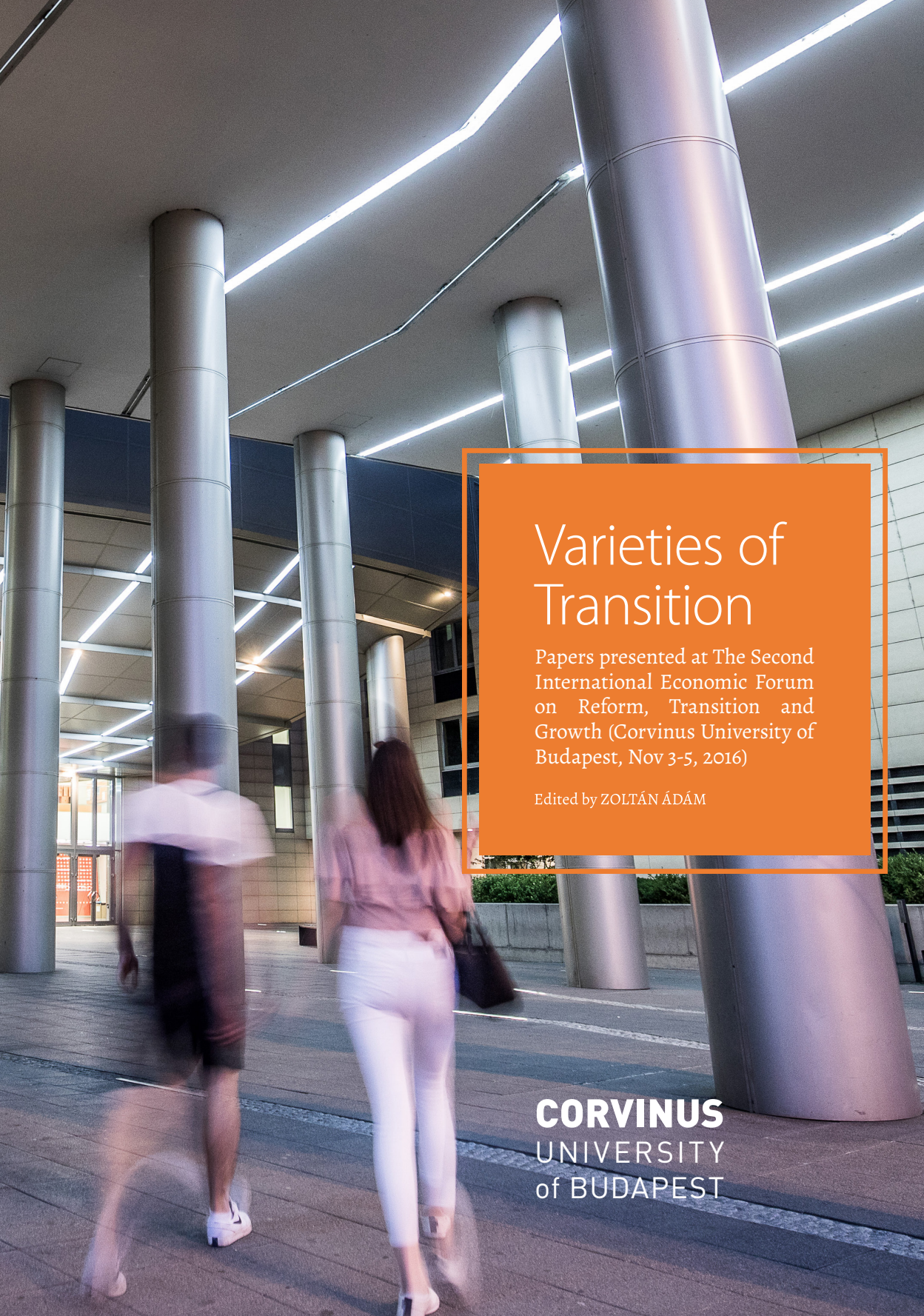

Varieties of Transition

Papers presented at The Second International Economic Forum on Reform, Transition and Growth (Corvinus University of Budapest, Nov 3-5, 2016)

Edited by ZOLTÁN ÁDÁM

CORVINUS
UNIVERSITY
of BUDAPEST

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To the memory of Professor Emerita Katalin Szabó (1944-2017), without whom neither the Corvinus University of Budapest, nor the Department of Comparative and Institutional Economics would be what they are now

CONTENT

Still in transition?

An editor's notes

When we with my colleagues at the Department of Comparative and Institutional Economics of Corvinus University of Budapest started to organize the 2nd International Economic Forum on Reform, Transition and Growth in 2016, we knew that we step on uncharted, yet extremely interesting territory. Our colleagues, Professor Emerita Katalin Szabó and Professor Emeritus Balázs Hámori, who was also chair of the organizing committee, had already participated in the 1st round of a conference put together by high profile international universities from China, Russia, Serbia and Hungary. We were eager to get to know the colleagues Kati and Balázs had been working with, and to host them at Corvinus at the 2nd conference round organized by our department.[1]

The title – International Economic Forum on Reform, Transition and Growth – was both familiar and slightly worrisome. After all, having experienced almost three decades of post-communist transition in this part of the world, can we still hold a conference with this title? What does it mean in the second part of the 2010s to talk about 'reform, transition and growth'? Who transits where? Can we still conceptualize a characteristic post-communist transition as an ongoing development? Or are we merely talking about the past? We received papers and were looking forward to receiving the guests. And when they actually arrived, and had their respective conference lectures, we were both surprised and calmed down: It appeared that researchers from a variety of post- (and in the case of China: still) communist countries still had a lot to talk about their experience in reform, transition and growth as a historically deeply embedded yet ongoing process.

Such a diverse conference necessarily produces a diverse set of papers that, when compiled, turn into a diverse collection of conference proceedings. This is what you, dear reader, have in front of you right now: A compilation of six characteristically different, yet in some sense still related papers that give a flavour of what had been presented at the Forum back in November 2016.

The first paper, written by the renowned comparative economist, Bruno Dallago of the University of Trento is about the Euro and the Eurozone crisis: a par excellence transition story taking place in the heart of Europe with a great impact on both post-communist countries (including those already in the Eurozone) and the entire world. Dallago argues that the Eurozone is not doomed to fail, but policies and institutional practices need to adjust to new realities and pragmatism is needed both in 'resilient' and 'vulnerable' countries of the monetary integration. The bottom line, he says, is that fiscal restriction, demanded by the 'resilients' can and should not prevent from tangible economic recovery, whereas inevitable

1 Within our department, a number of people made considerable efforst for the success of the conference. I will name only one, however, who probably worked the most on this project: Associate Professor András Székely-Doby, who was the chief organizer.

reforms can and should not be avoided by the 'vulnarables'. In other words, the Eurozone should survive, but not at any cost. Dallago offers some recommendations on how to achieve such a new pro-Euro equilibrium.

The paper by Dragana Mitrovic and Marko Tmusic from Belgrade University explores the relationship between institutional development and economic growth in context of the post-communist transition. As this is undoubtedly a two-way interaction, they examine both the impact that institutions make on growth, and the economic preconditions for developing economic and political institutions conducive for growth. They argue that the interaction between institutions and economic development depends on initial conditions as well as on the level of development that a particular country has so far attained. Hence, they conclude, no unitary approach can be adopted towards policies shaping institutions and/or growth. The course of post-communist transition in Central and Eastern Europe has taught a tough lesson, they claim, as the actual number of success stories has so far remained limited. One of the key elements of failure, they argue, has been the lack of adequate industrial policies that exposed a number of transition countries to de-industrialization and the accumulation of large trade deficits.

Csaba Moldicz of the Budapest Business School, University of Applied Sciences contributed a comprehensive paper on the Taiwanese development as a unique case of post-WWII transitions. Taiwan, the breakaway island-state at the Chinese coast, has become a fast developing Asian tiger and one of the world's leadings economies in past decades. Preconditions, again, played an important role in Taiwan as the Japanese colonial heritage in state administration assisted economic development. Taiwan also shared some development policies with other fast developing Asian economies, such as Hong-Kong, Japan, Singapore and South Korea. However, it still went along its own way, creating a globally competitive economy based on relatively small company size and an army of locally based small and medium sized enterprises. US aid policies and high household savings were also instrumental in attaining high, sustained growth rates, while the special relationship with mainland China has made the Taiwanese economy actually even larger than it appears in official statistics.

Irina Vasilenko of the Lomonosov Moscow State University came up with a highly provocative piece on diverging paths of globalization and modernization. Westernization of eastern economies and societies, she claims, resulted in social and economic decay in the 1990s, whereas a renaissance of markedly traditional, nation-, state-, family- and religion-oriented values has assisted in reversing the process of disintegration. In her account, preserving the 'socio-cultural identity' of non-western societies remain a condition for development, whereas 'promoting Western ideas of individualism, success, human rights, neoliberalism in these countries caused a negative reaction, when popularizing of these western values was called >>imperialism of human rights<< in the countries of the East.' A new, more successful practice of modernization must be 'built on the reconsideration of national traditions', she maintains, so that we shall never experience the return of the 1990s, when 'national cultural identity of the masses was destroyed, the nation has lost self-esteem, and morale was low'. Vasilenko's essay reads like an anti-west, anti-enlightenment manifesto, which is certainly (and luckily) not the only approach to understanding socio-economic developments in the east. Yet, precisely because we believe in the values of enlightenment and individual freedoms, including the freedom of expression and dissent in values and argumentation, we are glad to present this rather controversial essay.

Balázs Hámori and Katalin Szabó of Corvinus University of Budapest present a paper on the institutional conditions of innovation in Hungary. Explaining the conspicuously weak post-1990 Hungarian performance in innovations, they argue that insufficient business morale (with respect to adherence to formal contractual relations), clientele building and interventionism by the state, soft budget constraint and – relatedly – insufficient entrepreneurial spirit in terms of low propensity to risk-taking are the major obstacles. These factors, they claim, are not independent but form a "system". To survive under such conditions, "economic actors should deliver outstanding performance in building relationships to state institutions and expanding their relational capital, not in competition or innovation. If they succeed in doing so, they can get higher rents without taking any particular risk." This behavioural pattern is unlikely to be changed on the short run. Nevertheless, it is important to take account of the factors inhibiting innovation-based social and economic development in a country once considered a leading transition economy of Central and Eastern Europe.

Finally, my own piece is concerned with the rise of populism as a new, increasingly influential political phenomenon both in western and eastern societies, and with interpreting it in institutional economics terms. Based on the political science literature, I consider populism as a 'degraded form of democracy that holds elections in regular intervals as rituals of popular legitimation', yet makes democratic political choice effectively constrained and controlled by incumbents. From an institutional economics point of view, I maintain, this is explained by a need for reducing political transaction costs – a source of uncertainties societies prefer to keep under check at times of crisis and fast, unpredictable social and economic transformations.

In sum, our volume represents the diversity of problems, methodologies and intellectual approaches to some of the transitions the world has been experiencing in past decades. As social, political and economic changes have considerably accelerated in a globalized world, transitions are by definition continuing – and will be so. Hence, the term 'transition' eventually turns out to be more apt than ever, and our conference appears to be a valuable attempt at fulfilling it with actual content. Finally and very sadly, I would like to dedicate this volume to the memory of Professor Emerita Katalin Szabó, a key intellectual force behind this conference, who tragically passed away last year.

Zoltán Ádám

The strife of the princes
against the pagans
has come to an end,
for brother says to brother:
"This is mine,
and that is mine too,"
and the princes have begun to say
of what is small:
"This is big,"
while against their own selves
they forge discord,
[and] while from all sides with victories
the pagans enter the Russian land.

(The Song of Igor's Campaign, Translated by Vladimir Nabokov)

And yet it moves! ("Galileo Galilei, 1663,
according to The Italian Library", by Giuseppe Baretti, 1757.)

Between strife and progress: The Eurozone after Brexit

Bruno Dallago[1]

Abstract
One of the main problems of the Eurozone is the growing and considerable split between vulnerable and resilient member countries. The split pre-existed the crisis, but it was the institutional and policy incompleteness of the Eurozone and the management of the crisis that made the split evident and potentially dangerous for the monetary union. The European Union is gaining time by increasing the use of flexibility that exists in the treaties and pacts and coupling it with the supportive ECB attitude and action. However, it is difficult to see how the monetary union can continue in the long run by imposing unreasonable costs to and causing prolonged economic decline of vulnerable countries and if some of its member countries are unable or unwilling to implement the necessary reforms. External and internal events added a significant economic and financial danger to European integration, and an even greater institutional and political threat. The paper analyzes the causes and consequences of the division between resilient and vulnerable countries. The paper concludes that the EU and its member countries should pragmatically revise and relaunch the process of European integration and suggests important steps in this direction.
JEL classification: E02, E61, F15, G01, 052
Keywords: Crisis, Eurozone, European Union, Institutions, Policies, Reforms

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During the crisis, the Eurozone[2] tested and proved its resilience, yet the monetary union is at a crossroads. Participating in a larger and more liquid financial market and larger and more competitive goods market at lower interest rates and prices are sizeable advantages for the Eurozone member countries, their governments, firms, financial organizations, and their consumers. Yet presently these advantages are overshadowed by sizeable disadvantages and costs in terms of lost output and unemployment and growing public and private debt in various countries and the threat of financial instability. Monetary integration continue to be backed by remarkable popular and political support, along with the more obvious support of the business community, albeit weakened in later years, but growing again after Brexit referendum on 23 June 2016. Yet recurrent crises continue to loom around.

The prolonged economic difficulties of the Eurozone and the lack of institutional and political breakthrough show that time may not work in favor of the monetary union. It is difficult to see how the monetary union can stay together in the long run by imposing unreasonable costs to a significant part of its citizens and if some of its member countries are unable or unwilling to implement the reforms and policies necessary to revitalize their economies.

1. Optimum currency areas and the Eurozone

One important problem of the Eurozone is that it includes both vulnerable and resilient countries. Vulnerable countries have uncompetitive or unbalanced economies or important sectors (such as the financial sector) and need policies to adjust and strengthen their situation. Being members of a monetary union, they are unable to do so because they miss policy sovereignty and the necessary reforms are costly and need time to yield effects. Cyprus, Greece, Italy, Portugal, Spain and, to a certain extent, Ireland are vulnerable countries. These countries suffered particularly damaging consequences from external shocks. Countries having more competitive and balanced economies do not need policies or major reforms to adjust their economies and are resilient. Austria, Belgium, Finland, France, Germany, Luxembourg, and the Netherlands are resilient countries. Obviously, each group has internal differences and degrees of vulnerability and resilience.

To make the Eurozone fully sustainable, the performance of vulnerable economies should converge to that of resilient countries and their financial situation be stabilized or substantial and credible progress in the direction of a complete union and growth policies should take place. Missing progress and being the Eurozone still far from being and optimum currency area (OCA) (Dallago 2016a, De Grauwe 2014), the rules of monetary integration and the policy measures required by countries impose growing costs and stagnation on them and may cause

2 The Eurozone, or euro area, is the monetary union of 19 European Union (EU) member states which have adopted the euro (€) as their common currency and sole legal tender. It includes the following countries: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain. The remaining 9 countries, with the exception of Denmark and obviously the United Kingdom, have to join when ready to do so. The Eurosystem is the monetary authority of the Eurozone and the European Central Bank (ECB) is the common central bank which implements the monetary policy for the entire Eurozone. The ECB has a president and a board which also includes the heads of national central banks of the Eurozone.

their economic decline. A common currency leading to economic decline is neither desirable nor sustainable. In these circumstances, it may also be difficult to keep negative political consequences under control. An unfavorable external context may make this outcome more likely and serious.[3]

2. The problem and its consequences

The financial crisis originated in the United States, broke out in summer 2007 and reached the European Union through different channels and events (Eichengreen 2016). The crisis had serious financial and real effects and ultimately institutional effects, with different consequences in distinct member countries. Financial distress was at its peak in 2010-2011. In 2010 Greece and Ireland needed urgent rescue, followed in 2011 by Portugal and Cyprus, while Italy was in a critical situation with its public finances, although it could go on without any bailout. Spain followed in 2012, due to the financial distress of its private banks. Yet economic distress, unemployment and the fall of GDP, to levels that in 2017 are still lower than before the crisis in several Eurozone countries, continue to be worrying realities.

Vulnerability came from different sources: unbalanced and uncompetitive real economies with significant current account deficits (all with the partial exception of Ireland and Italy), unbalanced public finances and public debts (Greece, Italy and in part Cyprus and Portugal), distressed private banks that had to be rescued by means of public sources (Ireland, Portugal, Spain), the massive outflow of foreign and domestic capital following the international crisis and the burst of domestic bubbles (Cyprus, Ireland and Spain) (De Grauwe 2011, IMF 2012). The Eurozone policy approach was to require that countries in distress stabilize their public finances by means of restrictive financial policies and internal devaluation. The EU, the ECB and the IMF (the "Troika") secured rescue packages to each country, after progress in stabilization policies obtained positive assessment. This was curing the effect, overlooking the causes of financial distress. The situation was particularly serious in 2011, when the president of the ECB had to announce that the ECB would do "whatever it takes" to calm financial markets.

While financial stabilization was a must under the blow of international financial markets, the particular policy measures and priorities sponsored by the "Troika" jeopardized the long-run sustainability of vulnerable economies and in the end the very success of stabilization policies. A better approach was to deal also with the causes of vulnerability, not only its effects, with the aim of moving the Eurozone closer to an OCA. This required that effort was concentrated on reforms, both structural and institutional at both the Eurozone level and national level, investments and technical progress. Indeed, vulnerability derived from

3 The IMF (2015b) foresees secular stagnation to remain as long as demand is weak and inflation is expected to stay below target for an extended period, amid constraints on monetary policy at the zero lower bound. This situation causes an increasing likelihood of damage to potential output. See also IMF (2014). According to Lawrence Summers (2014), since the start of the crisis policies concern was focused on avoiding secular stagnation. This concern arose primarily from the long-run effects of short-run developments and the inability of monetary policy to accomplish more when interest rates already reached their lower bound. Roubini (2017) attributes the lack of inflation to supply side shocks.

ineffective economic structures and institutions and the lack of investment, along with financial disequilibrium and distress. It also derived from the institutional incompleteness of the economic and monetary unification and from asymmetric policies: common monetary policy and fiscal policies under the restrictive hand of the convergence criteria (Dallago 2016a). Moreover, the distrust of international markets towards these countries and the euro jeopardized the effect of stabilization policies; thus public debts increased significantly compared to GDP. Initially, debt service skyrocketed due to much higher interest rates that these countries had to pay in financial markets (but not on EU-ECB-IMF loans).

