of reforms is settled in elections.

The substantive approach is the one which relies on the substance or the quality of reforms. It may be believed that, for instance because of the public good problem, there will be little or no support for reforms before they are initiated and implemented. Once they are, they will be accepted and supported, i.e., the reformist government will have gained legitimacy *ex post* where it did not have it *ex ante*. At some point, this idea was explicated with the concept of the role of technopols, i.e., of technocrats turned politicians. A technocrat would take over a post in the government or at the central bank and would initiate and implement reforms, which would subsequently gain political support and legitimacy at the polling booths. This approach to reforms depends on the assumption that at least some reforms are a technical rather than a political matter.

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<sup>11</sup> An extensive treatment is in Roland, 2000. A good treatment of the failures to supply rule of law is in Hoff and Stiglitz, 2002, and Hoff, 2000a.

Both approaches to the political economy of reforms have had to be qualified significantly in recent years. Democracies have sometimes failed to produce the needed demand for reforms while technopols have sometimes failed both in terms of the success of their reforms as well as in the ability to mobilize political support and have thus often failed to gain legitimacy for their reformist actions and intentions. Clearly, reforms are a political and not a purely technocratic matter, so the issue of legitimacy has to be addressed if they are to succeed and to be sustained.

The issue of legitimacy can be seen to be even more important when one considers the fact that there is always a reformist path that is available to the policy makers. Theoretically, in the democratic setting, due to the theorem of the agenda setter, which is an implication of the more general Arrow theorem in social choice, there is always a path of reforms that can be supported by the majority, albeit a changing one. Of course, in more general settings, agenda setting power may be shared by different influential minorities. From that point of view, the central issue of reforms is that of sequencing. However, the failures of reforms in many instances show that these agenda setting powers are not a technical, but a political matter. And that is will mean that it will have to have a necessary degree of legitimacy otherwise the reforms may fail or may become unsustainable and thus may be reversed or sidetracked. Legitimacy in question may not be a democratic one, though an argument could be made, based on the research in the public choice tradition, that over time, sustainable reforms or rather processes of modernization require the emergence of democratic legitimacy.

### **The quality of public governance**

The theory of state is almost inevitably normative. Whether one has in mind political economy, public choice or social choice theories, they all combine positive analysis with some kind of realistic utopia, as Rawls has called it.<sup>12</sup> Even when the issues of market allocation of resources are discussed the normative element cannot be eliminated. The key concept of Pareto efficiency testifies to that. This is even more the case when it comes to the issues of distribution, i.e., to the issues of public finance more concretely. Both the determination of the level and structure of public expenditures and of the tax regime are inextricably connected with the notions of justice, fairness, equality and equity. These notions are also used to assess the quality of government.

What does that mean? Vito Tanzi, after discussing the role of the state, says the following: "I will define the quality of the public sector as the characteristic that allows the government to pursue its objectives in the most efficient way".<sup>13</sup> This definition is purely instrumental.

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<sup>12</sup> See for the latest statement Rawls, 2001.

<sup>13</sup> See Tanzi 1999.

The objectives referred to there are to be found in the public policy pursued, which is determined within the political process. He says that the distinction between the public policy, which includes a set of policies, and the public sector, which consists of the set of instruments that implement those policies, is artificial. It is probably not even useful. Though in many countries there is a distinction between the policy-making bodies and the administration or the bureaucracy, it is hard to see that the whole of the public sector can be understood in that way.

The one reason why the relation between the public sector and public policy cannot be usefully separated has to do with the principal-agent problem involved. This problem is the one that is captured by the notion of legitimacy. The state has the power to coerce its citizens into behaving in a certain way, but it does it on their behalf. Thus, though in every concrete case, or rather during the normal workings of the state, the state is the principal and the citizen is the agent, from the point of view of the legitimacy of state's actions, it is the other way around. Therefore, it is not enough for a state to function efficiently; it has to have the proper legitimacy.

### **Public and private partnership**

The other problem is that the public and private spheres are inter-related. For instance, let us take the case of a commercialized public firm or bank. It may be argued that the goods they produce or services they render are those that the public policy makers want them to make or perform, while the aim of that firm or that bank or rather of its management may be to make profits for the government. From that it cannot be concluded that the government's aim is to make profits when it sets up that concrete firm or bank. These two goals may in fact coincide and that may be the most efficient way to perform that particular public function, but the goals of the policy making body and the state firm or bank are clearly different. They of course may be in conflict because the question can be raised why is that part of the public sector not privatized if it is a profit making one?

The example with a commercialized public firm can be used to look some more into the issue of public and private partnership. This is a rather key issue in the post-socialist thinking on the role of the public sector. In a sense, it may be argued that as soon as profit can be made, it should be up to the private competitive business to go after that type of business. The state should retreat into the role of a regulator, but should not act as an entrepreneur. Alternatively, the business should be conducted on the basis of budget management. A state, on this thinking, should be a budget centre and not a profit centre. This is a neat distinction, but it cannot be always maintained. Indeed, recently, the idea of public and private partnership in transition and development has become quite a popular one.

This interconnection of public and private interests is the key one, and though it is not new, there are new ways that it has been analysed in recent times. These analyses are at the initial stage at this moment, but they will inevitably become more concrete because the neat distinctions between the public and the private sectors are not really satisfactory either in their normative sense or in their empirical applicability. This analysis of the public and private partnership gets even more complicated if the distinction between public and private goods is simultaneously introduced. Public and private agents can cooperate both in the supply of public as well as of private goods. As public and private goods will, at least to some extent, be complements, very complex issues of for instance regulation of infrastructure (including net-bound infrastructure) investments will be involved. To this, the international dimension should be added to see the full complexity of the role of the state that emerges. In that context, weakness, both financial and legal, of a state is a very serious impediment to reforms and development.