Vulnerable economies needed to stabilize, reform and invest to grow. These goals are not easy to combine at national level in countries members of an incomplete monetary union. One problem is timing mismatch: while stabilization must be decided and implemented rapidly, growth policies and reform require lengthy preparation, are costly, slow in implementation and ever more so in delivering their effects. This explains in part – along with the dominant policy theories, the concern for moral hazard and the lack of needed resources in vulnerable countries – why the Eurozone insisted so much in imposing structural reforms and disregard the more ambitious but more effective institutional reforms.[4]

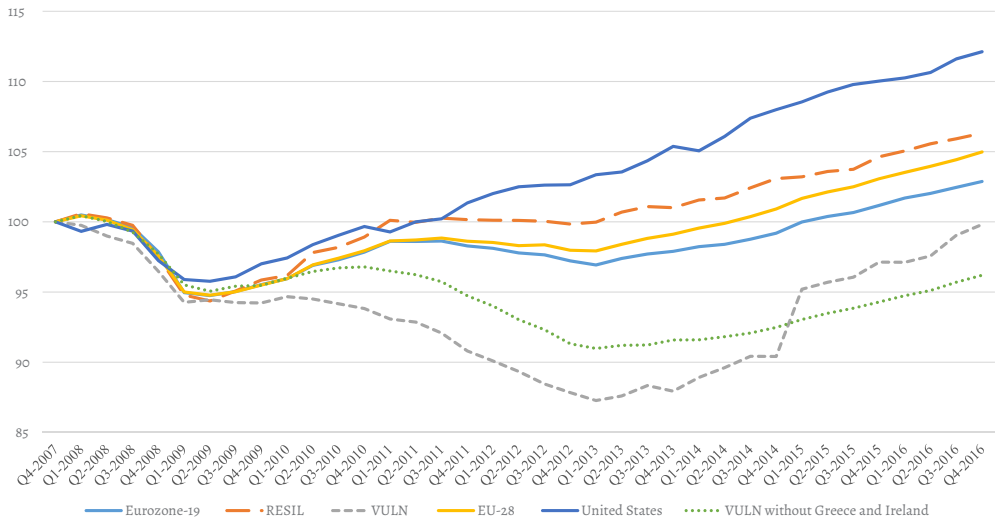
This timing mismatch caused stabilization policies to have a depressive effect through the financial multiplier (the ratio of a change induced in national income by the change in government spending) and increased the debt to GDP ratio (Blanchard and Leigh 2013). This is because during a recession public revenues decrease and social expenditures increase, thus causing public deficit and debt to increase. At the same time, employees and pensioners and young people paid most of the costs of stabilization through growing unemployment, wage and pension cuts, shrinking welfare and/or increased taxation.

A negative side effect for the economy is that these social groups, whose income is rather modest if not low, have high propensity to consumption. Their disadvantage translated into lower domestic demand. Although current accounts improved significantly in vulnerable countries after stabilization measures (often due to decreased import more than to increased export) and mild surpluses replaced sizeable deficits, the negative effect over GDP of shrinking domestic markets could be compensated by increasing exports only in small and open economies. Moreover, due to this policy mix vulnerable countries saw their distance

4 According to the European Commission, structural reforms address impediments to the fundamental drivers of growth by unshackling labor, product and service markets to foster job creation, investment, and productivity. These reforms aim to enhance an economy's competitiveness, growth potential and adjustment capacity. See http://ec.europa.eu/economy_finance/structural_reforms/index_en.htm. See also Canton et al. (2014). As a matter of facts, in vulnerable countries the policy accent is mostly, sometimes nearly exclusively on labor and consists primarily of changes to the labor market or the pension system that reduce production costs, ease dismissals and decrease public expenditures. Institutional reforms consist of modifying the basic formal rules and governance of the economy. Although these reforms are usually decided and defined by national governments, their nature, implementation and effect is mostly at microeconomic level. They aim at improving the efficiency of the economy, strengthening the effectiveness of policies, promoting competition and liberalization, reinforcing incentives, decreasing transaction costs, decreasing the tax wedge over economic activity (e.g. broadening the tax base through fighting tax evasion), encouraging R&D and innovation and at the end improving competitiveness. In short, while structural reforms in their strict sense aim at regaining competitiveness by cutting costs, institutional reforms aim at doing so by improving the efficiency and innovation capability of the economy. These were important components of the Lisbon strategy and play an important role in the Europe 2020 strategy, but hardly in the management of the Eurozone crisis.

from resilient countries in GDP, incomes and consumption increase substantially, after years of catching up before the crisis. In 2015, the real GDP of vulnerable countries was still significantly below the level it had at the beginning of the crisis (except Ireland) while the Eurozone real GDP was a bare 3 percent above that level (Chart 1.). In these same years, real GDP of China nearly doubled and that of the United States increased by more than 10 percent. Within the EU, the real GDP of Poland increased by nearly 30 percent and that of Germany by more than 7 percent. The revival of the EU economy in 2016 and 2017 slightly improved the situation.

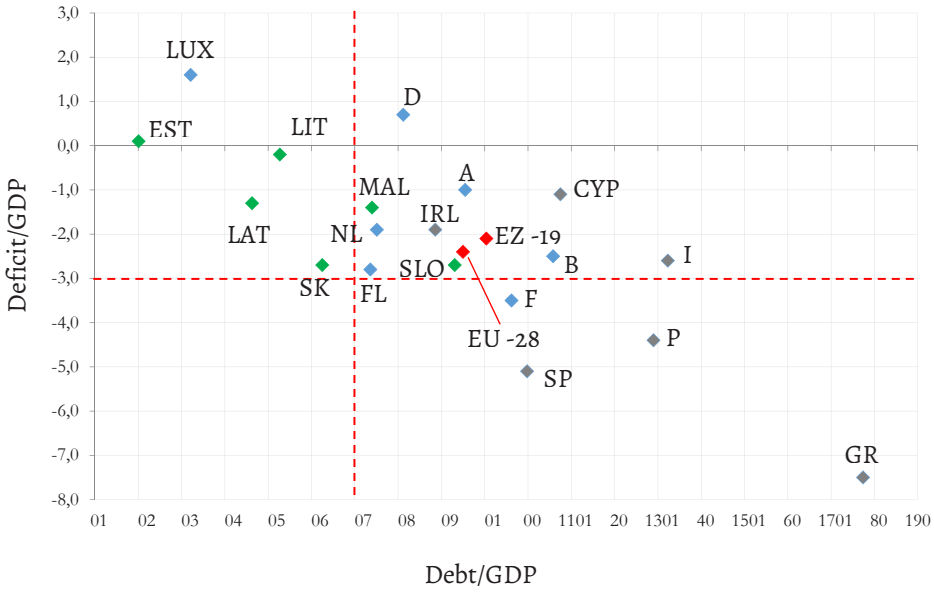
Chart 1. The internal divergence of the Eurozone:
Quarterly GDP in constant 2000 prices, (Q4 2007=100)



Source: Own elaboration on OECD data

The depressive effect of stabilization policies and price deflation decreased the denominator more than the nominator in the deficit/GDP and debt/GDP share, resulting in the increase of both ratios for years after the crisis (Chart 2.). the predictable outcome was that most Eurozone countries, including various resilient countries, violated the convergence parameters for financial stability, of 3 percent of deficit over GDP and 60 percent of public debt over GDP.

Chart 2. The compliance of Eurozone member countries with convergence criteria, 2015



Source: Own elaboration on Eurostat data

3. Toward a new awareness

After the initial, strict insistence on austerity and internal devaluation,[5] under the pressure of the worsening economic situation and the changing stance of the international community – particularly the IMF and the Obama US administration – the Eurozone policy control and policy making started to look for alternatives and timidly move.

The crisis had important effects in the Eurozone, in line with OCA theory previsions. In particular, it revealed the large and deep economic and financial differences among member countries. Equally important, these effects exposed the incomplete institutional foundations of the euro, the insufficient common solidarity, the excessive formalism of convergence criteria and the rigidity of the Stability and Growth Pact. These weaknesses existed before the crisis and were fully Eurozone-made. However, they went largely unnoticed, thanks to the sustained flow of private capital to countries in need, which allowed interest rates to converge

5 Austerity policies include measures that aim at reducing public budget deficits and public debts by increasing revenues and decreasing expenditures, both to solve insolvency risks and to show creditors and credit rating agencies the government's determination to strengthen fiscal discipline (see Blyth 2012). Internal devaluation is a set of policy measures aiming at increasing external competitiveness by decreasing domestic prices. This is done mainly by reducing wages and social contributions paid on labor in order to decrease labor costs (see Decressin et al. 2016, Decressin and Loungani 2015, IMF 2015a).

downward.[6] A further negative effect of the external shock was that individual member countries followed initially their own short-run interest, thus jeopardizing the common purpose and mutual trust. The EU insistence on financial austerity and internal devaluation was in a sense a device for avoiding worse consequences in an institutionally incomplete and insufficiently cooperative club of countries. In this situation, the common currency actually made economic and financial convergence more difficult, since it deprived member countries of policy flexibility.

However, reading the situation in this way risks to confuse the effect with the cause. The international crisis raised doubts over the institutional architecture and the governance of the Eurozone economy and the euro, in spite of the ECB increasingly resolute intervention and its interest rates constantly lower than in the United States. One problem was that external financial and monetary events contributed to the instability of the Eurozone economy and had internally asymmetric consequences for vulnerable and resilient countries. Perhaps more important in the long run, the international crisis exposed the weak institutional, economic, financial and policy base of the euro and the entire European construction and highlighted the need to intervene at the roots of the problems.

It is perhaps the fundamental failure of the former and the difficulty of the latter that contributed to shift the accent to what appears technically and politically easier: making labor cheaper and more flexible in the short-medium run, with scant concern for long-run consequences. To be sure, these policies may appear easier to implement thanks to the weakness of trade unions and social opposition in vulnerable countries and the promise to bear fruits faster than other policies. They also apparently guarantee the solvency of distressed national budgets. However, these policies often end up in lower fiscal revenues for the state and have negative macroeconomic consequences (Decressin et al. 2016, Decressin and Loungani 2015, IMF 2015a). Moreover, structural reforms imposed upon vulnerable countries as part of internal devaluation policies made these countries stepping back in the quality of their international specialization and weakened their investment in human capital. This effect enlarged further the divergence between resilient and vulnerable countries, particularly in technology intensive sectors (Palan 2013, Palan and Schmiedeberg 2008, 2010).

The recognition that austerity and internal devaluation policies were ineffective and possibly worsened the economic situation is not sufficient for economies to emerge from the crisis. The present wider, pragmatic and mostly tacit use of flexibility built in Eurozone institutions and treaties and the ECB action are useful to gain time. However, only institutional and structural reforms and policies better in line with the real situation, European and national alike, can fix the problems of the Eurozone.

Lack of political determination at national level may prevent or delay the implementation of reforms. Unfortunately, the rules governing the common currency itself makes more difficult and costlier for vulnerable countries to finance those reforms. There is a danger that the increase of debt to GDP ratio in vulnerable economies may cause the retreat of vulnerable economies into a low level equilibrium. Negative consequences may extend to resilient Eurozone countries both via the integration among economies and tensions on the euro (EC 2014).

6 Long-term interest rates coincided at approximately 4 percent between 2002 and 2007 in Eurozone countries.

The ECB determination to do "whatever it takes" to support the euro helped easing financial and monetary distress (Pisani-Ferry and Wolff, 2012). However, these measures could not solve the deep reasons for instability, nor could they complete the institutional setup of the Eurozone, as the ECB repeatedly warned.[7]

Since the Eurozone is neither a perfect optimum currency area (Dallago 2016a) nor has it a sufficient political and social support to compensate for important shortcomings, austerity and internal devaluation policies guarantee that the problematic financial situation of vulnerable countries does not jeopardize the monetary union and the financial stability of resilient countries, nor does it require automatic financial transfers from resilient countries. It is in a sense a least common denominator for cohabitation. However, this takes place at the price of limited and less effective policy instruments. Restrictive policies are implemented to the disadvantage of the economy and in particular employment and wages and hence consumption. Austerity as a policy mantra is wrong and dangerous (Blyth 2012), yet not much else is at hand in the present Eurozone.

The evidence of past policy failures and the commitment of vulnerable countries to the rules of the monetary union, even at significant or very high economic and social costs, are perhaps changing the scene. Slowly a new policy consensus is developing to address the apparently intractable Eurozone problems. Yet new dangers appeared. Incomplete Eurozone institutions with no bailout, non-monetary financing, rigid budget constrains have deprived the Eurozone of powerful countercyclical policies and led to bank-sovereign interdependence as a not so hidden way to circumvent institutional rigidities preventing better solutions to financial distress. Large stocks of undiversified national public debt securities are held by national banks even after the Euro fostered some cross-border financing. This added up to the growing burden of non-performing loans (NPL). The vulnerability of Eurozone countries increased, because adverse shocks to sovereign solvency could interact with adverse shocks to bank solvency. The ECB quantitative easing program started in March 2015 aims at solving this problem by transferring public debt bonds from private banks to national central banks. At the same time, the ongoing construction of a European banking union aims at strengthening large, systemic banks.

What the Eurozone finds particularly difficult is to identify a new, long-run strategy capable of incorporating the dramatic changes that the international crisis brought about in the international financial and economic system, the new perception that markets have of the common currency, and the deeply changed inter-country relations within the Eurozone. During the crisis, time horizons of governments and people dramatically shortened. It is therefore fundamental that a long term institutional, economic and political strategic perspective is worked out, however difficult this may be. This is necessary to induce the Eurozone member countries to cooperate for the sake of the common good.

7 "[W]e cannot expect those divergences to be addressed through means such as permanent transfers from economically resilient countries. The euro area was not created to be a union with permanent creditors and debtors. It is an area where each country, by exploiting its comparative advantages and the opportunities afforded by the Single Market, and by converging to the highest standards in terms of competitiveness and income, must be able to stand on its own two feet." (Draghi 2015)

Such perspective should include institutional reforms for completing the Eurozone architecture, institutional and structural reforms to make the Eurozone economies more competitive and policies supporting growth and common pool resources for investment. Completing the institutional architecture of the Eurozone is the most daunting goal, since it impinges upon national sovereignty of member countries and the stance and priorities of policy making. The most important institutional reform areas at the Union level include: a) broader European Central Bank mandate, b) creation of a Eurozone banking federation, and c) stronger EU budget and fiscal union with common bonds. All run into technical problems and above all serious political problems and opposition, a critically important issue since such reforms may require a change in the EU treaties.

It is clear that something needs to be done, but the precise features of this something are still unsettled. Preferences of European governments and countries are still different and perhaps apart. The crisis and Brexit changed the attitudes of Europeans, particularly in vulnerable countries. However, there continues to be a prevalent majority support to the euro (Eurobarometer 2016, Guiso et al. (2014), Roth et al. (2016), Stokes 2015). This fact, together with the endurance of vulnerable countries in implementing austerity, are apparently re-establishing some degree of inter-country confidence and trust. The economic and political precondition for a change may be building up.

4. Proposals and solutions

A consensus is developing among policy makers and scholars that policies and actions which were followed and implemented so far did not work. Those policies may have helped to avoid the worst consequences, including open default of some member countries or even the break-up of the Eurozone. However, such policies failed to bring vulnerable economies back to growth, which weakened the performance of resilient countries and are not sustainable in the long-run. However, scholars and policy makers disagree on what exactly should be done at this point to restore the sustainability of the Eurozone and promote the growth of vulnerable economies and whether this is a goal that is really worth pursuing.

A number of proposals for breaking up or even ending the euro were advanced also by serious scholars, even if this is sometimes considered in the lack of better viable alternatives (Kawalec and Pytlarczyk 2013, Steinherr 2013, Stiglitz 2016). Also the event of one country leaving the common currency comes recurrently back, particularly in the case of Greece and more recently Italy. Analyses of the conditions for a country to leave the euro and for the others to adapt (Bootle 2011) and estimates of the probable cost to countries leaving the euro (Guglielmi et al. 2017, Mchugh 2014) were prepared. The institutional set up of the Eurozone, though, makes the event of one country leaving the euro institutionally impossible and in any event so costly and disadvantageous, that the topic is mostly confined to political populism. However, no one can exclude that a country can be actually obliged to leave. As to the break-up of the Eurozone, it is difficult to understand why two or more small euros would be better and less problematic than one euro and preferable to national monetary sovereignty. The euro is one or none, at least for political reasons. The fact that the recent revival of Eurozone economies does not prevent the future return of dangerous shocks.

Catastrophic scenarios apart, there are proposals that go in the direction of making the Eurozone better viable. They can be grouped into four proposals which are advanced, considered and even partially implemented. The first proposal consists of keeping austerity policies and softening them by using the flexibility that exists in European agreements (EC 2015) or through continuing expansionary monetary policies. This is the present broad settlement and practice in the Eurozone. It includes the slowing down of the implementation of the budget adjustment foreseen in the fiscal compact, recalling exceptional circumstances; the definition of the budget deficit in structural terms; and expansionary monetary policies within the present mandate of the ECB, in conjunction with persistently low inflation. However, within Eurozone institutions a push towards a new fiscal stance is already evident (EC 2016, ECB 2016). The advantage of this proposal is to keep pressure on countries to balance their finances and reform, while leaving some room for expansionary policies. The disadvantage is that adjustment processes under these circumstances are too slow and costly to the population.

A second proposal, which can be considered as complementary to the preceding one, is the setting up of a European plan for investments. This is one of the important aims of the present European Commission headed by Jean-Claude Juncker.[8] The European Investment Plan, so-called Juncker plan, foresees an overall investment of €315 billion over three years (2015-2017). Of these, €21 billion is financed and guaranteed by the newly established European Fund for Strategic Investments set up by the European Union and the European Investment Bank. The rest should be financed by public and private contributions, with a leverage of 15. The advantage of this proposal is that it adds a European push to national economies, while financing industrial and infrastructural projects. The disadvantage is that, however important, it is not sufficiently massive to really improve the situation of vulnerable countries.

A third proposal, again complementary to the preceding ones, consists of proceeding to complete Eurozone institutions. A first, important step was moved in 2014 with the foundation of the European banking union.[9] The banking union consists of the Single Supervisory Mechanism and Single Resolution Mechanism. The third pillar, the European Deposit Insurance Scheme (EDIS) for bank deposits in the euro area, is still waiting for formal approval. These mechanisms are based on a common financial regulatory framework ("single rulebook"). Steps are moved also in the direction of a unified European capital market.[10] Bolder interpretations in the monetary fields consider transforming the ECB in a full lender of last resort. There are two versions of this view: lender of last resort only for private banks (Winkler 2014)[11] or also for governments (De Grauwe 2014, Goodhart and Schoenmaker

8 Claeys et al. (2014), Veugelers (2014). See also https://ec.europa.eu/priorities/jobs-growth-and-investment/investment-plan_en. The Commission proposes to extend the duration of the European Fund for Strategic Investments and provide at least €500 billion by 2020 and €630 billion by 2022 (https://ec.europa.eu/priorities/sites/beta-political/files/2-years-on-investment-plan_en_2.pdf).

9 Pisani-Ferry et al (2012), http://ec.europa.eu/finance/general-policy/banking-union/index_en.htm

10 "With the banking union, we are laying the foundations for a more complete financial integration in the future. But to be fully comprehensive, a single financial market must also extend to capital market integration." (Draghi 2017). See also the European Commission's Action Plan on Building a Capital Markets Union http://ec.europa.eu/finance/capital-markets-union/index_en.htm

11 Winkler (2014) addresses four arguments that are used to explain why it is acceptable to have the ECB as a lender of last resort for banks, while this role for governments should be rejected.

2014)[12]. Although various economists, particularly in Germany, oppose such views (Illing and König 2014),[13] this transformation of the ECB role is presently *de facto* nearly accomplished, albeit through secondary markets in the case of public debts.

A further issue on which there is some technical debate concerns solutions to be found for the more than 1,000 billion euro worth of non-performing loans (NPL) held by European banks. At a seminar in Luxembourg on 30 January 2017, organized by the European Stability Mechanism (ESM), the chairman of the European Banking Authority (EBA), Andrea Enria, proposed in his speech the establishment of a kind of "bad bank" – a European Asset Management Company – with the target of acquiring up to 250 billion euros of non-performing loans from EU banks.[14]

Mutualization of sovereign debt was an important issue at stake, particularly in 2011 and 2012, when vulnerable countries were in serious distress and interest rates on their sovereign debt were rapidly and significantly increasing. Various scholars and policy makers advanced the idea of introducing bonds, defined in different ways, in order to pool the sovereign debt of Eurozone countries under joint liability, typically up to 60 percent of GDP (Beetsma and Mavromatis 2012, Claessens et al. 2013). Predictably, this proposal met strong opposition, particularly by the governments of resilient countries. In fact, they were afraid to soften excessively the budget constraint of vulnerable countries[15] and foster moral hazard, thus being called to pay the bulk of the cost. However, it is fair to observe that the ECB quantitative easing program includes a partial form of debt mutualization. The advantage of these proposals is to ease the financial situation of vulnerable countries without really jeopardizing that of resilient countries. The disadvantage is that they do not really deal with the economic situation, with the need for expansionary policies and for reforms, neither with the keen issue of how to coordinate policies and reforms.

A fourth proposal is to set up a common economic government, or at least a European minister of finance, as a first step towards political unification. This proposal was advanced also by the presidents of the central banks of France and Germany in a common article (Villeroy de Galhau and Weidmann 2016). Such an accomplishment would give a compelling institutional and policy background to the management of the economy and finances, but would open new questions. If the ministry would be a rigid controller and enforcer of convergence criteria, but without own financial resources, political conflicts with national

12 According to De Grauwe (2013), the ECB should also be the lender of last resort in the government bond markets of the monetary union, in order to prevent countries from being pushed into bad equilibria by self-fulfilling fears of liquidity crises in a monetary union. Goodhart and Schoenmaker (2014) maintain that, after the introduction of the euro, the national central banks continued to act as lenders of last resort because bank supervision remained at the national level. Since supervision moved to the ECB through the new banking union, so should the lender of last resort function for the larger, cross-border, banks.

13 Illing and König (2014) argue that it is questionable whether the purchase of government bonds of distressed countries is included in the ECB's mandate. They also suggest that the European Stability Mechanism (ESM) would be better suited to act as a lender of last resort for governments and it should be given access to ECB credit facilities in order to fully perform this function.

14 The proposal received the approval of Klaus Regling, Managing Director of ESM. Apparently EBA's plan does not include the sharing of bank risks among EU states. See ttps://www.esm.europa.eu/speeches-and-presentations/seminar-andrea-enria-eba-chairperson

15 Wyplosz et al. (2011) stress that eurobonds would reduce the odds of a sovereign crisis at the cost of creating a serious moral hazard and softening discipline promotion. See also Claessens et al. (2013).

governments could follow. If the ministry would have a serious budget and if the role is not limited to the control of national budgets, it would be necessary to manage politically the inter-country distributive consequences of fiscal policies and perhaps also their inflationary effects. While the latter could be rather easily manageable, given the independence of the ECB, the former would require compensatory agreements among countries. Simplification on the side of policy making would consequently be compensated by increased complexity in the management of consequences. A European minister with limited sovereignty, acting as a pivot and coordinator of national ministers, together with a form of partial debt mutualization (e.g. up to the 60 percent of GDP) seem more realistic achievements for the time being. When these achievements show their positive effect, common government building could proceed to more ambitious forms.

A good starting point for proceeding towards a more effective monetary union would be to reach a consensus on past accomplishments and on the problems ahead and understand how different proposals could be combined to be more effective. Unfortunately, there is no such consensus and there is still a fundamental disagreement on how policies should be changed and institutions completed. Disagreement also concerns the future of the common currency and the fate of some of its member countries.

5. From muddling through towards a fuller integration?

The fundamental problem of the Eurozone is its necessity to implement institutional reforms and foster economic growth, while continuing fiscal consolidation. As stressed by OCA theory, the inability to pursue these goals was due to the institutional incompleteness of monetary unification. Additional reasons were the weak effectiveness of enforcement of common rules, the scarce willingness and inability of various national governments to comply and reform, the conflictual coordination and declining trust among member countries. Such inability explains the dominance of short term stabilization objectives and policies, duly supported by questionable policy rigidities and national interests. This approach unfortunately overlooked that the problem of the Eurozone was not only one of financial disequilibrium, but mainly one of decreasing competitiveness of economies. The fact that policies disregarded the long term structural aspects of the competitiveness of national economies and had asymmetric national effects led to poor performance and permanent damages to the European economic potential and the life of European citizens, particularly in vulnerable countries.

The Eurozone is confronted with the price of past mistakes and with new challenges and dangers. Some of the mistakes were common, others were in national opportunism and consequent moral hazard, still others were in the lack of cooperation by resilient countries before discipline was effective. The accusation that introducing the euro too early, before the necessary accomplishments of political and fiscal integration and amidst incomplete institutions, was a mistake, hits a point (Nuti 2015, Pisani-Ferry 2012, Rosefielde and Razin 2012). However, we should not forget that the euro was conceived also as a device for fostering European economic and political integration and as an important expedient to urge member countries to reform their economies. The fundamental conceptions founding the common

currency are the Werner Report (1970) and the Delors Report (1989). It is worth recall briefly these milestones.

The Werner Report was not particularly concerned with imposing hard fiscal discipline to the members of the monetary union, it foresaw inter-country transfers and transfers of sovereignty. It also considered political coordination and integration as necessary complements to the monetary union.[16] Indeed, "only the global balance of payments of the Community vis-à-vis the outside world is of any importance. Equilibrium within the Community would be realized at this stage in the same way as within a nation's frontiers, thanks to the mobility of the factors of production and financial transfers by the public and private sectors." Clearly this Report was under the influence of the federalist view of European integration that backed its construction since the Treaty of Rome.

The EU soon evolved into an inter-national kind of integration, of which the Delors Report is perhaps the most significant expression. In this Report national governments have greater role in the integration of Europe. Logically in this perspective, the lack of a common government of the economy requires that countries are bound in their financial freedom, in order not to destabilize the economic and monetary union. In a process integrating countries featuring many differences "a wide range of decisions… [should] remain the preserve of national and regional authorities" … "within an agreed macroeconomic framework and be subject to binding procedures and rules." The potential impact that these decisions have "on the overall domestic and external economic situation of the Community and their implications for the conduct of a common monetary policy" require that national policy making is coordinated and checked. Only such coordination and check "would permit the determination of an overall policy stance for the Community as a whole, avoid unsustainable differences between individual member countries in public-sector borrowing requirements and place binding constraints on the size and the financing of budget deficits." (Delors Report 1989, p. 14). Unfortunately, this Report overlooked that the performance of single economies also depend on other factors (such as investments or the existing industrial structure), that may require additional resources that countries with the greatest need for investment may not have, because of the austerity imposed on their economies.

In the perspective of optimum currency area theories, the Werner Report relies on the mobility of resources, in particular labor, and on price flexibility, neither one sufficiently high in most European economies. The Report also presupposes the existence of transfers of public resources, a problematic feature in a process integrating countries with overall disciplined and balanced public finances and other countries which, for various reasons, are unable or politically unwilling to do so. The Eurozone conundrum is fundamentally here: insufficient resource mobility, particularly labor, and structural problems that prevent resource mobility from contributing to the economic and financial convergence of countries. At the same time, open markets together with divergent economies and unbalanced public finances revers the

16 "To ensure the cohesion of economic and monetary union, transfers of responsibility from the national to the Community plane will be essential. These transfers will be kept within the limits necessary for the effective operation of the Community and will concern essentially the whole body of policies determining the realization of general equilibrium. In addition, it will be necessary for the instruments of economic policy to be harmonized in the various sectors." (Werner Report 1970, p. 10)

flow of financial resources to the disadvantage of vulnerable countries in times of distress and distrustful markets.

It was the Delors Report that shaped the European integration process, but this was in a different, inter-national perspective. In the Eurozone, exchange rate adjustments are no longer available to correct national economic imbalances. Abandoning the Werner Report's concern with "the global balance of payments of the Community vis-à-vis the outside world", the Delors Report concentrates on national imbalances.[17] There is thus a need to put these imbalances under control, but also of reforming economies in order to make national economies more efficient and avoid such imbalances.[18]

The problem with reforms, however important they are and leaving political and social issues aside, is that they meet a crucial timing problem: reforms promise advantages in the long run but they are costly in the short time. This opens three problems. First, vulnerable countries cannot support their reforms by depreciating their currency or running higher budget deficits and they may lack the necessary financial resources. Second, there is a problem with the inter-temporal (and perhaps inter-generational) allocation of costs and advantages. Third, it is not easy to coordinate reforms with the need for expansionary policies. Indeed, in the short run reforms absorb resources that cannot be used to expand the economy and may create uncertainty, thus jeopardizing the expansion.

The process of European integration was thus progressively transformed – from its political start based on a common vision based on the tragedy of World War II and idealism and in order to avoid the unpleasant choice between the nation and the common good – into a technical, nearly mechanical process. This choice worked reasonably well for decades and produced wellbeing and political stability. The crisis recalled Europeans back to the hard reality of the economy as also a social and political undertaking and to the necessity to remind that economic integration cannot disregard these dimensions.

So far the daunting problems of the Eurozone were managed through the accommodating monetary policy and the relaxation *de facto* of convergence criteria. These adjustments gave time, but could not solve the deeper problems. For the misfortune of the Eurozone and the European Union, the rest of the world did not stay motionless, nor did its internal components – be they countries or economic and political processes – remain immobile and unchanged. Fault lines appeared in the world, lately the dramatically changed policy stance of the United States following President Trump entry into office. Also fault lines within the European Union gained momentum, the most pregnant among these being the unforeseen event of Brexit.

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17 "Such imbalances might arise because the process of adjustment and restructuring set in motion by the removal of physical, technical and fiscal barriers is unlikely to have an even impact on different regions or always produce satisfactory results within reasonable periods of time. Imbalances might also emanate from labour and other cost developments, external shocks with differing repercussions on individual economies, or divergent economic policies pursued at national level… None the less, such imbalances, if left uncorrected, would manifest themselves as regional disequilibria" (Delors Report 1989, p. 15).

18 "Measures designed to strengthen the mobility of factors of production and the flexibility of prices would help to deal with such imbalances." (Delors Report 1989, p. 15).

6. Conclusions

A consistent and considerable split between vulnerable and resilient countries is perhaps the most distinctive feature of the present Eurozone. Although pre-existent, the management of the crisis made this division evident and potentially dangerous for the monetary union and the individual countries, in particular in a period of unstable financial markets. This division is not easily manageable, due to the construction of the Eurozone, the constraints this imposes on vulnerable countries and the spillovers to resilient countries through various financial and real linkages. In fact, the Eurozone lacks a common government of the economy and a full lender of last resort.

This is not to deny that important steps were implemented towards surrogate solutions in recent years, which relaxed somewhat the stringent rules and policy stance concerning public finances and fostered return to greater financial stability, the ECB move towards a *de facto* role as lender of last resort, the Commission's European investment plan and a viable coordination with the European Council. These improvements helped the present revival of growth in the European Union. In spite of these improvements, the impression is that the Eurozone is late in responding properly to mounting problems, although the consistent determination of the ECB has certainly eased the situation. So far, the Eurozone is chasing problems more than anticipating them. In particular, the fundamental reform of the Eurozone, while proceeding, continues to be slow compared to the needs. Coupled with the difficulty that vulnerable countries continue to meet in implementing the solutions to their problems discussed above, in decreasing part to their demerit, the outcome can be problematic for individual vulnerable countries and potentially hazardous for the monetary integration.

There are three factors and their interaction to be considered for assessing the present situation: a) European awareness and mutual trust; b) fault lines within the Eurozone and the European Union; and c) external problems. On the first of these factors, awareness and mutual trust, clearly there were improvements. The Eurozone and the EU became more pragmatic and better aware of the seriousness of problems. Various signs of a new spirit are around: the determination of the ECB; the engagement of vulnerable countries to reform; some increasing flexibility of the European Commission and its greater resolve to support growth; some pragmatism by resilient countries. Apparently the time is getting ripe for bolder steps towards better policies and a deeper and more complete monetary, economic and perhaps political integration. This refers at least to some kind of common government of the economy that complements the strengthened position of the ECB; completing the banking union, including instruments to support and clean European banks of the sizeable amount of non-performing loans, and a capital markets union; a stronger and permanent European investment plan; and a more complete common government in other spheres, particularly international and military affairs (or at least a more effective coordination of national policies).

The problem is that in an important part of the EU anti-integration national sentiments are still strong and there is a drive towards stronger national governments. Fortunately, this concerns less the Eurozone, populist parties apart. This leads to the second factor: the increasing fault lines within the Eurozone and the European Union. Obviously the most important and shocking is Brexit. The EU was clearly surprised and it seems to be in some difficulty (Dallago 2016b), although reasonableness seem to take hold. However, the most

important question is to see whether Brexit reinforces centrifugal forces in the EU or whether it will help consolidating the internal situation. For the time being, the latter seem to prevail. The danger of further splits could push the European Commission and national governments to prudence, to dilute the integration process. This could be viable for non-euro countries, but it is hardly an option for the Eurozone, since it would lead to jeopardize monetary unification. This opens a third possibility: a process towards a multi-level Union: a hard central core, the Eurozone, which will proceed to strengthen integration, and a softer external ring, in which national governments could perhaps slow down the integration. This "third way" would have many advantages and has good chances to progress pragmatically.

The third factor, external problems, is growing rapidly beyond expectations and is becoming a serious threat for the European integration. While the relations with Russia continue to be strained, but can be probably stabilized to mutual advantage, it is the position of the new US administration under President Trump, openly adverse to European integration and more interested in establishing strong partnership with Great Britain, which may constitute a more serious threat to the EU. And the Eurozone is at the center of this political offensive.

While the first factor is positive from the perspective of the Eurozone, the two other factors are worrying.[19] The problem is to understand how they could interact: the threats could strengthen the positive factor and accelerate its progress. However, they could also introduce and deepen the differences within the Eurozone. The Eurozone was established as an institutionally irreversible accomplishment. Time and events are testing whether it is so also in reality.

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19 In his letter "to the 27 EU heads of state or government on the future of the EU before the Malta summit' on 3 February 2017, the President of the European Council Donald Tusk, in an unprecedented alarmed move, highlights the existence of three threats. These are the new geopolitical situation in the world and around Europe, the rise in anti-EU, nationalist, increasingly xenophobic sentiment in the EU itself, and the decline of faith in political integration of the pro-European elites. Tusk then asks for "courage, determination and political solidarity of Europeans", stressing that "[o]nly together can we be fully independent". To this end it is necessary to "take assertive and spectacular steps that would change the collective emotions and revive the aspiration to raise European integration to the next level" (http://www.consilium.europa.eu/en/press/press-releases/2017/01/31-tusk-letter-future-europe/)

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The institutional environment and economic growth in transition countries[1]

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Abstract
In this paper we analyse separately the impact of economic and political institutions on economic growth in transitional countries. In the first part we examine whether and to what extent the economic and political institutions affect the growth rate in the observed countries, while in the second part we analyze the economic preconditions for development of economic and political institutions in these countries. We will show that political, e.g. democratic institutions depend on the level of development and initial and inherited conditions. However, they also depend upon the growth model of a relevant transitional country, which relies on lower share of industry in its GDP, as well as upon greater openness of that economy. This leads us to consider: (a) the very method of measuring the development of democratic institutions and its validity, since that development model has not produced economic growth, and (b) measuring the development of institutions related to the growth model that derived from the liberal concept of transition that produced that model's substance and an ideological conception of democracy.
Key words: political and economic institutions, transition, economic growth, initial conditions

In transitional countries it is necessary to provide certain economic preconditions for the construction of high-quality institutions that would further represent institutional basis for future economic growth. We will analyze the separate impact of economic and political institutions on economic growth in these countries. In the first part of this paper we will examine whether and to what extent the economic and political institutions affect the rate of growth in these countries, while in the second part we are going to analyze the economic preconditions for development of economic and political institutions in transitional countries.

Prior to the research part, we noted that the transition is a very dynamic process and a kind of social experiment, and as such it was the subject of numerous studies. It had been looked

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for an answer to the question what were the driving political and economic assumptions (or rather, force), which directed the transition in the right (or wrong) direction. Eicher et al. (2010) emphasized the impact of structural policies[4] and the rule of law on the growth rate. They found that there was a positive, strong and statistically significant relationship between them. Also, according to the OECD standards, increasing the quality of the rule of law, by 10 percent, leads to annual growth of 2.5 percent. What they called structural policies, other authors called public (social) infrastructure,[5] economic institutions[6], or simply institutions.[7] Common to them was that all these terms were used to point to identical or at least similar problems. However, the dynamism of transition coming from the different experiences that were the results of different political and economic preconditions was specific for each country in transition. Specifically, in this process none of them took a step from the same starting position. Hence one could expect different results and inadequacy for most of the transition countries to apply the same model of reform. Therefore, the initial institutional conditions (political and economic), as numerous studies have shown (De Melo et. al 1996, De Melo et. al 1997, Monastiriotis et al. 2010), were significant, almost the determining factor of transition in those countries. In addition to the initial conditions, as well as other important factors that determined the direction and intensity of the transition, empirical researches singled out structural reforms together with the associated construction market infrastructure.[8] The aim of all this researches was to identify the most important determinants of economic growth, thus the economic recovery in transition countries, and, accordingly, to set up their importance.