## **2 Bringing the state up**

### **Introduction**

The recurrence of theoretical controversies about the precise definition of “the state,” the most appropriate strategy of analysing “state capacity” and the heuristic value of the concept of “state weakness” should not make us oblivious to an obvious and simple fact: virtually all scholars who have spent some time researching post-communism agree that - cross-country differences duly acknowledged – quite a number of post-communist states are malfunctioning in some fundamental ways. That now the state is “weaker” than before, which may not be meant in a negative way, and that it is “weaker” than it should be, which is usually meant as a criticism, these are among the very few empirical and normative claims about many post-communist countries which would hardly engender serious dissent.<sup>14</sup>

“They may not provide liberty”, commented Huntington on communist states, “but they do provide authority. They do create governments that can govern” /Huntington, 1968/. A decade after the collapse of communism, the state of the post-communist state is quite different. These states may try to provide liberty but they often fail because they are unable to provide authority. They do not create governments that can govern. Why some transition countries, for instance most of those to be found in the Balkans, fail to create governments that can govern and how the vicious circle of state weakness can be broken is the central question of this part of the paper.

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<sup>14</sup> See Holmes (1996), Przeworski (1995), Amsden, Kohanowicz and Taylor (1994), Burawoy (1997), Kohanowicz (1994), O'Donnell (1993), Stark (1995), McFaul (1995).

## State and reform

In 1997 Global Development Report “The State in the Changing World” World Bank re-introduced the state as a major development actor. The new development paradigm outlined by the Report came as a response to the failure of the state dominated development on one side and the failure of the experiments with “the spontaneous birth of capitalism” on the other. The failure of the state socialism was the most powerful illustration of the limits and dangers of the state dominated development. The failures of the post communist transition in countries like Russia, on the other side, proved the point that the functioning state is a necessary pre-condition for the efficiency of the market and not an outcome of the work of the market. The Report stressed that development requires an effective state one that plays “a catalytic, facilitating role, encouraging and complementing activities of private business and individuals” /World Bank, 1997/.

The four key developments that provoked World Bank’s re-thinking of the role of the state were:

- The collapse of the communist system and of the socialist version of the developmental state that was fashionable even outside of the socialist block in 1960s and 1970s.
- The fiscal crisis of the welfare state in the West and practical impossibility to export a version of the social democratic state to the developing countries.
- The successful role of the state in the East Asian miracle that proves that a state is a critical player in the process of development.
- State collapse and the escalating need for humanitarian intervention that has boomed with the end of the Cold War. It was recognized that intra-state and not inter-state conflicts are the major risk for the global stability in the end of the 20<sup>th</sup> century.

In theoretical terms, the Report summarized the academic consensus that was born in the 1980s around the idea of the relative autonomy of the state as a developmental actor. Marxist and pluralist interpretations denying autonomous role of the state were marginalized. It was recognized that state could not be reduced to an “instrument of dominant class interests” /Evans, Rueschmeyer, Skocpol, 1985/. State was discovered as an institution and as a social actor. It was distinguished for its territorial and centralizing character /Mann, 1987/.

World Bank’s analytical perspective was expressed with the notion of “effective state”.<sup>15</sup> Effective state was introduced both as a normative and descriptive concept. Trying to bypass “big government” versus “small government” debate authors of the Report defined

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<sup>15</sup> Which is also reflected in Tanzi’s definition of the quality of the public sector quoted above.

effective state as a state where ambitions are matched with capabilities /World Bank, 1997/. The state capabilities were defined as “the ability to undertake and promote collective actions efficiently” /World Bank, 1997/. In the view of the World Bank the expansion of the state that has taken place under two different ideological systems in the period of the Cold war has reached its limits. Avoiding the scholastic debate about the proper size of the state, the Report underlined the complex relationship between ambitions and capabilities as the defining nature of the effective state. Report concentrated its interest on how the budget revenues are raised and how the budget is spent. The underlying assumption was that “the budget is the skeleton of the state stripped of all misleading ideologies” /Goldschied/

Achieving the effective state thus implied two reform strategies:

- Optimizing the size by matching ambitions with capabilities. The critics of the Bank called it the “withdrawal of the state”.
- Raising state capabilities by re-invigorating state institutions. Donors’ programmes called this strategy “institution-building”.

Post-communist countries were faced with the task of smartly downsizing direct government involvement while improving their bureaucratic capacity. To this, greater stress on the rule of law and the strength of institutions and of the civil society was later added. That coincided with the recognition that not only the state, but also the whole set of institutions are important for development.

### **Welfare state or farewell state**

The years that passed after the publication of “The State in the Changing World” questioned the usefulness of the effective state approach. The reform strategies designed around the idea of effective state assume a kind of functioning state as given. In reality the proliferation of the governments that cannot govern questions the ability of a post communist state to provide authority and to deliver rule of law. It turned out that fiscal sociology is not enough for formulating strategies for reforming or re-creating the state after communism. The study of the state could not be reduced to the studies of the state budgets. The major developments that shaped the thinking of our paper are:

- The crisis of the East Asian model that followed the 1998 crisis of these economies and that replaced the notion of effective state with much more normative concept of good governance as a precondition for development.
- The failures in the different parts of the world to overcome state weakness and the emergence of sustainable weak states.

- The rising security costs of the existence of failed states in the context of the global terrorist threat. This new developments provoked the debate on liberal imperialism and nation building from outside.
- The transformation of European integration into instrument of state building in the Balkans.

These new developments re-formulated some of the key questions that were raised in the 1997 Report. At the moment, as already mentioned, there is the shared view that many post-communist states are weaker than they were before and, what is more important, weaker than they should be. Public trust in the institutions in for instance Balkan post communist states is generally low /International IDEA/. Both from inside and from outside, Balkan countries are seen as corrupt and inefficient. Respective governments only nominally control sizable parts of their territories. How to overcome state weakness and failed states equilibrium are questions that await their analytical answers. In addressing these questions we will concentrate our attention on the experience of the Balkans in the last decade. There are several reasons for recognizing the Balkans as a God given laboratory for understanding state failure and state weakness.

- For the Balkans 1990s was a process of intensive state building following the dissolution of Tito's Yugoslavia. In the region we can observe un-peaceful coexistence between the traditional strategies for building modern nation-state with imposed constraints and attempts to transform the process from nation state building into member state building /members of EU/.
- The region presents a strange mixture of weak states, former failed states and present protectorates.
- The region presents a variety of constitutional choices.
- The Balkans is that part of the world where the outside driven state building is most intensive and strategic.
- The region presents a promising opportunity to understand the failure of the international strategies to overcome state weakness.
- The involvement of the EU and the existence of EU membership as the unique incentives for state-building makes the Balkans the best test for the limits of liberal imperialism.