In this paper, using the unbalanced panel models, we will test the impact of interconnectivity institutions on economic growth and development, and *vice versa*, in transitional countries. Here we want to emphasize that we are talking about a preliminary analysis, which "opens the door" for further research. Our main intention is to show that economic and political institutions are important factors of economic growth and development, but also to show that, especially for transitional countries, where institutional changes has been undergoing, it is wrong to ignore the importance of inherited preconditions and level of economic development of these countries and give precedence only to institutions (primarily political ones). This research started with the question: whether a growth model based on liberalization and rapid privatization, accompanied by rapid democratization without an adequate political and institutional infrastructure had been a good reform transition concept in these countries? Had it respected their mutual differences and peculiarities and with what results?

This paper is divided into two parts. In the first part we analyze the impact of different policies expressed through indicators that measure the effects of these policies on economic growth, which we connect with some of the institutional indicators of the European Bank

4 Torsten Persson (2005) dealt with a similar analysis. He showed that it was not enough just to rely on the usual claim that good institutions were necessary for economic development, but the analysis must have been deepened with the question – what were the social institutions that led to the adoption of certain developmental policies. In that context, unlike other authors who used only the term "institution", he used the term "structural policies".

5 Hall E. R. et al. (1998).

6 Acemoglu D. et al. (2005).

7 Rodrik D. et al. (2002).

8 Please consult a paper (Mervar A. 2002) that gives an overview of empirical researches on the topic of transition.

for Reconstruction and Development, and the Freedom House. We chose indicators of the European Bank for Reconstruction and development[9] because they were used in numerous studies dealing with the transition and provided the most comprehensive information relating to the success of transition reforms. At first glance between them we can spot those with institutional character (e.g. the banking and non-banking sector, restructuring), while some of them are part of the construction of the system (privatization, price liberalization), and we will keep them in the summary index of reforms. They were used to measure reported success in the institutional construction of the market system in the transition countries[10], which is why we are using them as a proxy for quality of economic institutions in these countries.

On the other hand, most of the analysis of the political reform and democratization process in the transition countries relied on Freedom House's indicators of political and civil liberties,[11] which is why we have decided to use them to display the level of the quality of political institutions in these countries. Among the first who decided to have a similar venture were Kormendi and Maguire (1985), who on a sample of 47 countries in the period 1950-1977, using the Freedom House's indexes of political and civil liberties, as a proxy for economic rights, the property rights, as well as enforcing contracts, showed their impact on investment growth and, consequently, on economic growth. Exploring the impact of the political infrastructure on economic growth in a sample of 113 countries, namely the impact of political repression and the lack of political and civil liberties, for the period 1951 – 1980, Grier and Talok (1989) used just index of the Freedom House. For our analysis the most important paper is one of Barro J.R. (1994) who used indexes of political and civil liberties on a sample of 100 countries, in the period from 1960 to 1990, to examine the effects of democracy on economic growth. Relying on these papers, we considered that with the indexes of political and civil liberties of the Freedom House we could adequately present level of quality of political institutions in transitional countries.

Our determination in this research to have some institutional indicators arose from the idea to use them to show the flow and quality of institution-building in these countries and its impact on economic growth. However, in the second part of this paper we point to the conditionality of building quality institution with a level of economic development of the observed countries.

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9 In the beginning we followed eight indicators, which covered three main areas of transition: a) companies (privatization on a large and small scale, restructuring), b) market and trade (pricing liberalization, trade and foreign exchange system, competition), c) financial institutions (banking and non-banking sector and its reform). We later added another field on which we observed the progress in transition, and that is the infrastructure (overall infrastructure reform). The progress in transition in the given countries is measured on a scale of 1 to 4, where 1 means almost no or little progress in reforms, while 4 indicates major progress in transition. Later the system of evaluation of progress in transition is expanded with marks + and – in order to obtain more precise results (numerical +/- 0.33).

10 List of these countries: Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Estonia, FYR Macedonia, Georgia, Hungary, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Moldova, Poland, Romania, Russian Federation, Serbia & Montenegro, Slovak Republic, Slovenia, Turkmenistan, Ukraine, Uzbekistan.

11 The methodology of the Freedom House indicators shows a level of political and economic liberties on a scale of 1 to 7, in the following manner: 1 expresses the country with the highest level of liberty, while 7 expresses the least free countries, or countries with extremely authoritarian political regimes.

Economic growth in transition countries – the impact of economic and political institutions

Economic reforms in transitional countries have opened a number of questions, especially regarding the policy of economic growth while significant deficiencies, some of which institutional, were noticed. The current global economic crisis in these countries further pointed at institutional weaknesses, which was why transitional reforms couldn't have better results, and in some cases, reforms have been even counterproductive. Economic development that based primarily on a high degree of liberalization and rapid privatization, which was suggested to the majority of transition countries, neglected the issue of institutional economic structures in these countries. Besides, the absence of industrial policy and developmental strategy in these countries proved particularly destructive especially expressed during the current global economic crisis (Cerovic et al. 2013).

The dilemma that now again occupies the scientific and professional community dealing with this issue is how to propel economic growth in transition countries. Which are the economic, and which are the institutional preconditions? In our empirical analysis, we assume that the stability and quality of economic and political institutions is an important precondition for economic growth in these countries.

The study was based on unbalanced panel models, in which the annual growth rate in transitional countries (GRWR) is a dependent variable (EBRD data), while the explanatory (independent) variables are: inflation rate (EBRD data) lagged for a year (in log terms) (LOG_INF (-1)), the impact of initial conditions over time (INC * TR), which represent some of the initial conditions to reflect macroeconomic distortions and the level of development of market processes (taken from De Melo et al. 1994, 1997), economic openness (import + export, share of GDP (EBRD data) (OPN), the level of government expenditure (GEXP), measured as a share of GDP (EBRD data). These indicators represent macroeconomic variables related to the economic policy, and also we are adding to them the average of nine EBRD indicators of progress in transition which, to a large extent, have the institutional character and are used to show progress in structural and institutional economic reforms in the observed countries lagged for a year (in log terms). Shortly, this independent variable can also be called the index of EBRD reforms (EBRDIN(-1). The panel model was rated on a sample of 25 transition countries during the period from 1990 to 2007, which we have defined as a period without major economic disruptions on a global level. Hence, the observed period is until the current global economic crisis.

Table 1. Evaluation of the effects of certain macroeconomic variables and economic institutions on the growth rate (GRWR) in transition countries (1990-2007)

Variables	Coefficient	t – statistic	Probabilities
LOG_INF(-1)	-2.901911***	-6.317154	0.0000
INC*TR	4.32E-05***	3.230137	0.0013
OPN	-0.020862**	-2.162856	0.0312
GEXP	-0.200080***	-7.358180	0.0000
EBRDIN(-1)	2.205566***	3.316126	0.0010
C	7.560289	3.428231	0.0007
R^2	0.452598		
Adjusted R^2	0.445396		
F – statistic	62.83773		0.00000
N=25; T=18			
Total number of panel observations	386		

Note: levels of significance: 1% (***), 5% (**), 10% (*).

Taking into account the results presented in Table 1, we conclude that five used independent variables explain about 45% changes in the growth rate (adjusted R^2). All explanatory variables are statistically important for different levels of significance. If we look at the rate of inflation and the level of government spending, we can see that reducing them (negative sign with appropriate coefficients) leads to increasing growth rates, which is expected. In transitional countries, we should expect that over time the high rates of inflation and high levels of government expenditure will reduce, which are accompanied the initial stages of reform, in order to establish a stable macroeconomic environment, which confirms its importance as a positive and important growth factor[12]. Initial conditions are positively correlated with the dependent variable, which means that they are an important factor of economic growth in transitional countries for a long period of time (in this case 18 years). On the other hand, a negative sign in front of the coefficient of the independent variable openness of the economy, which is statistically significant, shows that faster and higher growth has been achieved by transition countries which have opted for a slightly closed market economic model as were not too hasty when it came to opening of the economy. In their research, Cerovic and Nojkovic (2013) showed that transitional countries with less opened market economy were more export-oriented, while the increase of openness was usually manifested through the growth of imports. The explanatory variable EBRD's index of reforms is positively correlated with the dependent variable and also statistically significant, which suggests that the start

12 Similar results can be found in: Fischer S. et. al (1996).

of economic reforms in transition must be followed by the construction of stable economic institutions.

Given the fact that in this part of the paper, we assume that the institutional environment is an important factor of economic growth and development, especially for transition countries in which institutional changes take place, we will replace existing independent variable used to measure success in conducting economic reforms, with another, that otherwise shows the institutional environment. We opted for indicators of civil liberties and political rights of the Freedom House, which shows, in general terms, the level of democracy, and consequently, the level of development of political and economic institutions (which rules apply) in these countries. We looked specifically for the indicators of political rights, then civil liberties, as well as their average, to evaluate their possible impact on economic growth.

In the next model we evaluate the same dependant variable – the rate of growth in transition countries (GRWR), and regarding to independent variables we are holding back the inflation rate lagged for a year (in log terms) (LOG_INF (-1)), the effect of initial conditions over time (INC * TR), which are defined in the same manner as in the previous model, as well as the level of government expenditure (GEXP), measured as a share in GDP. We are adding a new explanatory variable, and that is the level of realization of political rights (Freedom House data) in transition countries (POLR (-1)), according to the reports of the Freedom House, lagged for a year. Analysis of this model also covers 25 countries that were in transition during the period of 18 years (1990-2007).

Table 2. Evaluation of the effects of certain macroeconomic variables and the level of realization of political rights on the growth rate (GRWR) in transition countries (1990-2007)

Variable	Coefficient	t- statistic	Probabilities
LOG_INF(-1)	-3.304837***	-7.301324	0.0000
INC*TR	8.58E-05***	7.566191	0.0000
GEXP	-0.160001***	-5.473877	0.0000
POLR(-1)	0.332437*	1.654160	0.0989
C	6.712844	3.503091	0.0005
R^2	0.412284		
Adjusted R^2	0.406287		
F – statistic	68.74729		0.00000
N=25; T=18			
Total number of panel observations	397		

Note: levels of significance: 1% (***), 5% (**), 10% (*).

Four independent indicators explain a little more than 40% (adjusted R^2) of the impact of the independent variables on the dependent variable (growth rate). All explanatory variables can be considered statistically significant and have different levels of significance. The coefficients of the two independent variables – inflation rate and government spending – have a negative sign, which suggests that a lower inflation rate and a lower government spending have a positive impact on the growth rate, and that is a result that is consistent with the previous model. In this model, it can also be seen that the influence of initial conditions on the growth rate is maintained over time. However, the coefficient of the independent institutional variable that expresses the level of realization of political rights in countries in transition, that is statistically significant, have a positive sign, which is why it can be concluded that those countries with less political liberty achieved higher growth rates (this conclusion comes from the fact that lower levels of political liberty are expressed with higher values of indicators of the Freedom House).

At first glance, this result, although econometrically correct, seems economically unfounded and irrational. This is why, in the next model, we replaced the independent variable, used for measuring the level of realization of political rights, with the level of civil liberties in these countries lagged for a year (CIVL (-1)), also measured by the Freedom House.

Table 3. Evaluation of the effects of certain macroeconomic variables and the level of civil liberties on the growth rate (GRWR) in transition countries (1990-2007)

Variable	Coefficient	t-statistic	Probabilities
LOG_INF(-1)	-3.381904***	-7.455943	0.0000
INC*TR	8.86E-05***	7.799550	0.0000
GEXP	-0.152095***	-5.132420	0.0000
CIVL(-1)	0.589399*	2.286744	0.0227
C	5.402618	2.601248	0.0096
R^2	0.416242		
Adjusted R^2	0.410286		
F – statistic	69.87785		0.00000
N=25; T=18			
Total number of panel observations	397		

Note: levels of significance: 1% (***), 5% (**), 10% (*).

As we can see, the results are similar to the previous model. Selected independent indicators explain a little more than 41% (adjusted R^2) the impact of independent variables on the dependent variable (rate of growth). All explanatory variables can be considered statistically

significant for those different levels of significance. However, there is still a correlation between lower level of civil liberties and higher growth rates.

Because of now observed regularities in the results obtained in the previous two models, in the next model we replaced an independent variable used to measure the degree of civil liberties in the countries in transition, with the average of indicators of civil liberties and political rights in these countries, also expressed according to the methodology of the Freedom House (FHAV (-1)), lagged for a year. We have evaluated the same dependant variable – the growth rate (GRWR) in transition countries, and regarding to independent variables we were holding back the inflation rate lagged for a year (LOG_INF (-1)), the effect of initial conditions over time (INC * TR), which were defined in the same manner as in the previous model, as well as the level of government expenditure (GEXP), measured as a share in GDP.

Table 4. Evaluation of the effects of certain macroeconomic variables and political institutions (average indicators Freedom House) on the growth rate (GRWR) in transition countries (1990-2007)

Variable	Coefficient	t-statistic	Probabilities
LOG_INF(-1)	-3.341403***	-7.378685	0.0000
INC*TR	8.74E-05***	7.684451	0.0000
GEXP	-0.155288***	-5.261072	0.0000
FHAV(-1)	0.461757*	1.986640	0.0477
C	6.020746	2.993777	0.0029
R^2	0.414173		
Adjusted R^2	0.408195		
F – statistic	69.28487		0.00000
N=25; T=18			
Total number of panel observations	397		

Note: levels of significance: 1% (***), 5% (**), 10% (*).

As we expected, the results were very close to the results of the previous two models. Four independent indicators explained a little less than 41% (adjusted R^2) the influence of independent variables on the dependent variable (growth rate). All explanatory variables could be considered statistically significant for those different levels of significance. The odds of two independent variables – inflation rate and government spending – had a negative character, which we already explained as a connection of lower inflation and lower government spending with a higher growth rate. The influence of the initial conditions also remained highly significant. In this model there was a positive correlation between the independent variable which was used to measure the degree of civil liberties and political rights and the dependent variable. Although our result in this model, as in the previous two, led us to the

conclusion that the weaker institutional environment, i.e. lower level of democracy in the transition countries was a precondition of their rapid economic development, we believed that that result still pointed to the others, very important economic preconditions of institutional transformation in these countries, which would be the focus of the second part of this paper.

The importance of economic institutions had often been neglected in a transitional process as it was expected that the market itself would be able to achieve optimal solutions. Such an approach to transitional reforms proved incomplete and probably wrong, despite the fact that changes were necessary and the direction of changes was correct. That is why the insistence on introducing reforms such as privatization, liberalization, and political institutions in these countries that were compatible with the political institutions in developed market economies, which have the centuries-long tradition of institutional heritage, could not give good results, because they were not in the process of creating transitioning recipes of a certain respected institutional arrangement (level of general and political culture and tradition, i.e. the existing informal institutions that prevent the "import" of any formal institution, then the stability of the political institutions, etc.) and economic preconditions (level of economic development of a certain country at the moment reforms began) in transitional countries.

The relevant authors (Rodrik D. 2008) in the series of studies point out that – although institutional "rigidity" is a reasonable option for the countries in transition looking for "quick solution" in the lack of time, especially if one takes into account the fact that there is no unique set of the best solutions applicable to all countries at all times – there has to be taken into account that institutional conditions are specific to each country as well. On the other hand, there are studies (Raimbaev A. 2011) that indicate the smaller importance of institutions on economic performance in transitional countries and explain the fact that these countries are in the process of building and development of market institutions. If these institutions do not have the potential to affect the business environment, then the transactions in the market will be managed by so-called "informal institutions", which are changing very slowly over time and which impact on economic growth is not easily measurable.

So, starting from these assumptions, in the second part of this paper we will try to find answers to the questions: why the institution-building process in transition countries is slow and often ineffective, and why the results in previous models suggest to us that political institutions have a negative impact on economic growth in these countries.

The economic predetermination of institutional development in countries in transition

Among many empirical studies (Arsic M. et al. 2016) where it was confirmed that a greater impact on economic growth had economic, rather than political institutions, in which the effect was often negative and non-linear, we wanted to single out the paper of Robert J. Barro (1994) which had explored the relationship between economic growth and democracy in a sample of 100 countries in the period from 1960 to 1990. He came to the conclusion that there was a non-linear relationship between democracy and economic growth in which the low level of political freedoms encouraged economic growth, while, on the other hand, it was slowing as the country were progressing with the development of political freedoms (democracy).

His analysis showed that a better standard of living, measured by the value of GDP per capita, as well as better education, encouraged the development of political institutions, which were becoming more democratic over time. The main conclusion of his work was that "the developed Western economies", would far more help developing and underdeveloped countries if they "exported" their economic institutions (especially property rights and some of the mechanisms of the free market), instead of imposing their political institutions upon them, which had arisen as a result of improved living standards. The establishment of stable economic institutions in underdeveloped and developing countries promote economic growth and those countries will eventually be more democratic. In the long term, this method of implementation of economic institutions of the developed economies would have a better effect on growth and spread of democracy.

Guided by his conclusions, in subsequent models, we will explore the economic propositions for development of political institutions in transition countries. Unlike previous models, in which we tested the effect of some macroeconomic, as well as some institutional variables on economic growth in these countries, in this part of our paper we will try to answer the previously mentioned questions about the economic preconditions of successful institutional reforms in transitional countries.

Thus, the dependent variable will be certain institutional variable and explanatory or independent variable will be certain macroeconomic indicators, which are related to economic growth and development in these countries. Specifically, for the institutional dependent variable in this model, we determine the quality of certain economic institutions in transition countries, which we defined as an average of nine indicators EBRD progress in transition which have institutional character, or shorter, EBRD reform index (EBRDIN)[13]. With these indicators we show the progress in structural and institutional economic reforms in transition countries. Independent or explanatory variables are the level of development, expressed by the value of GDP per capita (i.e. GDPPC (-1)) lagged for a year (EBRD data), the openness of the economy (imports + exports, the share of GDP) (OPN (-1)) also lagged for a year, the share of industry in GDP (EBRD data) as an indicator of economic structure (IND)[14], inflation rate lagged for a year (LOG_INF (-1)), as well as the level of government expenditure (GEXP), measured as a share of GDP.