Perhaps the following classification of political regimes in the Balkans could be useful:

Countries approaching an advanced stage of democratization:<sup>16</sup> Romania and Bulgaria.

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<sup>16</sup> By democratization the process of building of democracy is meant. It is taken to include at least two or three more or less free and fair elections and at least one orderly change of the parties in government.



Countries in apparently sustainable process of democratization: Croatia.

Countries in the (post-crisis) process of democratization: Albania.

Countries at the start of the process of democratization: Yugoslavia (Serbia and Montenegro).

Countries recovering from a severe political crisis (breakdown of democratization): Macedonia.

Countries with significant international security and political presence (quasi-protectorates): Bosnia and Herzegovina.

Territories at the start of the process of democratization: Montenegro.

Territories that are *de facto* international protectorates: Kosovo.

Political entities within quasi-protectorates: Federation of Bosnia and Herzegovina and Republic of Srpska.

Divided cities, out of control cities and villages or cities under special international care: a number of them in Kosovo (e.g., Kosovska Mitrovica), Bosnia and Herzegovina (e.g., Brcko) and Macedonia (e.g., Sipkovic).

Clearly, the types of failed or weak states that emerge from this classification span most of what can be found in the rest of the world too. The difference, perhaps, in the level and extent of international involvement, though the same can be said for a number of other regions. Otherwise, in the Balkans, as in the development world as a whole, there are countries in the process of democratization, which may not be a sustainable one, there are those that are beset with a protracted political crisis, stemming from a deep internal division, there are failed states or territories, that are under one or another type of international observation or protection and there are states that are in conflict with their neighbours or with the region in which they find themselves. All of these states tend to be weak in the sense to be defined below.

### **Defining weak state and failed state**

The notions of “weak state” and “failed state” became critical elements in the current discourse on the concept of the state, but in most of the cases they are used as metaphors and less often as analytical terms. The notion of a “failed state” is used with misleading easiness for cases as diverse as Somalia and Russia /RAND, 2001/. A “failed state” is assumed to be like an elephant, when you see it you will recognize it.

In the Balkans, Bosnia and Herzegovina, Kosovo and Albania in the spring of 1997 were defined as failed states. In theoretical terms a failed state represents a form of return to

what Hobbes called the state of nature. Kaplan prefers to describe this new condition as “criminal anarchy” /Kaplan, 2001/

From the perspective of international law “failed state” has three decisive characteristics:

- Absence of bodies efficiently representing the state. In other words lack of government that can be legitimate partner in the negotiation process.
- Intensive violence.
- Need for humanitarian intervention. In practical terms it is the decision of the UN Security Council to intervene that is used as the practical criteria for enumerating the failed state.

In Weberian terms failed state has the characteristics of a non-state. It represents the disappearance of the legitimate monopoly of violence over certain territory that formally has been recognized as a state. Security and justice as public goods are either not provided or provided by illegitimate private agents. Albania in the spring of 1997 represents a classical case of state failure. The structures that should have guaranteed the rule of law had failed completely. There was no police, no judicial system. To the extent that policemen were to be found on the streets, they were agents of private violence. There were a lot of weapons grabbed by the population; the state of insecurity was total. The state was neither taxing nor spending. In this sense “failed state” should be contrasted not only with functioning state but also with the state of civil war where the war parties control parts of the territory of the state and are fighting either to control the other part or to consolidate the control over the territory they have. This is not the case with the failed states where none of the agents succeeds in establishing monopoly on violence over the significant territory of the state.

Overcoming state failure is a major challenge not only for the Balkans. In his reflections on the need for liberal imperialism, Robert Cooper singled out the proliferation of failed states as the major challenge for the new international order /Cooper/. In his provocative vision of the need for new imperialism, Cooper described the current situation as the one in which there is a demand for intervention but the supply is absent. In the view of Alain Joxe the major characteristic of the new world order is that the world hegemon /US/ is a strange type of an empire. US come, but it does not stay. US “does not intend to assume the general protection of citizens, only regulates disorder through norms of behaviour implanted on their allies” /Joxe, 2002/. This new imperial chaos directly affects the process of state building in the Balkans when it comes to the function of the existing protectorates. In the case of Kosovo protectorate functions as both an instrument for state building and as a legal and administrative corset preventing the emergence of the independent state in Kosovo. The situation is even more complicated by the fact that protectorate regimes are combined with the forms of democratic representation. Following parliamentary elections in

Kosovo in November 17 we can observe a situation when we do not know how many de facto states we have in the Balkans what we know is that they all are democracies.

### **Defining the weak state**

In the World Bank Report “weak state” is interpreted as an ineffective state, state that suffers from the mismatch between ambitions and capabilities or the one that suffers from low state capacities. But this interpretation of state weakness seems to be insufficient in understanding the twists of the post-communist statehood on the Balkans. There are two types of analytical questions that await their theoretical answers and both of them define two promising research agendas. The first question has to do with the weakening of the state in the transition period. The other one has to do with the re-production of the state weakness. “It is easier to explain why communism had to fall than why it did”, wrote Adam Przeworski. This observation is even more relevant to the process of the collapse of the communist state. What happened in the process of transition that explains the collapse of the statehood? Did the state collapse as a result of the collapse of the communist type of society or was the collapse of communism primarily the collapse of the communist type of state? The second question is even more unexplored, and it is still not known why after a decade of transition the weak state is re-producing itself in places like the Balkans.

The discussion of the state weakness has long tradition in the theoretical literature. “Weberian minded comparativists started labelling states “stronger” or “weaker” according to how closely they approximate the ideal type of centralized and fully rationalized Weberian bureaucracy, supposedly able to work its will efficiently and without effective social opposition” /Evans/. Neo-Marxists will not accept such a definition because for them “strong state” is a state with a strong capitalist class that can efficiently articulate its interests. In the Weberian sense, Prussia in 19<sup>th</sup> century is stronger than US in the same period while for the neo-Marxist it will be the opposite.

In his influential work “Weak States, Strong Societies” Migdal defined the strength of the state as its ability to penetrate society. In this respect we can define state weakness either as the weakness of the autonomous role of the state or as a weakness of its organization capacities. The weak state is either captured state or a state with inefficient bureaucracy. In “Bringing the State Back In” Evans ...have demonstrated that the general judgments about the strength of the state can be misleading. They have demonstrated that there is not necessarily a positive relationship among different kinds of state capacities. A state can be efficient as tax collector and a bad public manager and so on.