13 This variable is defined as in Table 1.

14 We decided for this variable, because it is, in addition to the trade balance, all the more notable as a decisive element of the "new growth model" in transition countries. More information: Cerovic B. et al. (2013).

Table 5. Evaluation of the effects of certain macroeconomic indicators on the quality of economic institutions (EBRDIN) in transition countries (1990-2007)

Variable	Coefficient	t – statistic	Probabilities
GDPPC(-1)	5.03E-05***	7.105421	0.0000
OPN(-1)	0.001895***	3.366688	0.0008
IND	-0.015479***	-5.550656	0.0000
LOG_INF(-1)	-0.254356***	-11.97893	0.0000
GEXP	-0.012760***	-5.870854	0.0000
C	3.641996	28.86170	0.0000
R^2	0.550989		
Adjusted R^2	0.544647		
F – statistic	86.87998	0.00000	
N=25; T=18			
Total number of panel observations	360		

Note: levels of significance: 1% (***), 5% (**) i 10% (*).

All explanatory variables are statistically significant. Five independent variables explain a little more than 54% (adjusted R^2) of the impact on the dependent variable (index of reforms EBRD). There is a positive relationship between the independent variables – the level of development and openness of the economy, with the dependent variable, which points to conclusion that a higher level of development, as well as a more open market economy, have a positive impact and encourage the development of economic institutions in transition countries, which is in line with the results of the previously mentioned Barro's paper. A negative sign in front of the coefficients of the variables of inflation and government spending, which in previous models indicated that lower levels of these variables encouraged growth, should now be understood as that through the growth rate these variables had a positive impact on the development of economic institutions, i.e. on economic reforms in these countries. That result could be explained by economic and structural adjustments which were meant to reduce the impact of the industry on the economic growth in these countries, especially if one took into account the fact that till the beginning of the transition, i.e. until 1989, the industrial sector in these countries was dominant and also, according to some estimates, over-industrialized (De Melo et al. 1996), and therefore it was not surprising that the reduction in the industry had a positive effect on the economic reforms in the early stages. However, problems occurred later when it went over the expected level (Cerovic et al. 2014).

In the initial stages of the transition in most post-socialist countries the impact of the industrial policy has been neglected, while the priority components of the economic policy were liberalization, macroeconomic stabilization and privatization, in accordance with the recommendations of the Washington Consensus. However, in the early 2000s, the situation

started to change, so the industrial policy ranked among important policies of transition,[15] which was partly caused by the process of accession of ten new countries[16] into the European Union. After the outbreak of the current global economic crisis, industrial policy became a central policy of the strategy of the European Union in its efforts to remain a global economic leader (Cerovic et al. 2014). We concluded that economic reforms such as liberalization, macroeconomic stabilization and privatization could not be substitutes for an industrial policy, or a specific developmental strategy neither for given country in transition, but precisely the opposite: in a long term, these economic reforms could not support the economic growth if reforms were not also consisted of the appropriate industrial or development policy, which favors production and export, in correspondence with the inherited institutional conditions of a given transition country. Cerovic and Nojkovic, in one of their studies (2013), used the empirical analysis to show that in the period of crisis, i.e. during the first years of recovery, export-oriented policy was essential for transition countries.

Taking into account that we indicated in the model, Table 5, a positive relationship between the levels of economic development of transition countries and economic reforms, i.e. building their economic institutions, below we will examine the economic assumptions of the reforms of political institutions in these countries, starting from the previously imposed postulation that stable economic institutions must be the basis for building stable political institutions, and that together they represent an institutional basis for economic growth in these countries.

Hence, starting from the aforementioned conclusions of Robert Barro, in the following models we will examine the impact of levels of development and initial conditions, as well as some factors that influence the growth of GDP in transitional countries on the development of their political institutions. We assume that the level of development of political institutions in these countries, as well as their quality, is directly related to the initial, i.e. inherited conditions. This assumption is based on a number of studies in which is demonstrated that the rate of reforms, progress in transition, the economic performance of transition countries, as well as their institutional development, largely depend on the initial conditions[17]. We also want to examine how the model of growth in these countries – which until the advent of the

15 The European Union in Lisbon in 2000 adopted a document known as the "Lisbon Strategy", aiming to EU by 2010 become the most competitive and dynamic economy in the world. The realization of the set goals did not take place at the desirable pace, partly due to the deteriorating global economic situation, which was why the redefinition of the set goals started. This process resulted in the creation of a new strategic document entitled "Europe 2020: a strategy for smart, sustainable and inclusive growth". This document clearly separated three priority areas: smart growth (developing an economy based on knowledge), sustainable growth (while encouraging competitiveness and production that efficiently treats resources) and inclusive growth (better participation in the labor market, the fight against poverty and social cohesion). All three areas were covered by the relevant initiatives. Within the framework of sustainable growth, we particularly point to the importance of the initiative entitled "An industrial policy for the globalization era", which supports the development of strong and sustainable industrial base competitive on a global level. For more information: Kronja et al. (2011).

16 In 2004 the European Union was expanded with ten new members: Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovenia and Slovakia, which represents the largest number of countries that have been admitted to the EU at once.

17 Looking at the transitional reforms as an endogenous process, in a large number of papers it's shown that the initial conditions, although ignored by the proponents of rapid transition (see e.g. Sachs J.D. (1996)), had defining influence on the direction and outcome of transitional reforms (see: Cerovic et al. (2008); Cerovic B. (2010); Falcetti et al. (2002); Campos et al. (2002)).

current economic crisis (2008) was based on an import-oriented growing demand (which increase was relying on the inflow of foreign assets), followed by de-industrialization and in favor of growth of the service sector[18] – has affected construction of their political institutions.

In Table 6 the results of model evaluation, in which the dependent variable is presented as the average of indicators of civil liberties and political rights in transition countries that demonstrates the quality of political institutions, measured according to the methodology of the Freedom House (FHAV) are shown (Freedom House data). Independent, i.e. explanatory variables are the level of development, expressed through the value of GDP per capita (i.e. GDPPC (-1)), lagged for a year, the initial conditions (INC) (taken from De Melo et al. 1994, 1997), the share of import (EBRD data) in GDP (IMP), the share of industry in GDP (IND), as well as the level of government expenditure (GEXP), measured as a share of GDP. Here we have also used an unbalanced panel model. By modeling we included 25 countries in transition in the period of 18 years (1990 – 2007). During this period there were no major economic disruptions.

Table 6. Evaluation of the effects of certain macroeconomic indicators on the quality of political institutions (FHAV) in transitional countries (1990-2007)

Variables	Coefficient	t – statistic	Probabilities
GDPPC(-1)	-6.57E-05***	-5.622700	0.0000
INC	-0.000425***	-3.262759	0.0012
IMP	-0.006125**	-2.554838	0.0110
IND	0.026927***	5.013097	0.0000
GEXP	0.000747	0.176373	0.8601
C	5.586533	7.102891	0.0000
R^2	0.187490		
Adjusted R^2	0.176390		
F – statistic	16.89117		0.000000
N=25; T=18			
Total number of panel observations	372		

Note: levels of significance: 1% (***), 5% (**), 10% (*).

All explanatory variables, except the level of government expenditure, are statistically significant, with a certain degree of error. It explained about 17% of the impact of selected independent variables on the changes in the level of institutional development in transitional

18 Until the outbreak of the current economic crisis (2008) GDP growth in countries in transition relied on a model of a import driven demand and de-industrialization, and in favor of the growth of the service sector. See: Cerovic et al. (2015); Cerovic B. (2015a).

countries (adjusted R^2). The independent explanatory variable – the level of development is significant and negatively associated with the dependent variable. This means that a higher level of development (higher value of GDP per capita, i.e. a better standard of living), encourages the construction and development of quality and stable political institutions (it is expressed with a negative sign taking into account the methodology of measuring the level of quality of political institutions of the Freedom House, which was previously discussed). Initial conditions also significantly influenced the dependent variable, suggesting that the initial conditions predetermine the quality level of democratic political institutions. In addition, the greater value of imports (reliance on import encouraged demand) and deindustrialization which marked the model of growth in transitional countries – showed in the model as a lower share of industry in GDP – contributed to the improvement of political institutions and statistically significantly affected the dependent variable. This means that a lower share of industry in GDP causes the formation of quality political institutions. This result will be more explained below. The level of government spending, as the results show, is not statistically significant, although the character before the coefficient agrees with the assumption that the reduction in government spending leads to improvement of political institutions in these countries.

Since we have showed in the previous model that, in addition to the level of development, initial or inherited conditions had defining influence on the direction and quality of transitional reforms, in the next model we want to examine their importance over time and more specifically, whether their importance over time decreases or not. The dependent variable and all the independent variables are defined in the same way as in Table 6, while an independent variable, initial conditions, are multiplied with the trend to evaluate whether their impact on the quality of the reform of political institutions in transition countries decreases over time, or not.

Table 7. Evaluation of the effects of certain macroeconomic indicators on the quality of political institutions (FHAV) in transitional countries (1990-2007)

Variables	Coefficient	t – statistic	Probabilities
GDPPC(-1)	-9.70E-05***	-5.244192	0.0000
INC*TR	3.38E-06*	1.888085	0.0598
IMP	-0.006365***	-2.665202	0.0080
IND	0.027133***	5.063770	0.0000
GEXP	0.002389	0.534192	0.5935
C	3.052431	8.322013	0.0000
R^2	0.171897		
Adjusted R^2	0.160584		
F – statistic	15.19475		0.000000
N=25; T=18			
Total number of panel observations	372		

Note: levels of significance: 1% (***), 5% (**), 10% (*).

The results confirmed some of the conclusions obtained in the previous model. All explanatory variables, except the level of government expenditure, proved statistically significant, with a certain degree of error. It explained about 16% of the impact of selected independent variables on the level of institutional development in transition countries (adjusted R^2). Even in this model the results showed that the higher level of development was an economic precondition of construction and development of quality and stable political, i.e. democratic institutions. Initial conditions remained important, but with reducing impact.[19] The independent variable that showed share of industry in GDP was also significant and positively correlated with the dependent variable, meaning that the lower share of industry in GDP was a condition for construction of quality political institutions.

However, in the previous analysis, substantiated with other studies with similar results, we have shown that the importance of the industry in the overall economic reforms was neglected, given the fact that most countries in transition had too big industrial sector in the pre-transition period. But, despite the initial structural adjustments that were intended to reduce the industrial sector in these countries, we found very similar results in models in which we had examined the impact of the share of industry in GDP on the development of economic and political institutions in these countries, expressed through index EBRD and scale of the Freedom House, and it could be understood as another, first of all, a methodological problem. In fact, both the indicators contained a certain degree of subjective assessment, most likely coming from the impact of the same ideological base, a neo-liberal doctrine that excludes the importance of industry and industrial policy in general for the development of transitional countries. This approach can lead to better grades for institutional development only in those economies which are more close to the neo-liberal model. That is why only one concept of reforms, which is imposed on all economies, regardless of their inherited conditions or level of development, has proved as incomplete and often wrong.[20]

We continued deepening the analysis by making the next model to examine the effects of economic openness on the construction and development of political institutions in transitional countries. The reason why we opted for this variable was the openness of the economy as one of the most recommended policies for transitional countries and as such a more general factor than imports (external influence on domestic institutions through a spillover effect, or the effect of emulation). So, the dependent variable remained the same – the average of indicators of civil liberties and political rights in transition countries, showing the quality of political institutions, measured according to the methodology of the Freedom House (FHAV). Independent, i.e. explanatory variables, were the level of development expressed through the value of GDP per capita (i.e. GDPPC (-1)), lagged for a year, the initial conditions (INC) as defined in Table 6, share of industry in GDP (IND), as well as the openness of the economy (import + export, the share of GDP) (OPN).

19 Cerovic and Nojkovic (2008) obtained similar results, which showed that the initial conditions had a lasting and significant impact on progress in transitional reforms. According to their findings, the impact of economic and institutional heritage lasts much longer than anticipated at the beginning of the transition.

20 Similar critics can be found in: Campos et al. (2006); Babetskii et al. (2007); Hoskisson et al. (2000).

Table 8. Evaluation of the effects of certain macroeconomic indicators on the quality of political institutions (FHAV) in transition countries (1990-2007)

Variable	Coefficient	t – statistic	Probabilities
GDPPC(-1)	-7.44E-05***	-6.450683	0.0000
INC	-0.000429***	-3.567680	0.0004
IND	0.037945***	7.147822	0.0000
OPN	-0.002837***	-2.471210	0.0139
C	5.357092	7.383226	0.0000
R^2	0.232410		
Adjusted R^2	0.224372		
F – statistic	28.91537		0.000000
N=25; T=18			
Total number of panel observations	387		

Note: levels of significance: 1% (***), 5% (**), 10% (*).

All explanatory variables were statistically significant. A little more than 22% of the impact of selected independent variables on the level of institutional development in transition countries (adjusted R^2) was explained. The results of this model also showed that the level of development, as well as the initial conditions significantly affected quality of political institutions in those countries. Also, the independent variable, an openness of the economy, as the recommended policy for these countries, proved statistically significant and negatively correlated with the dependent variable, meaning that more open market economy was a stimulating economic framework for the reform of political institutions in transitional countries. Given these results, which indicates the justifiability of recommendations to these countries to aim at opening up their economies, especially from the point of institution building,[21] in the following model we examine whether the effect of initial conditions combined with the policy of increasing openness of the economies of these countries over time increases or not.

We evaluated the dependent variable as average of indicators of civil liberties and political rights in transition countries to show the quality of political institutions (Freedom House data), measured according to the methodology of the Freedom House, (FHAV). Independent, i.e. explanatory variables, were the level of development (GDPPC (-1)), lagged for a year the initial conditions as defined in Table 7 (INC * TR), the share of industry in GDP (IND) and openness (imports + exports, the share of GDP) (OPN).

21 Admittedly, in this case, as well as in the results for the industry, we should retain a certain degree of caution considering the assessments of institutional development are based on subjective estimates, and can be understood as an agreement or disagreement with some elements of transitional policies, based on ideological preconceptions.

Table 9. Evaluation of effects of certain macroeconomic indicators on the quality of political institutions (FHAV) in transitional countries (1990-2007)

Variable	Coefficient	t – statistic	Probabilities
GDPPC(-1)	-9.20E-05***	-4.765469	0.0000
INC*TR	1.54E-06	0.892058	0.3729
IND	0.038003***	7.071835	0.0000
OPN	-0.002937**	-2.557375	0.0109
C	2.928581	9.472235	0.0000
R^2	0.208903		
Adjusted R^2	0.200619		
F – statistic	25.21842		0.000000
N=25; T=18			
Total number of panel observations	387		

Note: levels of significance: 1% (***), 5% (**), 10% (*).

As could be seen, all explanatory variables, except initial conditions, and their impact over time were statistically significant, with a certain degree of error. It explained about 20% of the impact of selected independent variables on the level of institutional development in transition countries (adjusted R^2). This model also showed that a higher level of development, as well as more open market economy had a positive impact on the political institutions' reforms in these countries. However, an independent variable showing the influence of initial conditions over time on these reforms was not statistically significant. This leads us to the conclusion that the initial conditions lose their importance over time while their effect on the development of political institutions is being replaced by economic development, structural changes (increase in the share of industry in GDP) and especially by the spillover effects and emulation effects coming from outside influences that, due to the increasing openness of the transition economies has been transmitting to their institutions.

In any case, based on the aforementioned model, we conclude that the political (more exactly, democratic) institutions depend on the level of development and inherited conditions. However, they also depend on the development or growth model of transitional countries – relied on a smaller share of industry in GDP – as well as on a greater openness of the economy (primarily import oriented). This leads us towards two possible conclusions: (a) the validity of the very method of measuring the development of democratic institutions since in the long run this development model did not lead to growth (and thus nor to the growth of GDP per capita as a factor of quality of institutions) and (b) the very *measuring* of the development of institutions which was neglected in the model of growth that came from the liberal concept of transition led us to conclusion that the model itself was burdened with the ideologically based understanding of democracy and the Washington Consensus as equal.

Interest for measuring the democratic capacity and the quality of political institutions is not completely new.[22] It becomes especially important at the end of the Cold War, when the United States straight away assumed the global leadership position. And almost immediately, as part of triumphalist doctrine, there were proposed packages of political and economic reforms that had to be implemented in order to political and economic transformation of transitional countries and along, methodological foundation of indicators which were used for such purpose attracted more attention of scientists and experts (Hartman et al. 1988; Steiner D.N. 2012). However, various deficiencies had been observed, primarily methodological. Most of them did not dedicate too much attention to political and ideological issues that can be found in the background of constructing and the structure of these indicators, which have influence on the order, as well as the regularity of the received assessments. Among many studies, our attention was attracted to an analysis (Giannone D. 2010) in which the emphasis was on these issues. Our interest was further reinforced by the fact that that study analyzed the methodological merits of indicators of the Freedom House, which we used in our research.[23] The analysis in this study assumed that the neo-liberal doctrine had significant impact on creation of indicators of the Freedom House. From one side, indicators were formed to provide a solid knowledge and information about the state of democracy, but there were also noticeable political and ideological motives of their occurrence, especially in the early 1970s, when the concept of neo-liberalism was developed in the leading Western countries, in order to strengthen their power in international relations. The results obtained in this analysis suggested that, besides pronounced political and ideological motives, FH data did not constitute an unbeatable and politically neutral time series, so that their use in research, as well as recommendations for various policies, was questionable. Hence the results obtained in our models can be received with certain amount of reserve. We assume that there is no a universal form of democracy, and that it would be wrong to attempt to impose such concept in transitional countries, especially because this concept does not take into account the importance of the inherited and different institutional conditions, which we proved to be very important for the outcome of political and economic reforms.

Another implication concerns the model of growth that was recommended to transition countries that comes from the liberal concept of transition. Immediately after the fall of communism and the disintegration of the Soviet Union, the dominant form of transition into a market economy was established. This form was based on a package of fundamental reforms that were intended to lead command economies to a new path of commercialization and economic development. The concept of structural reforms was relying on three pillars – stabilization, liberalization and privatization, which the international financial institutions (WB, IMF, and EBRD) have signed over to Third World countries at the beginning of the 1980s (Mitrovic D. 2008). This neo-liberal concept rested on the idea of the market as a meta-institution of social changes and contained the universal (general) understanding of institutional changes. But, this package of economic reforms, covered by the neo-liberal

22 For example, Freedom House is a non-governmental organization established by the US government in October 1941, with the goal to investigate and advocate for the process of democracy, political liberties and human rights.