The metaphorical use of the notion of a “weak state” has become an obstacle to the study of state weakness. In the transition discourse, “state weakness” has been related to the shrinking of the state, to the collapse of the health and pension systems, to the inefficiency

of the state bureaucracy. In this sense there is an urgent need for definition of weak state that can be analytical tool for understanding the failure of the state in the process of transition. For us weak state can be defined as a state that fails to protect the rights of citizens and property rights. The failure in providing rule of law is the basic characteristic of weak state.

Interpreting the weakness of the post-communist state raises several research questions.

### **The sources of state weakness in the Balkans**

There are four interesting trends of research that try to understand the state weakness as a post-communist phenomenon:

- (1) Already in the beginning of transition Jon Elster and Claus Offe have developed the idea that transition societies are facing a triple transition and that the task to build simultaneously states, markets and democracies can result in the state failure. Elster-Offe hypothesis urges for re-reading of the policy sequencing as the major choice to be made in the period of transition. Can state weakness be defined as the failure of simultaneity?
- (2) The developments in the Balkans gave rise to more strictly constitutional explanation of state failure and the emergence of weak states. Robert Hyden and others have interpreted the dissolution of Yugoslavia as an outcome of specific constitutional choices that were made in 1960s and 1980s. The current debate on the paralysis of the state in Bulgaria predominantly refers to the constitutional choices that were made in 1991 constitution. Similar trend can be noticed with respect to the Macedonian constitution and the debate on the Dayton Agreement on Bosnia and Herzegovina.
- (3) In his insightful analysis of the collapse of Soviet Union Steven Solnick does not use the collapse of communism as an explanation for the state weakening. In his view the collapse of communism was basically a break of communist state and manifestation of the weakness of the central power. "In effect, Soviet institutions were victimized by the organizational equivalent of a colossal "bank run", in which local officials rushed to claim their assets before the bureaucratic doors shut for good. As in a bank run, the loss of confidence in the institution makes its demise a self-fulfilling prophecy. Unlike a bank run, the defecting officials were not depositors claiming their rightful assets, but employs of the state appropriating state assets" /Solnick, 1999/. In this interpretation state weakness is result of the state failure of communism, a kind of a post-run condition.
- (4) There is also a trend that views weakening of the state as the strategic outcome of the interests of post-communist elites. Weak state creates the crime without punishment

environment that is the optimal environment for the Great Re-Distribution that took place in the last decade.

A weak state is not necessarily a state that does not dispose of significant resources. In the Balkans, some states are weak in that sense too. Thus, Albania and the territory of Kosovo are weak in the key sense of the rule of law being weak or very weak, but they are also weak in the sense that they do not influence the economic developments very much. This can be seen from the level and structure of their public finances. Tax revenues are hovering around 10 to 15 percent of GDP while public expenditures are larger by about 10 percent of GDP, which is effectively the fiscal deficit. Most of public investments are part of the international reconstruction effort or are financed from international aid or with soft-loans. This could be taken to be the prototype of a weak state.

Other states in the region collect significant resources in public revenues and have even larger public expenditures. Thus, a number of states or territories spend more than 50 percent of their GDPs via the budget. They also collect a lot of revenues. In that sense, a number of Balkan states cannot be called weak. However, as in other developing countries, the sources of revenues and the structure of expenditures show significant weaknesses or inefficiencies. There is no need to go into details, so only some general characterizations should be given.

On the revenue side, the usual problem with the tax base being rather narrow can be found. There is a large and growing informal economy and the taxes are collected mostly from state owned companies and from consumers. To this the revenues from tariffs should be added, which are essential in a number of cases.

On the expenditure side, a lot of money is spent on wages and salaries, on the military, on transfers and subsidies and relatively little on public investments. Thus, public expenditures are “selectively paternalistic” a euphemism for what is otherwise called a captured state.<sup>17</sup>

### **Modes of state weakness**

Following the theoretical discussion on the strength of the state we can separate two different modes of state weakness. State can be weak as a result of losing its relative autonomy with respect to civil society and the result will be a captured state. State can also be weak as a result of total inefficiency of its bureaucracy. In the current research on corruption these two modes of state weakness are well distinguished. In their influential study “Seize the Day, Seize the State” Kaufman and Hellman have demonstrated that state capture and administrative corruption are not identical and that it is the state capture

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<sup>17</sup> More on that in Gligorov, 2000.

that has more negative effect on the business environment and the confidence in institutions. In our definition of weak state it is the state capture much more than administrative corruption that determines the essence of state weakness.

Still, corruption is not an unimportant phenomenon, quite to the contrary. The sources of corruption are many, but some have to be attributed to the state interference with the allocative role of the markets. Also, as indicated above, some of the Balkans states transfer a lot of money. This is another sign of state weakness as identified in the theoretical literature also. Political unstable countries tend to spend more from the budget because they need to buy the support of different strata of the society. In the Balkans, the population is rather old, so transfers to pensioners and other recipients of social welfare are quite significant. Also, unemployment is high, so subsidies are also significant. Finally, the large number of unemployed fuels the large informal market. In some cases, between one third and one half of the GDP is produced in the informal economy. This large-scale tax evasion leads to the large demand for bribes and thus to the pervasive and persistent corruption. There is nothing special about the Balkan corruption, so whatever is known about the effects of corruption applies to the Balkans too.

One is of special importance. That is the fact that it is very difficult to root out pervasive corruption. Though the presence of corrupt practices tends to be overestimated, there is no doubt that it is very much a reality. The effect on the quality of public governance is obvious. There is clearly no way in which it will be efficient in the sense of the World Bank and it is not going to be functional too, as it will not perform some of the functions of the state almost by definition. However, a corrupt state is not necessarily a state that is out of a legal, economic and social equilibrium. Indeed, corruption is a way in which certain public functions get privatized and that arrangement can be even Pareto-optimal. It can also be equilibrium one even if it is Pareto-inferior. All of this is not unknown in the theoretical economics of development as the subject is almost presumed on the existence of multiple equilibria that could be Pareto-ranked.

Indeed, this one of the justifications for the important role that a state should play in the development process. However, the principal-agent problem is crucial here and the case of corruption exemplifies it very well. The state should act against corruption, i.e., the corrupt agent should be the main agency in the eradication of corruption. There is clearly a problem of will and determination involved.

### **Overcoming state weakness**

In the current debate there are two principal approaches with respect to state weakness. The first is the administrative approach that is promoted by EU and other donors and it can be summarized as bureaucracy building. It implies that external conditionality coming from

EU will be the instrument for successful state building. On one side EU is re-capturing the captured state turning the legislative process into a process of harmonizing local legislation to the legislation of the EU. On the other side the very process of accession creates the need of efficient bureaucratic elite that will be the skeleton of the future Weberian ethos. The essence of this strategy is designed around maximal strengthening of the autonomy of the state.

There is an alternative approach that views the overcoming of state weakness through re-politization of the society and increasing the influence of the social interests over state's decision. In this perspective, overcoming state weakness is possible only as an intensive democracy building and increasing the representative character of the regimes. Can these two strategies work together, under what conditions each of them can break the weak state equilibrium are the basic questions to be asked.

### **Transition as state-building**

In our view, the moment has been reached when social sciences are ready to read the transition as a state-building exercise and to develop what Gianfranco Poggi calls "a state-centred understanding of the state," in other words a clear understanding of "how state power is generated and stored" and what factors impact on that process in concrete contexts.<sup>18</sup> This understanding does not entail turning the state into the sole factor of post-communist development. It mandates, however, that the analysis of various "inputs" in the political system - such as the ideology of incumbent elites, international pressures, "blueprints" for reforms - be juxtaposed to an interpretation of the internal dynamic within the set of institutions concerned with the exercise of the political and economic prerogatives of the state. Given the sprawling institutional legacy of communist, this is a daunting task. But if properly approached, it will yield better understanding of the causes of state weakness in post-communism. And the first step in this respect is the recognition that inquiries into the dynamic of evolution/involution of institutional arrangements is more important for the analysis of the post-communist state than the critique of specific policies designed by temporarily empowered elites.

One of the major insights to be drawn from the literature on state formation is that the proposition that state institutions are "there," available upon demand, is valid only in certain times and places.<sup>19</sup> The absence of the state is what makes its reform so difficult. Thus the analysis should proceed on the assumption that these institutions have to be re-made. And the "re-making" of states - as Tilly points out - involves "the combining, consolidation,

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<sup>18</sup> Poggi, *op.cit.*, pp.99-98

<sup>19</sup> For a similar idea regarding the availability of coherent and corruption-free bureaucratic institutions, see Evans and Rueschemeyer.

neutralizing, manipulating a tough, complicated and well-set web of political relations.<sup>20</sup> It is these relations that need to be explored more fully. What is the nature of “pro-“ and “anti-state” coalitions, and what factors have an import on their formation? In what organizational forms do these coalitions crystallize and what is it that they fight over? How should we think of their failures and successes? What spheres of government are more likely to be infested with the virus of destabilization and why?

Another crucial problem from a state-building perspective is the problem of “extraction” or “predatory action.” In fact, there is a widely shared consensus in the literature that without a proper account of dominant modes of extraction the provenance and functioning of modern states will remain obscure.<sup>21</sup> Historically, the institutional origins of modern states - the emergence of the administrative agencies and bureaucratic bodies - have been traced to the efforts of powerful elites to make extraction a sustainable social process. This set of issues should be applied to the study of post-communist state formation in order to explore how various tactics are used to establish control over flows of resources and what patterns of institutionalized interaction emerge when the state’s monopoly over the use of violence is weakened.

### **3 State, growth and reform**

#### **Introduction**

The capacities of the state and its strength are important from the point of view of growth and development. Even if a state is legitimate and relatively strong, it should still not be taken for granted that it will be successful in bringing about the necessary reforms and in ultimately reaching the developmental goals that it may have. This is partly the consequence of the lack of knowledge that social sciences and especially economics can supply.

#### **Development and disintegration**

The developmental role of the state was initially discussed within the framework provided by Rosenstein-Rodan, Hirschmann and Gerschenkron.<sup>22</sup> It was eventually summarized in the idea of a “big bang”. From the point of view of the role of the state, certainly Gerschenkron’s discussion of backwardness is the central one. The idea may be expressed in the following way. Assume that capitalist development has not emerged spontaneously in a country or a region. Entrepreneurs are scarce and the financial

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<sup>20</sup> Tilly, p.25.

<sup>21</sup> On the importance of “extraction,” see Tilly, ch.1 and Downing.

<sup>22</sup> For a recent restatement see Hoff (2000b).



institutions are weak. So, they cannot be the agents of development. What can be the functional alternative? The answer is that the state should step in. It can mobilize resources and investments. Especially in those areas which are crucial for development but fail to be provided for privately. For instance, when it comes to infrastructure development or education or even in the case of production of consumer goods and services.

The collapse of the socialist thinking has led to the rethinking of this idea of the developmental role of the state. The state came to be distrusted as an entrepreneur, an owner and a manager. It was, however, realized that development is still a problem, so functional alternatives to the state were found in privatization and liberalization. When these ideas were put into the macroeconomic context, the so-called Washington consensus set of policies emerged. Without going into the details of this consensus, it suffices to say that the ideas of privatization and liberalization were seen as substituting for the state in the sense that the private sector will provide for entrepreneurship and management and the lack of these resources domestically could be supplemented by the reliance on the international market. The latter would provide not only for the added demand but also will supply the necessary investments and technology.

This same idea was applied to transition economies. Only later in the process it was recognized that rather than spontaneous creation, a process of disintegration can set in.<sup>23</sup> The sources of disintegration are several.

One is that which emerges with the break up of states.<sup>24</sup> There are quite a number of theories of secession and of collapse of states. Not all of them due to disorganization. But certainly the disorganization of the centrally planned economies leads not only to the break up of large industrial complexes but to the break up of "budget centres" as well. Whether the break up of states is an outcome of disorganization or is the cause of disorganization, the consequences are similar. Public governance initially suffers. And thus the developmental role of the state can hardly be maintained.<sup>25</sup>

The other aspects of disorganization have to do with the emergence of large informal sectors in the economy. In some cases, three distinct sectors coexist uneasily in a transition economy: the state sector, the private sector and the informal sector. The state has a rather difficult task to regulate the economy in such circumstances. This state of affairs is not really characteristic of economies and states in transition only, but of many other developing countries too. Though in the case of transition countries this is the consequence of disorganization connected with transition, in other cases it can be

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<sup>23</sup> On that, see Blanchard, 1997.