23 Our commitment to use indicators of the Freedom House stems from the fact that today they are the most common indicators used in studies, which show a level of democracy, and therefore the quality of political institutions.

paradigm, was under strong political influence. This was best illustrated by the fact that in the period from January 1990 to April 1995, 24 countries in transition have consistently applied this concept of reforms (Muller et al. 2011). Pro-market ideas became instruments of policies recommended by leading international financial institutions. In the early 1990s, the International Monetary Fund (IMF), World Bank (WB) and newly established European Bank for Reconstruction and Development (EBRD) have coordinated their positions in the form of a standard neo-liberal package that governments in post-socialist countries had to accept so that they could be granted loans by those institutions. Governments were told that they had no choice but to accept this package of measures, based on a Washington Consensus. The main argument was that all measures had to be implemented into a package, and that a failure in one area would lead to a reduction of the success in other areas (Rutland P. 2013). Some proponents (Griffith B. 2006) of this concept of reforms went a step further and talked about its paradox, which was that if it was not implemented consistently, that would lead to a deepening of political and economic instability. The collapse of socialist political systems resulted in an ideological vacuum, and as such, represented a fertile ground for launching and development of ideas about the superiority of the market and liberalism.

The questions from which we went into this research concerned the role of institutions in fostering the growth as well as growth models in transitional countries, i.e. institutional and economic preconditions on which their growth model was based. The process of institution-building, i.e. institutional reforms in these countries turned out to be slow and often ineffective one. The results coming from the evaluation of the models indicate that in these countries stable institutions can not arise by themselves, because appropriate economic preconditions must be satisfied, while institutional building must be supported by economic development.

Assessing the effects of the transitional process, we can not neglect the fact that since the beginning of this process more than two decades past, and that only 11 of the 27 countries that were commonly observed and monitored managed to achieve an average growth rate of GDP of two or more percent during the period from 1989 to 2008, i.e. until the beginning of the global economic and financial crisis. Among these 11 countries, only four economies, according to the EBRD, have well advanced in terms of transitional reforms, while the other seven are close to or even well below average (Cerovic B. 2015). These results show that the transitional process can hardly be evaluated as successful.

Numerous studies, and we have mentioned some of them in the previous paragraphs, have dealt with the factors that affected the efficiency in achieving the transition reforms. Some authors (Fidrmuc J. 2001) pointed at the interactive relationship between the growth, economic liberalization and democratization during the transition, with conclusion that liberalization had a strong and positive impact on growth, that democracy facilitated the process of economic liberalization and that because of its impact on liberalization, democracy had a positive overall effect on growth. However, progress in democratization largely depended on the economic performances of countries in transition, but also on the political factors that led to the formation of different forms of democracy in them. Some studies (Persson T. 2005) have gone a step further by analyzing what forms of democracy, i.e. of the political system, were the best promoters of the growth in the long term. It was concluded that the formation of parliamentary system compared to a presidential one, and proportional system compared to majority voting system, as well as constant democracy compared to the current democracy,

were essential political preconditions for the promotion of policies that favored long term growth.

The transition is at the same time a change of economic structures and institutions, and its final outcome crucially depends on the connection of economic reforms in terms of liberalization, macroeconomic policy and institutional development. However, poor results in some countries of Central and Eastern Europe, especially the former Soviet Union space, indicate a lack of compliance in reformed strategies. Pointing out the positive aspects of reforms in China, Campos and Coricelli (2002) draw special attention to the importance of initial, i.e. inherited conditions. Good results of certain segments of transition in China draw attention to the importance of inherited conditions and send the most important message of the first ten years of transition, and that is that the reform strategies and recommendations should not ignore and negate the existing different institutional structures. Other authors (Heybey et al. 1999) go even further in emphasizing the importance of initial, i.e. inherited conditions, and claim that the recognition of initial conditions is far more important than the political reforms as a determinant of growth.

Neglecting of the inherited conditions and disregard for the existing institutional structure, i.e. the tendency to take the same model of institutional reforms and apply it to all transition countries represented one of the shortcomings of the transitional concept. Another equally important fault of this concept concerns the growth model that was recommended to these countries. Namely, the concept of transitional reforms did not predict specific measures that would have reflected the growth and development of their specific economies. Basic recommendations to these countries were based on the rate of reforms and liberalization without a detailed consideration of other measures and policies that could have positive effects on the economic performances of their relevant economies. Furthermore, some of these policies, among which we singled out the industrial policy, were even seen as a departure from the reforms (Cerovic B. 2015).

The current global economic and financial crisis has pointed to some shortcomings and deficiencies of the transitional process. The interest in these issues started to grow more and more as a result of numerous studies that emerged, which focused primarily on industrial policy (Rodrik D. 2008) and its importance and role in the future development of countries in transition. Chang (2009) pointed at the importance of industrial policy as an export growth promoter. He believes that export is one of the most important indicators of economic performances of the given country and that without good export performances economic development is not possible. Calling himself "the lawyer of industrial policy", he points out that export is the key segment of a successful industrial policy, and *vice versa*, that a successful export is not possible without a successful industrial policy. Cerovic et al. (2014) have shown that the lack of an adequate industrial policy was actually the main problem of relatively slow and unsustainable reconstruction and development of transitional countries' economies. Neglecting the importance of industrial policy in these countries had led to a sharp decline in industrial production and to over-rapid growth of the services sector, which resulted in an apparent lack of tradable goods for export and consequent deficit in their trade balance sheets.

Simplified understanding of the expected effects of the transition process led to, as we have seen, suboptimal results, which created a need to develop a new growth model for those

countries. Conception of a new growth model must take into account the importance of neglected policies in the transition concept, a greater participation of tradable goods, and especially the increasing role of industrial policy. These measures must be accompanied by greater investments in education and infrastructure as well as a more active role of the government, especially in terms of improving the institutional and investment environment in order to enhance existing business, but also when it comes to attracting new (large) investors.

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Differences in East-Asian economic institutions and consequences for European countries or the squaring of the circle – Lessons of the Taiwanese model

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Abstract
This paper seeks to look at the basic features of Taiwanese economic development and at the same time, it attempts to connect these elements to theoretical questions of economic development. While doing so, it compares the development process of the Taiwanese economy to those of other advanced economies in the region. Thus, the paper includes South Korea and Japan in the analysis. Although Singapore and Hong Kong have very different historic backgrounds and dimensions in terms of population and size leading to dissimilar maneuvering rooms, at certain questions the analysis refers to special experiences of the two economies as well.
Keywords: China, Taiwan, Europe, economic structure, institutions
JEL: F-13, F21, F-31

1. Introduction

The squaring of the circle in economics is to find a general recipe to the economic problems of developing countries. Classic economists of the 18th and 19th century – focusing on microeconomics – did not pay too much attention to macroeconomic matters and economic development questions, then neoclassic economists of the 20th century believed in solutions which were supposed to be 'one size fits all' medicines to problems of both advanced and developing countries. The Great Depression can be viewed as a turning point in economics since John Maynard Keynes and the Neo-Keynesian economists later highlighted the importance of state policies in general and in particular in economic crises. However, only after WWII, economists started to address economic development issues

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by searching for reasons for backwardness, and policies to jumpstart economic growth of the poorest nations. Thus after 1945, development economics became one of the emerging subfields in the study of economics. Since then, its main goal has been to define the basic preconditions of rapid economic development, offering pragmatic answers to problems of underdevelopment. These schools of thought that became popular in the 1950s and 1960s, in the era of decolonization, differed widely from each other in their origins, methodology, and conclusions. (See later!)

The 1980s and the 1990s were dominated by neoliberalism which offered one-sided and one-size fits all solutions. One of the most popular recipes was the Washington Consensus, which stemmed from 1989 and dominated the 1990s and the period up to 2008-2009. This paradigm that lost much of its popularity after the Global Financial Crisis, rested on two main pillars: more competition and smaller state (Ostry – Loungani – Furceri, 2016, pp. 38-41), whereas opening the economy often led to externally financed economic growth in many countries. This sort of growth was fueled in good times by foreign direct investments and in bad times by foreign credits creating financial bubbles. The prescription provided by the Washington Consensus also included privatization, open trade policies, and deregulation.

After the crisis, this approach has fallen from pedestal. One of the main consequences has been the end of the foreign finance reliant growth model, see Iceland and the Eastern European countries. Another element which has changed economic policies of the post-Great Crisis period is the renaissance of industrial policies, bolstering the notion that competent bureaucrats are able to manage state involvement in productive sectors.

No surprise, attention has turned to the economic development policies of China ('Beijing Consensus')[2] which has been successful over the last decades, however, China's experiences may influence other countries, but clearly, they are unrepeatable by any other nation, moreover, the outcome of the Chinese experiment is more obscure than ever. The 'developmental states' of the Far East deliver more relevant lessons to other developing or middle-income countries.

As previously mentioned, there are still many different approaches to economic development problems, but there has been a growing consensus among development economists over the last decades, that economic and political institutions are crucial in explaining success or failure, as they are key elements in creating and maintaining a favorable environment for businesses and innovations, as long they are able to include broad layers of society. Acemoglu-Robinson argue that the way institutions within society are organized is decisive in the outcome, in the productivity of the economy and the well-being of citizens (Acemoglu – Robertson 2012). This is a very old argument; Lipset (1959) was the first social scientist who connected economic success to democratic pluralism, thus provoking debate. A modern version of this argument is to be found in Ferguson, who summarizes all these important elements of success under six headings: competition, science, property rights, medicine, the consumer society, and the work ethic (Ferguson 2011, p. 12). These "killer apps" not only characterize Western European countries, but Taiwan as well. However, these explanations put more emphasis on similarities

2 The term began spreading, when Joshua Cooper Ramo published his paper 'The Beijing Consensus'. He underlined three crucial elements of Chinese success: the value of innovation, rejection of GDP per capita approach and self-determination (Ramo, 2004, pp. 11-12).

existing between Western and Asian success stories, while the 'developmental state' paradigm underlines discrepancies between Western and Asian free market models.

The term 'developmental state' describes one version of the free market economies, indicative of East Asian countries. (See the term described in more detail in Csáki, 2016, pp. 123-146.) This expression also refers to a state-determined, albeit more or less market-friendly approach to economic development. Asian developmental states can generally be characterized by a strong emphasis on diverse forms of state intervention; however, these institutions differ to some extent in Japan, Taiwan, and South Korea.[3] In this paradigm, democracy is a less pronounced variable in explaining success.

The dilemma in the aspect of Washington/Beijing consensus, or developmental states arises is whether a convergence or divergence of economic institutions is to be observed. While different national needs require diverse policies, pointing to divergence in the models, economic globalization confronts these countries with identical problems, forcing them to use similar approaches, leading to convergence. Wan points out that there are essential differences in the literature with regard to the convergence/divergence question: "Modernization theorists argue that developing nations should converge with developed nations if they want to achieve development. Neoclassical economists also believe that national economies will eventually converge as a result of market forces or harmonization through political negotiations. An opposing school sees a persistent divergence among nations" (Wan, 2008, p. 22).

Rostow's five stages growth model still can be viewed as a neoclassical approach to economics, since he develops a theory of uniform pattern of economic development (Rostow, 1960). Gerschenkron goes one step further in his 'Economic Backwardness in Historical Perspective', emphasizing the role of the state. The more backward the country is, the more interventionist approach of the state is needed in channeling the capital to newborn industries. He clearly opposes the idea of uniform development, but he still believes in convergence (Gerschenkron, 1964).

Wan's reference to the 'opposing school' includes very diverse schools of developmental economics, which in contrast to the neoclassical free-market counterrevolution, do not take convergence for granted. Moreover, one of these schools, the international dependence school, advises a delinking strategy to developing countries based on the assumption that coexistence of poor and rich countries is being dominated by such unequal power relationships that it makes it impossible for poor countries to catch up with the most developed ones (see e.g. the works of W. Arthur Lewis, Hollis B. Chenery, Gynnar Myrdal, Celso Furtado and Raul Prebish).

Instead of delinking, Taiwan and other developmental states chose another strategy, and they became successful in an ever-changing global economy by adopting globalization-friendly policies. In our comparison, which only includes the most developed nations of East Asia, the delinking strategy was never an option or a real alternative. Market-friendly economic policies pursued by Japan, South Korea, and Taiwan have been very different in

3 Hong Kong and Singapore are not only different because of their size, but also their position on democratic values is also dissimilar. Taiwan, Japan and South Korea without doubt have inclusive democratic institutions, while Hong Kong's special status and Singapore, which has been featured as a partly free country in the Freedom House Report (2014), create different links between the economic and political institutions of these countries.

nature. The degree of economic openness of these countries has fluctuated over time, depending on whether good times or bad times prevailed in international politics and the world economy. This means that a favorable business environment has always encouraged countries to go further toward liberalization (for example in the 1990s). However, crises have from time to time exposed the vulnerability of these countries, caused by their openness and dependence on external powers and economic forces.

Certainly, the developmental state model does not mean homogenous solutions in these countries, each of them has idiosyncrasies. In order to demonstrate the different nature of the Taiwan model, the next section first looks at the mainstream explanations of the success of Taiwan.

2. Basic elements of the Taiwan model

2.1. Effects of colonization

There are some basic elements of Taiwan's success on which there is broad consensus among scholars.[4] It is clear, by and large that the economic development of mainland China and Taiwan were determined by more or less the same forces up to 1895. Only after the Japanese seized the island, different patterns of development began growing and getting visible. These similarities enable us to ask the following questions: What is common in the two regions? And what are the elements of industrialization which distinguish the Taiwan region from Western Europe?

An often-recurring argument is cultural differences must lead to different forms of capitalism. Max Weber was the first researcher who paid attention to the importance of cultural, ideological influences and religion while explaining the successes of Protestant North European countries. The limitations of this explanation are palpable if one considers the divergent path of economic development in the two Korea or Germany. This differentiation cannot be explained by diverse cultures or languages in these cases. However, John Hicks' notion of the market gives us better understanding of the Chinese and Taiwanese developments (Hicks, 1969). He states market economies of the past always coexisted with „customary" and „command economies". In the case of Imperial China, there were three kinds of economies which could be distinguished: (a) a customary economy which was based on kinship, friendships, relations, emerged when self-sufficiency gave way to economic cooperation. (b) Along with the creation of a state, a command economy was created. The logic of economic cooperation was of ideological or liturgical in this case. Liturgical arguments were used to collect the tax revenues, for example. (c) The market economy which only emerged in

4 Although Taiwan's successes of the 1980s and 1990s are much less likely to be explained by differences in culture, or by Sun Yat-Sen's legacy, it is another line of reasoning many pundits use. It attempts to emphasize the importance of cultural values, mainly pointing to Confucianism. Confucian values might be important in these economic successes, however, only when comparing this region to the rest of the world. Even in this case, Confucian values do not offer a rationale for why the catching-up process of these countries did not start earlier. Another cultural aspect originates from Sun Yat-Sen, who had had a strong influence on the foundation of the Republic of China (ROC), and in establishing the characteristics of the initial setting of the state.

the 18th century in China could complement the customary and command economy and it could efficiently encourage private households to produce for the market. Karl Polanyi uses the term Great Transformation; however, he clearly connects the creation of the market to the emergence of the state which is obviously not the case in China. Since policies of the imperial China failed to boost the development of a market economy, China's economic failure had a deep impact on the country's political history. Although the country was never colonized, the last decades of Imperial China were determined by colonial empires.

The fundamental difference between China and the Taiwan region is that after 1895, the Japanese effectively implemented policies aiming at the integration of Taiwan with Japan's imperial market economy. The Japanese launched modernization programs, including public health reforms, reforms of the land property rights system, transportation, the money supply, standards as well as upgrading administrative capabilities. Although by the end of the Japanese colonization, customary and Chinese liturgical economies were already declining, there were clear setbacks after 1949. In 1945, the Nanjing government took over former Japanese firms and transformed them into state-owned and state-managed companies which was the base of planned economy. The government also set up an agricultural procurement system, while at the same time it imposed control over foreign trade and the money supply. In the decades after 1949, a dual strategy was implemented: This was the promotion of exports to the global economy, while protecting domestic firms, coupled with selective industrial policies.

After 1949, when the communist seized the political and economic power in China, the liturgical command economy was only replaced by another type of command economy, so effective industrialization of China only could take place after 1992. In comparison, the failure of the Chinese industrial development can easily be measured by comparing changes in productivity. As Wu-Xu emphasizes: „In terms of value added per person employee in 1990 PPPs, with Taiwan equal to 100, the comparative level of labor productivity for the Chinese economy as a whole was 50 in 1950, fell to 17 in 1973, declined to 15 in 1990 and only then showed a slight improvement to reach 18 in 1998" (Xu-Wu, 2007, p. 100-101).

Ranis (2007), Booth (2007), and Thorbecke & Wan (2007) also highlight the overall positive effects of Japanese colonization between 1895 and 1945. Ranis put it this way: "Taiwan's colonial heritage undoubtedly made an important contribution to subsequent economic growth. The Japanese colonial administration—if for its own selfish reasons, such as its need for sugar and rice—expended substantial resources and attention on Taiwan's rural sector, in the form of road, drainage, irrigation and power construction projects. It also improved the rural institutional infrastructure through promotion of agricultural research, creation of experimental stations and, most importantly, the establishment of farmers' associations" (Ranis, 2007, p. 37).

When it comes to the effects of Japanese colonization, Taiwan stands out, since colonization rarely generated positive effects in other colonized countries. Fukuyama, referring to an unpublished paper by Matsuzaki, states that the success of state-building in this case depended much on the autonomy of the agents on the ground (Fukuyama, 2015, pp. 313-322). That was a good start for economic development, however the benefits were clearly restricted to improvements in the island's infrastructure.

Paul Rosenstein-Rodan's big push theory which underlines that a minimum level of resources must be devoted to economic development in order to have at least a chance

of success, was developed in the 1940s. Although this approach seems to be a plausible explanation to Taiwan's success at first glance, the problem is that it advocates large scale industrialization, which was never the case in Taiwan. But not only in Taiwan, as critics of the theory claim, but no economy could grow rapidly and catch up only relying on state-funded industrialization programs.