<sup>24</sup> On that, more in Gligorov, 1994.

<sup>25</sup> There is more on that in the second part of the paper.

connected with the lack of organization in the sense of non-existence and non-emergence of appropriate public and civil institutions.

Other aspects of disorganization are also quite important. Especially because they lead to the state losing its capacity to initiate and implement reforms. This is the other aspect of state role that should be discussed here. With the disillusionment with the developmental role of the state came also the belief that its major role as a reformer is mostly negative. It was to divest itself from the economy and to open up its internal and external barriers or borders to the workings of the market. Initially, it was believed that the social and institutional support for these reforms would not be lacking or rather that they would emerge as the demand for them appears and grows. The experience shows that this was not altogether correct. And the reasons are rather fundamental and should not have been easy to miss.

### **The special importance of growth/development**

In the final analysis economic policy and everything economics has to say on it is about two things. First it is about improving living standards and welfare, which reflect an economy's absolute growth/development capacity, and second it is about economic convergence, which reflects an economy's relative growth/development capacity. The success with which policies deal with these two issues to a large extent determines the fate of policy makers, often even in the short run but certainly in the medium run. In economic history there are very few examples where policy makers who generated "modern economic growth" (Kuznets, 1955) and convergence lost power. At the same time there are many examples of otherwise quite disgusting regimes and policy makers maintaining power while they were able to generate high economic growth rates and convergence. The Austro-Hungarian Empire in the early 20<sup>th</sup> century is perhaps the only example of the former (Good, 1984) while Stalinist regimes during the fifties are examples of the latter (Estrin and Urga 1997). There are also many examples of policy makers losing power or even of a regime change when growth and convergence stopped. The collapse of socialist economies and the transition are largely explained by this (Blanchard 1997). Continuing along this vein, one must also note that many policy makers gained power by promising growth and lost power when they could not do good on their promises. This is because absolute and relative growth issues are intricately built into population expectations and hence voting behaviour. This kind of "real world importance" gives absolute and relative growth related issues special importance.

Southeast European economies offer an excellent example. The high growth rates during the Golden age of European growth made two of them, Bulgaria, Yugoslavia, each in its own way success stories (see Estrin and Urga, 1997); but with the growth crises from the eighties onwards, the regimes lost legitimacy and failed the population's expectations. That

was certainly an important building block leading up to the eventual transformation of the nineties. Since then they have undergone massive institutional and sectoral restructuring (the transformation) largely with the expectations of growth and convergence. The failure of the regime change to deliver “modern economic growth” is, arguably, a major source of instability and discussions about failed transformation, second transformation and the like (Bicanic and Franicevic 2002).

A discussion of absolute and relative growth performance contains three central issues. The first concerns the secular long run growth path of an economy and its determinants. The second and more challenging issue concerns path determinacy and whether the secular long run absolute and relative growth performance can be improved upon by accelerating it and making it socially more acceptable. The third and arguably the most challenging is whether the secular growth path can be improved upon and how can this be achieved, by what reform strategy and its policy package.

The first two issues could be considered as purely academic and the concern of theoretical and empirical economics (covering a wide range of disciplines). The third, in contrast, by its nature is both an academic and a policy issue involving social choice. However, since the economic profession offers no clear answer to any of the three issues, none of them can be considered purely "technical". This in turn means that differences cannot be resolved just by economics and economists, with those who are the better professionals (and with their theory and empirical results) winning the day. Issues regarding different approaches, differences of interpretation and especially various offered pro-active policy solutions cannot be resolved by economics alone.

The "technical" ambiguities translate outside economics and into the social environment. Here, the complex mixture of population expectations, Krugmanite "growth policy entrepreneurs", politicians with political cycles, make the area of discussion even broader and the ambiguities even greater. Because of this pressure to abuse growth related issues, the economists (and in turn the social environment) should be aware about the nature and the scope of the "technical" ambiguities and, equally importantly, where the profession offers and does not offer results.

### **The "menu" of results from theoretical and applied economics**

The fact that all three above mentioned aspects do not command a consensus with clear answers in the economics profession (and from that point of view are "soft") does not mean that economics cannot set boundaries within which a serious discussion can take place. To appreciate these boundaries it may be useful to review the relevant results from theoretical and empirical economics.

Economic theory offers two dominant and mutually irreconcilable approaches to the issue of absolute and relative growth. Each has radically different policy implications

The first, and probably still dominant, is the neoclassical growth model (Solow-Swann, dealt with in every major macro and growth textbooks, in the case of the latter Jones, 2002, provides a standard presentation while a more technical approach can be found in Barro and Sala-i-Martin, 1995), which solves both relative and absolute growth issues at the same time. In this view, all economies are converging to a common long run equilibrium rate whose growth features are exogenously determined. However, the growth path is structurally determined: remove structural differences and the path economies are converging to becomes the same as well. The convergence is guaranteed by the efficient performance of market institutions, complete private property rights and optimizing economic agents. Individual economies deviate from this path because of barriers, institutional and others, to the requirements of efficiency. The policy implications of this approach are twofold. The first set is passive but clear, see Solow (1997). Since it is exogenously determined the features of the long run equilibrium growth rate cannot be influenced, so policy is confined to removing anything that is preventing the efficiency of markets, private property or limiting agent optimization. These barriers must be removed through a policy package. The second set does not concern the growth rate, or absolute convergence, but the growth path and structural differences which lead to divergence (see Pritchett, 1997), produce club convergence (see Quah, 1996 or Gomulka, 199x) or the lack of any general convergence (Islan, 1995). This path can be influenced by two kinds of policy choices and thus active policies. The first concerns an optimality problem and the second is related to club convergence and to the ability to move from an unwanted into more favourable growth club (called club-skipping).