Maybe not the big push, but the first push that came from the US, mattered. Most experts (Ranis, 2007; Booth, 2007; Thorbecke & Wan, 2007) also agree on the importance of US aid of the 1950s and 1960s, and that this was one of the few building blocks of success, which was shared by Japan and South Korea, as well as in Europe by Germany, France, and Italy (through the Marshall Plan). Beyond US aid, American influence was decisive in the formulation and implementation of the new export-oriented economic strategy of the 1960s and the redressing of the science technology policy in the 1980s.[5]

2.2. Land reform

The success of the land reform after WWII was another shared element of the Taiwanese development story with South Korea and Japan. In each case, the land reform was considered as an initial condition which significantly contributed to subsequent industrial successes. Ranis contends that "A second, related and substantial initial advantage, shared in the region only by South Korea, was that of a three-step land reform, implemented between 1949 and 1953" (Ranis, 2007, p. 37). In the case of Taiwan, it provided savings, the necessary initial step, in order to build up a broad industrial base.[6]At the same time, land reform meant a shift in the structure of agricultural products as well; the new products[7] required more labor, but they could be sold in international markets.[8]

In Japan, Takada stresses the salience of agricultural reform as well. According to Takada, the American's reform efforts targeted the break-up of the Zaibatsu system, the speed up of the land reform and the democratization of the labor market. Land reform meant "landlords were forced to sell their holdings of land. These lands were bought up by the government for redistribution to tenant farmers" (Takada, 1999, p. 8.).

2.3. Urbanization

An additional, maybe unintended, but important effect of the land reform was that modernization in Taiwan didn't trigger a massive urbanization process, which is typical for industrialization in developing countries. Urbanization in Taiwan was gradual and slow. Booth emphasizes that fast-growing non-agricultural incomes in rural areas resulted in a very equal income distribution in the area (Booth, 2007, p. 97). The moderate urbanization and

5 Greene (2008) looks at Taiwan's science policy and its institutional development. The book emphasizes the role of the American politicians and scientists.

6 Large landowners were urged to sell their land. The compensation helped them invest in industry.

7 Instead of rice and sugar, there was a heavy emphasis on mushrooms and asparagus.

8 That is why Ranis contends this export-oriented period had already begun with the agricultural exports of the 1950s. He emphasizes that "Taiwan is one of the few countries that adopted a non-durable consumer goods-oriented export strategy as part of an increasingly competitive human-resources-based development path" (Ranis, 2007, pp. 40-41).

relative income equality improved the macroeconomic environment as well. This connection is described by Ranis: "… the features facilitated the implementation of a relatively decentralized rural industrialization strategy, which generated a workable competitive industrial sector that was less subject to the degree of industrial concentration and government directed credit syndrome of other Asian economies" (Ranis, 2007, p. 52).

Thorbecke and Wan placed the same process in a different context, highlighting the smooth inter-sectoral structural transformation between agriculture and industry. "Taiwan represents a textbook example of a country that admirably solved the set of issues related to the size, timing and form of the mechanism whereby a potential agricultural surplus is translated into a net flow of resources that benefits the rest of the economy" (Thorbecke & Wan, 2007, p. 62). With that, Thorbecke and Wan shift the attention to the process of capital accumulation. Much of developmental economics is concerned with the question of how surplus capital can be accumulated in a poor region, where due to the lack of capital low investment rates don't allow for better technology; the poor technological level leads to weak productivity and to low income levels. Consequently, low corporate profits and low incomes for the workers are unable to generate strong demand, which would be an essential incentive for new investments and consumption. This is a classical vicious circle, often described by proponents of development economics (see Myrdal 1974).

In development economics, one of the basic explanations of fast economic growth is the Lewis theory of development, which was formulated in the mid-1950s. In this model, there are two sectors: the traditional rural sector, to be characterized by surplus labor and the modern urban industrial sector, to be characterized by high productivity and demand for labor. In this concept, the transfer of labor from the rural to the urban sector determines the development. In other words, the emphasis is put on the rate of investments and capital accumulation in the urban sector. A similar argument can be found in the Marxist school of thought: Yevgeny Preobrazhensky stressed the salience of capital accumulation arguing surplus capital is to be accumulated by agriculture and these resources have to be channeled into industry through state interventions.

It is clear that the Lewis theory has very strong limitations in the context of Taiwan, since there was no rapid urbanization leading to fast capital accumulation, and Preobrazhensky's theory cannot be utilized here either, despite the existence of a strong state, because in his model state interventions also meant adaptation of no market-prices, typical in planned economies. Moreover, compared to Japan and South Korea, interventions by the developmental state in Taiwan were less forceful. As Ranis argues: "Admittedly, government intervention in credit markets remained substantial and directed credit was also in evidence, as was the important role played by informal, family-dominated allocation decisions—now generally maligned as 'crony capitalism'. But it is also true that the notion that money creation was not to be used to shift profits to favored private or state enterprises—and certainly not to the same extent as was practiced in other East and Southeast Asian countries—came relatively early in Taiwan" (Ranis, 2007, p 41). Copper stresses the same feature in a different context: "There is another difference to note: unlike Japan, which has protected its manufacturing sector from foreign competition, Taiwan let its industries move out and encouraged global economic integration" (Copper, 2003, p. 178).

With that, he refers to a Taiwan-specific characteristic, which can be summarized as 'less state, more competition'. This phrase, however, is only true in a regional comparison, and within the framework of a developmental state.

2.4. Egalitarianism

Egalitarianism, when it comes to credit market access and access in the workplace, has been another important characteristic of the rapid development of Taiwan, Japan, and South Korea. The strong connection between egalitarianism and rapid growth is obvious if one considers that there are different types of growth; for instance, growth induced by agriculture or mining, growth created by the domestic market or international market might create diverse effects related to equality in society. Andersson and Gunnarson put it thus: "These different sets of dynamics in the transforming economy have impacts upon the pattern of equality in terms of wrenching and leveling forces, i.e. when the dynamics of the growth process are interpreted in terms of shifts in the relative advancement between sectors and segments of the economy" (Andersson-Gunnarson, 2004, p. 7).

Taiwan's economic development could not be based on an abundance of natural resources, only on education, technology development, and other policies of a competent and efficient state which also included the adaptation of an egalitarian approach leading to a very equal income distribution. This is the reason why, along with South Korea, Taiwan's Gini-co-efficient[9] (which captures the extent of income distribution) is very low: 0.28 in 2014. In Japan and Singapore, income inequality is much higher (0.31 and 0.46 in 2014, respectively). Looking at the income ratio of the richest to the poorest, a similar pattern can be perceived. The ratio of income shares of the highest 20 percent to that of the lowest 20 percent is only 3.98 in Taiwan and 4.42 in South Korea, while these figures are 5.13 in Japan and 12 in Singapore.[10]

2.5. Devaluation policy

In contrast to Western European countries, where integration of markets was linked to currency convertibility, Japan, South Korea and Taiwan were not forced to liberalize monetary policy and money markets as early as Europeans did. They could take advantage from managed exchange rates and they clearly could capitalize on devalued currencies in order to boost exports.

In the region[11], Japan has had the most liberal exchange rate regime among the regional competitors over the past decades. When in 1971 Nixon announced that the US dollar would not be convertible into gold, Japan immediately switched to a managed floating system. However, free floating exchange systems were legalized only in 1975, at the Jamaica conference

9 Gini-indicator co-efficient is a number between 0 and 1, where 1 responds to total income inequality and 0 to total income equality in a society.

10 National Development Council 2015: Taiwan Statistical Book.

11 Although being featured as developmental states, Singapore and Hong Kong share very different experiences not akin to those of Japan, South Korea and Taiwan. As having been part of British Pound Sterling area, Hong Kong and Singapore pegged their currencies to the British pound before 1972, but all other currencies were fixed to the American Dollar (USD). In general, countries of the region benefited from this system, hence narrow fluctuations

of the International Monetary Fund. During the late 1970s and early 1980s, the Japanese Yen was under appreciation pressure. The Plaza Accord adopted by the United States, Germany, the United Kingdom and Japan triggered a new wave of appreciation of the Yen in 1985, which probably contributed to the Japanese property bubble in 1991 and the subsequent slowdown of economic growth. Since then, Japanese monetary policy has attempted to depreciate the Yen several times. (e.g. after the Asian financial crisis, and after the Global Financial Crisis). The new Japanese economic policy (Abenomics) has also included depreciation of the Yen.[12]

After a currency reform in 1949, the ROC government devalued the New Taiwan Dollar (TWD) in 1950-1951. After maintaining this exchange rate in the 1960s, and in the early 1970s, the TWD's exchange rate was much less influenced by the government's decisions, since after dismantling the Bretton-Woods system, exchange rates of capitalist countries became determined more and more by market forces. A foreign exchange market was established, and a managed floating rate system was introduced in 1979, then a new wave of liberalization took place in 1989. Since then the most long-standing element of monetary policy has been the depreciation of the domestic currency in order to improve competitiveness.

In the 1950s, a multiple exchange rate system was implemented in South Korea. The currency had an overvalued official rate and a more realistic exchange rate, in which trade transactions could be conducted. However, after the military coup in 1961, the currency was sharply devalued and a unitary exchange rate was introduced. In 1965, South Korea pegged its currency to the US dollar. Between 1971 and 1980, the currency depreciated several times. This regime was replaced by a multiple currency basket system in 1980. Not until 1990 was the so-called market average system introduced, which determined, "the exchange rate against the US dollar within a specified range around the weighted average interbank rates of the previous day" (Nam-Kim, 1999, p. 236). South Korea officially adheres to a "free float" regime, but official interventions are not excluded.

bands limited the vulnerability of these countries to external shocks, and significantly decreased the scope of exchange rate fluctuations. After the era of Pound pegging; these countries switched to American dollar in the early 70s when the British Pound was floated. Singapore has soon turned its exchange rate regime into a more market-oriented one by first using a multiple currency basket, then by introducing a so-called monitoring band. Hong Kong, however, implemented a currency board regime in 1983. In this regime, the exchange rate is fixed against the USD. Stability of the regime is achieved by only issuing that volume of domestic currency which the country can back by its dollar reserves.

12 In 2010, the reform of the economic policy (Abenomics) also included other areas of economic policy providing a comprehensive policy framework. The government has launched reforms in taxation; in investment policies, to attract more foreign capital; and in employment and social policies. Despite the bond-buying programs of the central bank, a plummeting Yen, and the stimulus program, the Japanese economy is near to recession. One of the more plausible explanations is that economic reforms in the labor market, tax system, and migration policy have stalled.

As it could be seen, the process of liberalization began much later in Japan, South Korea and Taiwan than in major Western economies, and it was more limited in its scale. No wonder, these countries have been often criticized by the Americans and Europeans for using devaluations as tactical weapons. The same criticism can be applied to the slow opening process of the banking sector.[13]

2.6. The industrial background—a short history and its consequences

Table 1. Competitiveness indicators (2013-2014)

	Global competitiveness index	Innovation	Cluster development
Singapore	2	9	8
Hong Kong	7	23	11
Japan	9	5	7
Taiwan	12	8	1
South Korea	25	17	28
China	29	32	24

Source: WEF Global Competitiveness Report, 2013-2014

13 The structure of the Japanese banking sector was highly influenced by the approach of the American Glass-Steagall Act (1933), which divided the banking sector into commercial banking and investment banking. After the war, the Japanese adopted this approach. Investment banks could accept deposits, but they were not as tightly regulated as the commercial banks which, on the other hand, were protected by the state in case of a bank failure. In addition, long-term banking was separated from short-term banking in Japan. This is not the only difference which distinguishes the Japanese banking sector, compared to the entire Asian region. The keiretsu groups found broad attention in the literature. These were groups of companies which were built around a bank. The advantage of keiretsu groups has been a long-term connection with banks, however it created a cozy relationship between government and business which led to the heavy extension of easy credit by government-guaranteed banks to closely allied companies. This business environment was the main cause of the Japanese financial crisis of the early 1990s (Krugman, 2009, pp. 56-76). South Korea was able to avoid this trap by employing a different approach. South Korean banks did not hold shares in the firms; however, the government strongly directed the banks which were turned into public enterprises in the 1960s. Over the 1980s and 1990s, deregulation and liberalization were trends in the banking sector around the world; however, this trend was punctuated by the Asian crisis. As a response to the crisis, South Korea's government launched serious reforms. After the Global Financial Crisis, South Korea was forced again to take stabilization measures which included: (1) generous liquidity support in Won and US dollars; (2) guaranteeing external debt of banks; (3) recapitalization and restructuring funds; and (4) SME's access to credit (JP Morgan, 2002, p. 5). Thanks to prompt policy measures which enhanced the stability of the financial sector, the flow of money was not disrupted severely (IMF, 2014 p.11). The Taiwan banking sector underwent a similar metamorphosis beginning with heavy state intervention, and leading to liberalization. After WWII, Taiwan's banking sector was highly regulated, because the KMT government, while facing galloping inflation, introduced controls on bank deposits, interest rates, and different banking transactions. In the period between 1949 and 1992, state-owned banks dominated Taiwan's banking sector. These banks channeled capital into favored large, state enterprises. Only in the late 1980s, and early 1990s, internationalization and liberalization started to change the sector: "By 1988 a significant proportion of regulatory controls had been swept away. In a significant move, the Ministry of Finance removed the restriction on the establishment of new banks. In 1989, the central bank began to put foreign exchange reserves in foreign branches of peer banks. This move enhanced their international competitiveness and set the stage for the banking sector to increase the number of overseas branches from 27 in 1990 to 149 by the end of 2001" (Chung, 2015, pp. 297-288). On the other side, several legislative changes made it possible to set up foreign banks in Taiwan. Liberalization in the banking sector, and the reliance on high domestic savings rates, added resilience to the banking sector during the Global Financial Crisis.

The Asian miracle started with a full-scale industrialization in Japan, and it continued in South Korea and Taiwan. Later, in these countries, labor-intensive production of the early stages was replaced by capital-intensive production.

Although the fundamentals in these economies were very similar, catching up with the West took place in different epochs, led by Japan, where the well-designed policies and traditions of early 19th and 20th century industrialization created a favorable environment for a successful economic "take-off" (Rostow 1960, pp. 4–16). In the "flying geese paradigm"[14], Japan was followed closely by South Korea and Taiwan. Taiwan's industrialization started with the labor-intensive textile sector, of which the pattern can be found in Japan and South Korea as well, however, later stages of industrialization were quite different as public enterprises were emphasized less in South Korea and Japan than they were in Taiwan.

Only after the second oil crisis did Taiwan's modern and internationally competitive sectors emerge. In the 1980s, the emphasis on the ICT sector turned the Taiwan Area into one of the largest ICT exporters in the world economy. After significant investments in China, Taiwan's importance began decreasing in this segment, but its role as a powerhouse of ICT production still remains. When it comes to cluster development and innovation, Taiwan stands out among its regional and global competitors (see Table 1).

Liberalization and privatization of publicly owned enterprises took off in the 1990s, however, even today, there exist limitations on foreign ownership. "In its 2015 Investment Climate Statement on Taiwan, the US Department of State also underscored stalled progress on the privatization of state-owned enterprises (SOEs) and foreign ownership caps in the telecommunication, television, and transportation sectors as weaknesses in Taiwan's investment climate" (Rosier–O' Connor–Cuevas, 2016, p. 20). As of 2012, In Taiwan there are 19 state-owned enterprises, and on grounds of security and environmental protection, it limits foreign ownership in public utilities, power distribution, natural gas, postal service, telecommunications, mass media, and air and sea transportation (US, Department, 2015a). However, Taiwan is not alone with this attitude: South Korea restricts foreign ownership in 27 industrial sectors, which is well above the OECD average. In contrast, there is only one formal

14 In the flying gees model, the main driver of industrial change is the leader's (Japan's) need to minimize labor costs, based on shifts in comparative advantages. The concept suggests that industrialization and internationalization of production spreads from one low wage country to another. The mechanism only sets in when competitive advantages of the first low wage country have been fully exploited. But on the other hand, recent technological changes pose new threats since they diminish the importance of wages; since more and more labor phases can be carried out by automation that constrains economic policies exploiting wage differences. It is clear that latecomers, (China, Malaysia, Indonesia, and the Philippines) are already facing this challenge. This also increases pressures on Taiwan to adjust its industrial policies. In other words, it is a key question, where production takes place, but it is equally or even more important where are the hubs of chains of production in the region. Dominant players of supply chains are Japanese, South Korean, Taiwan, and more and more Chinese firms, while American and some of the European companies are also able to take part in this regional competition. (1) The more centralized Japanese model differs from that used by European and American firms, which are more willing to share knowledge and technology. (2) Small Chinese firms usually have familial, flexible networks, however, they are much less likely to build supply chains. Only giant state-owned enterprises have sufficient capital to organize supply chains, but the question which still remains is whether they can do it in a sufficient way. According Goa, the profitability of SOE's is roughly comparable to that of non SOE's, but only in sectors in which they have monopolies. (Gao, 2010a) (3) Taiwan's networks have a mixture of Japanese, Chinese, and Western elements, which enable them to pick the most successful elements of adaption and organization.

limitation on foreign ownership in Japan, which provides the most liberal, investor-friendly legal environment in the region—at least on paper, since despite this freedom, foreign firms do not dominate investments carried out in the country.

2.6.1. Firms

Table 2. Expenditures on research and development (2014, percent of GDP)

Japan	3.54
South Korea	4.30
Taiwan	3.00
China	2.05

Source: OECD database

The other obvious difference among these countries—often reflected in the literature—is that Taiwanese firms are smaller than those of South Korea, and Japan. The significance of this can be seen in Taiwan's weakness in creating global brands, but maybe more importantly, the capital which stand at the disposal of these firms is more limited. This might be one of the reasons why expenditures on research and development are significantly lower than those in Japan and South Korea, since with research and innovation, the amount of invested capital, and thus the firm's size, matters (see Table 2).

However, there are advantages as well created by the same circumstances: (1) Wan states that firms in Taiwan are less willing to borrow money from capital markets and as a result they are less vulnerable to financial shocks (see e.g. the case of the Asian crises of the late 1990s; Wan, 2008, p. 201). As the backbone of the Taiwan economy consists of small and medium-sized enterprises (SMEs), reduced exposure of SMEs to external funding enhances financial stability on a macroeconomic level. (2) According to Wu, the dominance of these small and medium-sized enterprises (SMEs) can be traced back to "Taiwan's dual market structure" (Wu, 2005, p. 325). He explains this duality the following way: "We need to distinguish between two different marketplaces. The first market consisted of the upstream and intermediate-stream industries in which SOEs and LEs operated. The second market was the downstream industries dominated by the SMEs. The state governed the first market while leaving the second to market forces"[15] (Wu, 2005, p. 329). Operating in an environment shaped by market forces gave the advantage that Taiwan's success depends less on state economic policies, since the bulk of the region's success was created by small and medium-sized enterprises.