The second and more recent approach is that of endogenous growth approach (Romer-Rebelo, included in all macro and growth textbook, but often also in a less technical manner, e.g., in Jones, 2002, or see for a technically more demanding treatment Aghion and Hewitt, 1998), which retains the institutional framework of markets and private property in a world of optimizing agents but defines the features of the long run growth rate and growth path endogenously through a technological progress generating assumptions. The usual technological progress generating assumptions are based on versions of learning-by-doing or research and development theories, and in either case this makes the long run growth path and growth rate subject to choice and thus a policy issue. The approach expands the policy scope since, in addition to all the passive and the optimum growth policies of the first approach, it also includes active ones in order to determine the long run growth rate. This is done through the policy dependence of technological change. But with the gain in the ability to choose the long run growth path - and with it the ability to account for the very important issues of overtaking and falling behind - comes at a cost of losing

the ability to discuss non-equilibrium growth and with it the possibility of discussing convergence. Another loss is the inability to directly test the validity of the theory.

Regarding the results in standard empirical economics there are three strands: regression analysis with growth factors, the residual and global factor productivity and the analysis of economic convergence. Over the recent past all three standard strands of empirical growth research has led to some important results which have significantly increased the understanding of growth and the possible scope for growth policies.

Regarding the first approach, it is probably the case that the mining of panel growth data, which started in the early nineties with Barro's seminal paper (Barro, 1991, and Barro, 1997, and a number of subsequent publications), reached its climax in the mid-nineties and has probably come to the end of its productive life. It seems now that the econometric techniques and computer capabilities have outgrown the data and the researchers are trying to squeeze new results out of increasingly massaged data of ever more dubious quality requiring assumptions, which stretch the imagination to the limit. With millions of growth regressions (see Sala-i-Martin, 1997) and with the voluminous literature on growth regressions (for a survey and more sceptical view see Temple, 1999), researchers have used panel data to introduce ever-greater number of new explanatory variables. Except for realizing the obvious importance of factor accumulation (physical and human capital and labour), and hence of the share of investments/savings, the profession has reached a consensus only about another growth factor: international trade (even though the direction of causality remains unclear, see Rodriguez and Rodrick, 1999). Regarding the other growth factors most frequently used in regressions (share of state expenditure, level of economic inequality, infrastructure investment, population growth, competitive pressures, rule of law, expenditure on research and development) there is no consensus in the profession either regarding their importance or their causal links to growth. Various studies offer different results, though most economists remain convinced that these should be the main growth factors and that more research is needed to show that. In spite of quantitative ambiguities, these growth factors have influenced the policy discussion and have had an important influence on mainstream economists. Still, because of the existence of these ambiguities and under the influence of the dissenters in the profession, the economists have started to include other factors, such as the notion of social capital and the importance of institutions (for the latter see Rodrik, Subramanian and Trebbi, 2002).

The second strand of research dealt with the factors that contribute to growth (for a survey see Temple, 1999). The research in the sixties started with the initial dominance of global factor productivity (which was interpreted as technical progress and not as a residual, measuring ignorance) with the small influence of factor accumulation. Via "squeezing the residual", by introducing new variables (human capital) or redefining traditional ones (capital and labour), the research results returned to the 19<sup>th</sup> century importance of factor

accumulation (Rodrick, 1997) only to recently return back to a pruned resurrection of technical progress (Easterly and Levine, 2001).

The third strand of empirical research concentrated on economic convergence. This is the only one directly linked to a theoretical approach (the neoclassical model). The results are clear. With respect to global convergence no absolute convergence has been found and growth rates do not behave as predicted (Pritchett, 1997). But very interestingly growth clubs have been found (most importantly for OECD economies) and for limited data sets (EU regions, US states, Indian states, Swedish and Japanese counties) convergence seems to exist (Quah, 1996 or UN ECE, 2000). Ongoing work is still attempting to show that the data, when suitably sanitized, does behave in the manner predicted by the theory.

To these dominant strands of empirical research in mainstream economics, one must add another kind of research, which breaches theoretical and applied research and includes many disciplines. Because of the apparent "softness", this kind of work is often looked down upon by some mainstream economists. The empirical aspects of studies of growth can either go under the more impressive title of time series analysis, which is using modern econometrics and economic theory, or under the less weighty one of story telling (or even worse case studies) in which simpler statistics and economic history have as prominent a place as standard economics. Data problems often limit the first approach (Southeast Europe is an excellent example where a wealth of data has not yet been reconstructed into a "usable" time series framework). This "softer" research has produced a great number of important results. For example:

- growth/development are disequilibria processes related to points of discontinuity and spurts of growth and not a continuous smooth process best described by linearity and regressions,
- we are yet to find a real world example of successful generation of "modern economic growth" in which the state did not have an overriding (if not dominant) role,
- growth/development success is not guaranteed, as the number of growth disasters, bad equilibria and non-linearities clearly indicate,
- research seems also to indicate a frequent lag of institutional development behind economic progress,
- and in general that growth successes, when they have come, have not been in accordance with the current "textbook cases" (e.g. simple identifiable goals, horizontal non-discriminating policies, market driven investments, attraction of FDI, transparent institutional stability, etc).

Of course these results are still difficult to generalize but arguably the scope for modern quantitative techniques will continue to increase and with that the unavoidable high

reliance on intuitive arguments may still prove to have been the most productive area of research.

### **Where does this leave us: examples from Southeast Europe**

The level of our ignorance makes the growth/development policy-determining environment very complex and the political economy of growth extremely challenging. The social context makes growth/development issues an area of special concern for the population with intense opinions, which in turn provides policy makers with a strong incentive to use and possibly abuse the growth/development issue. In any given environment, when it comes to the issues of factors of growth/development, economists are typically left with results, which are to a large extent theoretically and empirically ambiguous. This is true both on the normative and on the positive side. As a result, only some differences and abuses of current knowledge can be resolved by "technical" discussions. Many cannot, especially some of the more fundamental ones.

One such area of limited ambiguity concerns the role of the state in the context of policy issues for economic growth/development. Even disregarding economic history, which clearly shows that states have always played a central and active role in growth/development, and also disregarding those economic results that indicate that the 20<sup>th</sup> century "growth miracles" (both the European "golden age of growth" and later East Asian growth) were heavily dependent on state activities, it is still the case that today's mainstream economic analysis does in fact give the state a prominent and active role. Both standard economic theories of growth, discussed above, have a role for pro-active policies and a large role for passive ones. Concerning the active ones, the exogenous growth theories afford the state an active role with regard to convergence clubs and economic restructuring, for club skipping and determining long run growth path levels, while the endogenous growth theories provide the state with the means for influencing the long run growth levels and rates. Both provide a scope for passive policies of eliminating inefficiencies, especially market related ones. Empirical results show that of all the standard growth factors most are related to some aspect of state activity: 1. infrastructure, 2. size of state, 3. human capital generation, 4. inequality, 5. rule of law, 6. competitive pressures, 7. R&D/technical progress, 8. macroeconomic stability. However, with regard to all the state related growth factors, it is important to note that they all involve a matter of degree. Too much or too little can act as a barrier, the right amount can be conducive to growth. For example regarding infrastructure or human capital generation, too much public investment crowds out private investments, but too little acts as a barrier for technology absorption and entrepreneurship. For determining the right amount, however, there are no fixed rules. It seems that they must be determined on a case-by-case basis. With regard to growth/development the "minimalist" state vision is at odds with both the reality and theory.

Because of its special position in bridging social and economic considerations, economic inequality requires separate consideration. Too low economic inequality levels are viewed as having serious negative incentive effects on entrepreneurship and human capital investments, while too much inequality leads to redistribute pressures that are reducing growth and are introducing disincentives for entrepreneurship. Furthermore growth/development is an inequality generating process involving well-known growth/development asymmetries (regarding the different time distribution of costs and benefits, the asymmetric growth effects on individuals, social groups and, very importantly, regions and sectors and finally probability differentials for winners and losers). Policy ambiguity regarding appropriate levels of inequality and managing redistribution effects of growth/development and social sensitivity represent a formidable challenge. It is important to note that without a clear relationship the growth/development concerns managing a disequilibrium generating process, not a smooth economic growth trajectory. Similar results with acceptable bands of values shifting during the growth/development can be derived for the other factors that are or can be under the strong influence of the state.

Of course in real world economies, these fundamental ambiguities are mixed with many other considerations determining the growth/development policy environment and its political economy. For understanding the political economy of growth/development three are especially important. The first is the external environment, the second are discontinuities and the third the size of the economy. The Southeast European economies provide arguably the best example of the contradictions involved in the mixture.

External influences are crucial for Southeast European economies. For them, relative growth/development is clearly defined by nominal and real convergence to EU membership. As a result, for these economies relative convergence is to a great degree regulated by a contract, conditionalities and self-imposed path determinacy. This leaves an unclear but certainly not large scope for national differences. In this sense, they are different from many other developing economies. In general terms, the preferences for this convergence have been disclosed by the population, though significant differences already exist regarding a lot of the "small print" and implications of such convergence shifting.

The importance of discontinuities is also visible. Absolute growth/development is also defined for these economies. With respect to that, by the initial development gap these economies are facing (Europe's development gradient has a clear discontinuity towards the Balkans), the initial conditions they are starting from (regarding growth factors and position) and secular growth rates they experienced in the past (if short lived sports of high growth are set aside, that is around 3% per year). Again while the population has expressed clear preferences for growth, there is impatience regarding the expected growth and capabilities of the economy. Satisfying these growth/development expectations unavoidably implies a discontinuity with inherited absolute growth/development patterns.



The problems are best seen in the efforts for pro-active growth policies chosen by these economies in the last decade. Building on the inherited tradition of state managed growth/development (an inheritance which spans both their capitalist and socialist past), the policy makers in all of them have shown a strong taste for intervention. High on the policy agenda were infrastructure investments (motorways for example) and a continuous relapse to an industrial policy based on national champions (in Croatia the authoritarian nationalist regime chose the 100 families programme while the social democrats a successful managers concord), and similar examples can be found in other Southeast European countries. The difficulty is that all these policies at the same time are very susceptible to corruption and crony capitalism.

In the case of size, all Southeast European economies are small economies, both with regard to population, but especially with regard to their economic size. In the growth/development policy context, size imposes some special considerations in a couple of aspects. In addition to the usual size imposed constraints for growth/development (the quality of policy with civil servants lacking specialization, small human capital pool, negative selection in competition with the private sector), there are some additional ones. In small economies these policies are a priori personalized both with regard to the actor (the policy maker and civil servant are known and recognisable individuals) and the target (known and personalized entrepreneur and known region/location and specialization, often not only by sector but even by product too). Finally, in small economies there is an additional pressure to micromanagement and industrial policies based on choosing national champions and flagship sectors as well as a belief in the ability to recognize engines of growth. All these are strong pressures for state led growth. Under the special conditions of policy making in small economies such policies, like those mentioned in the previous passage, are very susceptible to corruption and crony capitalism.

Macroeconomic stability is also a growth/development factor whose optimal value is indeterminate, but also under the strong influence of economic policy. While excessive instability is indisputably bad, a level of excessive stability may also act as a barrier. Constant prices prevent changes in relative prices and factor mobility and maybe even slow down creative destruction, e.g., constant exchange rates erode firm's competitiveness and export redirection. Southeast Europe provides an example of this. While Croatia opted for price and exchange rates stability as its primary goal, hoping that this would lead to growth/development even after the post-war reconstruction, Slovenia, starting from a very similar initial position, opted for controlled low-level instability implied by depreciation and low inflation. The latter country ended as the most successful transition economy while the disappointing growth record of the former country can be explained by the choice of the different macroeconomic policy in addition to special and often unfavourable circumstances. Of course the different approach to macro stability is not the whole explanation of the difference, but it has certainly contributed to it.

## **Conclusions**

The paper emphasizes the importance of the role of state for reforms and development. It especially emphasizes the dangers that the weakness or the failure of the state can give rise to. Weakness is defined in terms of legitimacy, authority, institutionalization and especially in terms of rule of law. Also, when it comes to the use of resources by the state, the stress is on the targets and efficiency and not so much on their level. Indeed, weak states, being captured states too, often allocate and distribute a lot of resources, which does not contribute to their capacity to lead in the reform and development effort.

In the introduction to the paper, we stress the possibility to see the build up of states and nations as the outcome of development as much as seeing them as agents of development. In the last part, we allude to that treating somewhat sceptically the possible conclusion that a strong, legitimate state will be by that fact alone able to pursue a growth and development strategy effectively. This is for the lack of knowledge and because many other factors play a very significant role. Thus, the contribution that even a well-organized state can bring to reforms and ultimately to development has to be supplemented with the favourable environment factors, especially market, social and international ones.

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