In many countries, industrialization is linked to foreign direct investment (FDI) inflows. Poor and middle-income Asian countries are characterized by FDI-led industrialization while Japan, Taiwan, and South Korea based their development on domestic savings (See 2.3). The latter countries have been the main sources of foreign direct investments for developing Asian nations as well. Between 1990 and 2014, Japan, Taiwan, and South Korea were net FDI

15 SOEs: state-owned enterprises; LEs: large enterprises.

investors; most of the FDI was directed into China, Thailand, and the Philippines. As a result of FDI-led industrialization, the regional division of labor has changed. Over the last few decades, de-industrialization has characterized FDI exporter countries (Taiwan[16], Japan, and South Korea), while industrialization has only speeded up in the net FDI importer countries.

2.6.2. Supply Chains

Industrial states of the 19th and early 20th centuries (US, Germany, Japan etc.) built up their own industrial bases while relying on their domestic markets. In the late 20th and 21st centuries, economies of scale do not allow for this strategy: latecomers have to find their niche in the global supply chain. So industrialization of these countries has been linked to internationalization, and building regional/global supply chains. That is why the late industrialization of China—without any exaggeration—has changed the entire region. The process has altered the main patterns of manufacturing, not only in Asia, but in the entire world economy. Based on manufacturing output, China alone accounts for more than one-fifth of the production of the world (2012: 22.2 percent). The United States ranks second on this list, with Japan in third place (Meckstroth, 2014).

The economy of Taiwan fully used chances to cooperate with China. Taiwan has a highly-developed economy. For the time being, Taiwan's economy is the size of the Belgian economy (US$490 billion in 2014). But, adding the performance of Taiwanese firms operating in China, "Chiawan"[17] generates around US$700 billion, which equals the size of the Turkish economy, or that of South Korea. There are also estimates regarding the Chinese workforce working in Taiwan firms. These calculations range from 13-15 million and 20-23 million workers. The last figure is roughly equal to the entire population of Taiwan (Lee-Makiyama–Messerlin, 2014, p. 3).

The future of Chinese economic development, and the catching-up process, seems to be more opaque than ever, as the recent slowdown of the Chinese economy reveals fundamental problems which economists usually summarize with the term "middle-income country trap." This refers to scores of problems which fast-growing economies face when they can no longer base their development on low wages. As a result of successful modernization and industrialization, incomes have risen significantly in China, in particular along the coastal regions. But due to higher wages, this economic model won't be tenable in the long run, which is why new competitive advantages must be sought. The shift to a new model accompanied by deep structural changes in the economy, with more emphasis on the service sector and a higher added value, is not an automatic process; there is no guarantee of success. Because of these challenges, Taiwan's reliance on China as a broad industrial base has already changed, and the new situation requires strategic decisions be made in Taipei.[18]

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16 While in 1983, manufacturing accounted for 42.80 percent of Taiwan's GDP, this ratio decreased to 29.80 percent in 2012.

17 The term 'Chiawan" refers to added value generated by Taiwanese firms in Taiwan and China.

18 The other part of the difficulties derives from the political institutions of China. Mixin Pei connects the problem of political institutions to economic challenges: "The absence of a competitive political process and a free press in China makes these high-risk sectors even more susceptible to fraud, theft, kickbacks, and bribery" (Pei, 2007, p. 3). Mary Gallagher states that in fact the Chinese liberalized economy doesn't necessarily lead to a less authoritarian political rule (Gallagher, 2002, p. 340). Although successful countries tend to be democratic ones, (limited) liberal economic regimes can be found even in non-democratic countries.

3. Theoretical conclusions

Chalmers Johnson was the first to conceptualize the term 'developmental state'. He emphasized the competent and far-sighted bureaucracy as a defining feature of the Japanese economic miracle. The purpose in making a distinction between capitalist and capitalist economies was to call attention to differences, not to similarities in these economic systems. He put it like this: "One of my purposes in introducing of the "capitalist developmental state" into a history of modern Japanese industrial policy was to go beyond the contrast between the American and Soviet economies" (Johnson, 1999, p. 32).

Later, the concept of 'developmental state' became popular, and major contributions were made by Alice Amsden (Asia's Next Giant), Robert Wade (Governing the Market), and others. However, the emphasis was shifted in some cases, some analysts highlighted infrastructure, policy tools (saving and credit giving schemes, foreign investments, export zones, government interventions to spread technology etc.), history, culture. Only Hong Kong adopted a free market approach among the Asian Tigers. In South Korea and Taiwan, where governments were not democratic, economic performance was needed to legitimatize the political regimes. One of the often recurring argument is that a strong state is needed to mobilize resources for public goods, since only a strong state is able to convince people and firms that painful political adjustments are necessary to make the economic breakthrough. At the same time, politicians must be credible in the strategy to convince the private sector.

Macroeconomic and political stability are crucial; they are preconditions for economic success. Political stability, as we could see, was not necessarily associated with democratic regimes in the early stages of economic development, as authoritarian regimes built strong and efficient states. In each of the cases, import-substituting policy was part of history, however, it was short-lived. Another common element in the economic development of these countries was the importance of agriculture, which was not heavily-taxed and agricultural workers were not impoverished. A strong social infrastructure of family, local communities supported by the culture, a modern physical infrastructure financed by governments and donors are to be found in Japan, South Korea and Taiwan. In each case, the 'benevolent' external supporter – the United States, pursuing its own political and economic interests – is also there to aid the countries and to advise the elites of these societies.

These are the most important elements of the developmental state concept. Peculiarities of the industrialization process – structure of firms, the way domestic firms are linked to the world economy, the role domestic firms have in the supply chains – do differ, but differences do not matter a lot when it comes to success.

Although Taiwan is a developmental state with strong capabilities in enforcing strategies and policies of the state, it is still the economy in the analyzed group which has implemented the most flexible and cautious attitude to economic development policies and techniques over the last few decades. As we can see, the firm structure in Taiwan is based more on small and medium-sized enterprises than the Japanese and the Korean model. Copper contends "Japan and South Korea, however, have far more large [sic] companies and more heavy industries than Taiwan. Hong Kong and Singapore, also high-growth countries, have almost none" (Copper, 2013, p. 177).

The SME-based firm structure has two consequences: a more limited need and ability for capital accumulation at the firm level, and a stronger need for state incentives to save in private households. The downside of this otherwise highly efficient firm structure is that, compared to the size and developmental level of the economy, the weakness of Taiwan's own global brands is apparent, which is a strategic disadvantage. However, the region does not have to face financial challenges, since domestic savings are more than sufficient, and the gap between savings and domestic investments is the highest in the region in Taiwan. Surplus savings have been invested more and more in China after the turn of the millennium, in order to leverage the comparative advantages of China, which are based on a cheap labor force. With the slowdown of the Chinese economy, this strategy faces challenges.

Berger & Lester emphasize the threats of the Japanese path. Japan did not change its strategy when it had been necessary in the early 1990s, facing a slowdown. Japan created big internationally competitive firms, and at the same time it protected small businesses. This policy resulted in a dual economic structure, in which investments in other Asian countries were preferred over domestic reforms. The Japanese embedded mercantilism[19] embodies a model where interests of large firms overwrite those of small firms and the majority of the population (Berger & Lester, 2005, p. 27). South Korea clearly tried to avoid this trap by relying much more on domestic economic development, however, there is a downside as well, since this policy has encouraged protectionism in South Korea, and made the country into one of the most protected economies among the advanced countries. Protectionism is evident in policies related to foreign trade and foreign direct investments.

Taiwan has more room to maneuver than its competitors, since SMEs are the backbone of the economy, and thus economic policy cannot be based on the protection of SMEs without losing competitiveness. The Taiwan developmental state is weaker but more flexible in implementing policies than its competitors. Stricter rules and policies with regard to exchange rates and foreign direct investments merely demonstrate security concerns over a Chinese takeover of strategically important firms.

In other words, Taiwan's specialty has been a cautious, but in some aspects unconventional, economic policy, which has clearly been different from that of Japan and South Korea. This economic policy has been able to rely on strong small and medium-sized enterprises and on substantial domestic savings, reinforcing stability and the freedom of economic strategy and planning.

4. Practical conclusions for Europe

Taiwan's economy offers various opportunities to European firms, however, there are limitations in several areas, which basically can be traced back to the non-conventional implementation of trade and investment policy measures which by and large attempt to limit foreign participation and influence in different markets. In this area, it is evident that European investments do not pose any risks to the nation's economic security hence redressing policies regarding European investments would improve and strengthen economic ties between Taiwan and the EU.

19 It is mercantilist because economic growth is based on the dynamism of exports, whereas the sectors producing non-tradable goods and services are protected.

The unsolved political questions have heavily affected Taiwan's trade relations. To add to the problems, after early and profound successes in the implementation of the Economic Cooperation Framework Agreement signed between China and Taiwan, further advances have been limited by a growing sense of economic security, and economic independence in Taiwan.

From a European perspective, there are clear benefits from the cooperation to gain (see Table 3). The reason for this optimistic assessment is that Taiwanese firms' capital and technology (e.g. ICT, solar panels) offer chances for firms in EU member states, especially in Central European countries, which still can be featured by suffering from capital scarcity and by the need for technology imports. Relatively low wages in Central European manufacturing firms could be incentives for Taiwan-FDI in the region as well, especially in Hungary, where the re-industrialization process of the economy has been supported by the government since 2010. Since the backbone of the Taiwanese economy consists of SMEs, specialised in ICT and other high-tech related areas, there are excellent opportunities for European SMEs as well. However, these are limited by trade barriers that could be loosened by signing a comprehensive trade and investment agreement.

Table 3. Advantage and disadvantages of Taiwan – the European view

Area	Advantages	Disadvantages
Industrial policies	1. Innovation to buy (ICT, solar panels) 2. Cluster development – broad industrial base 3. Smaller firms with cooperation opportunities 4. Smaller firms less vulnerable to external financing shocks 5. Net borrowing position is stronger than those of the competitors, consequently capital export to EU in form of FDI accessible	1. Smaller firms with small capital 2. Relative weakness in building global brands 3. Lack of natural resources
Trade	1. The trade agreement with China (ECFA) gives plenty of opportunity for European firms to enter the Chinese market via Taiwan 2. Infrastructure, border efficiency and operating environment belong to the best in the world.	1. Excluding trade with China, most of the Taiwanese trade is regulated by the WTO, which can be assessed as a disadvantage compared to regional trade agreements 2. Market access, both domestic and foreign, is significantly lower than world average
Finances	1. High saving rates 2. Reduced exposure to global financial shocks	1. Limited access to financing for European firms in Taiwan
Monetary issues	1. Stability of financial markets 2. Sound government finances	1. Restrictions on foreign investments in bond markets 2. Limited access to the domestic banking market 3. Registration process for FDI

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Political modernization and culture: Russia's experience of the post-communist transformation and global trends

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Abstract
This essay focuses on the problem of correlation between the universal and the national aspects of political modernization in the global world. The author emphasizes the fact that globalization boosts cultural pluralism in the modern world. The reliance on national culture and traditions has become a key feature of successful modernizations in China, India and other "Asian dragons". The experience of post-communist transformation in Russia reveals the positive role of strong socio-cultural identity in the process of modernization. Despite the blurring of boundaries between countries and people in the global age, the socio-cultural identity still remains an important factor of enhancing the "blossoming complexity" in the modern world.

The issue of the correlation between the universal and national aspects of political modernization has been a subject of scientific discussion for many decades. The first modernization theorists (e.g. V.S. Neypol) argued that the Western civilization is universal and suitable for all mankind, and suggested that modernization and economic development contribute to the uniformity of different societies, generating a common universal culture, which is similar to the western world. Pioneers of modernization expected that the transition from traditional to modern society in the countries of the "catching-up" will proceed according to western standards. In this approach, the western political culture and political institutions of constitutional democracy were seen as the universal standard in comparative studies in countries of "catch-up" modernization.

However, the process of modernization transformations in Russia, Latin America, Africa and many other countries has shown that in modernizing societies traditional cultural values and political modernization goals often came into confrontation, creating a conflict of values, which often led to the destabilization of society, social divisions and "color revolutions". Modern comparative studies in the field of modernization reveal that in cases where the

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pattern of modernization is not approved by the values of national culture, they can trigger powerful social mass movement of protest, the desire to destroy, wipe out unpleasant political innovations, and return to the traditional political institutions.

Cultural values and the goals of modernization often come into contradiction, because in many developing countries the goals of modernization were imposed by pro-western governments on societies that were not ready for modernization, with the majority of citizens not understanding and sharing western values and ideas. For example, more than 40 countries in Africa have literally copied the Constitution of the USA. However, this fact did not bring them closer to the ideals of western democracy, but led to numerous political protests and social instability.

In response to these experiments with traditional cultures in the process of modernization was the splash of ethnic separatism and religious fundamentalism in modernizing countries. In the beginning of the twenty-first century, a powerful process of "de-westernization" started in modernizing countries of the East: the world has started talking about "re-Islamization" of the Middle East, and the "return to Asia" in China and Japan. Promoting Western ideas of individualism, success, human rights, neoliberalism in these countries caused a negative reaction, when popularizing of these western values was called "imperialism of human rights" in the countries of the East.

UNESCO experts conducted a global survey which showed the following: only 11% of those surveyed identified themselves with the world in general or with a specific continent, whereas 29% did with the country, and 57% did with the city or the province they lived in. The results of this survey undermine the hypothesis of the possible unification of the world's cultures in the process of modernization.

Hence, the majority of citizens identify themselves with the local community, which means they share the values of the local community, rather than the idea of universal values promoted during the process of globalization. That is why the hypothesis of a possible unification of the cultures in the process of globalization still remains under discussion. This issue is also profoundly studied in the work "Many Globalizations: Cultural Diversity in the Contemporary World" by Peter L. Berger and Samuel Huntington (2003, Oxford University Press, USA), surveying globalization from individual countries of the five major continents.

Moreover, in the end of the twentieth century, many modern states, such as India, China, Hong Kong, Taiwan, Singapore, started the new stage of modernization based not on following western patterns, but on the reconsideration of national traditions and cultural values in the process of modernization. There is a phenomenon of "Confucian capitalism" with lifetime employment and clan organization which is in many ways opposite to the western model of individualism and success. As a result, eastern people working for the sake of the family and for the sake of the clan were ready to work much harder than western people working for the salary and individual success.

The successful practice of modernization, built on the reconsideration of national traditions required a profound revision of the basic notions of modernization theory. Political scientists are now discussing the advantages of traditionalism in modernization: It became clear that reliance on traditional values in the process of political transformation can significantly accelerate the process of political modernization. Moreover, modernization appeared to be able to reinforce the role of traditions. For example, in China, in the period of transition to a

market economy was created the "Confucius Society", which included leading philosophers from the Academy of Sciences. Their purpose was to reconsider the values of Confucianism (such as work, education, merit and frugality) and to adapt them for the targets of modernization. And they made a success of it: it was possible to explain to different sections of society (and in rural districts of China the majority of the population is still uneducated) the goals of modernization using the ideas of Confucian ethic.

Considering the successful experience of China's and India's modernization, where high priority were placed on national traditions, it is interesting to analyze the dynamics of Russia's modernization in the post-Soviet period. The period of post-Soviet transformations could be divided into two phases of political modernization in Russia: the "western" and the "neoconservative". The "western" phase, which began with the collapse of the Soviet Union, led to the ultimate demoralization of the Russian society before the onslaught of western ideology in all spheres of public life. The Russian political establishment of the 1990s openly preached western values and focused on western political standards, aggressively denying national traditions. As a result, national cultural identity of the masses was destroyed, the nation has lost self-esteem, and morale was low. People did not want to work, to create, and have lost self-confidence.

At the same time Russia, was confronting a serious economic crisis: the transition from the Soviet economic model to the market, in which privatization of state enterprises were accompanied by the destruction of industrial potential of the country. Privatization is a controversial topic in Russia owing to the pervasive cases of fraudulence and unjust distribution of wealth surrounding it. Compared to the indicators of 1980, the industrial production index decreased to 60% in 1998 and recovered to 80% only in 2001.

At the same time, fundamental changes in the national economic structure were made with a high priority placed on the commodity industry. The continuation of these trends would have ruined the national economy and the Russian society.

In response to the policy of "westernization", Russia has always been building its identity as the eastern empire, based on traditional values, such as the religious and ethical principles of the national tradition. In the beginning of the XXI century, a new stage of deep socio-cultural transformation in Russian political culture started, which could be labeled the "neoconservative wave". Many Russian experts point out that in the early 2000s, there was a recovery of traditional values, such as statehood, patriotism, family values and morals in the public consciousness.

Restoration of the traditional national values, which provide a powerful motivation for labor activity in the modernization process, was one of the essential reasons for Russia's economic recovery in the past decade. During 2001-2008 (before the global economic crisis), serious progress had been made in the restoration of scientific and technological potential of the country. GDP growth rate in this period was at the level of 7%. By comparison, the US economy grew by 4.4%, while the Japanese did by 3.7% in this period.

The process of strengthening traditional conservative values, which takes place in the modern Russian society, has two dimensions. On the one hand, it is promoted by the political elites, supported by the majority of parliamentary parties, including United Russia, LDPR and Just Russia, as well as by the traditional confessions, including the Orthodox Church as well as the Muslim congregations. On the other hand, the majority of citizens, according to recent

polls, share and uphold the values of patriotism and traditional family values. Therefore it is both a political and a social process.

The global economic crisis, falling oil prices and economic sanctions in recent years hindered the growth of Russia's economy and contributed to the ongoing downturn. In 2016, Russia's economy was still experiencing the long recession. However, the International Monetary Fund forecasted that GDP would return to growth in 2017 with a gain of 1 percent. In 2016, industrial production, transport and agriculture were the main factors behind economic contraction. During the economic crisis, significant steps had been made in a direction of import substitution policy. According to the Ministry of Industry and Trade, the total cost of the announced import substitution projects was estimated at RUB 2.5 trillion.

Polls conducted by VCIOM in 2016 show that 74% of Russians believe that their country is a special Eurasian civilization, which should not follow the western way of development, and only 12% consider Russia as part of the West. Considering this point, it is possible to conclude that traditional national values are shared by the majority of population in Russia. Incorporating the ethical values and core attitudes – such as family values, patriotism, conscience and generosity – in the modernization strategy, could be the key to success of a new stage of modernization in Russia, with a priority placed on innovative technologies.

The restoration of traditional values in Russia in the past decade has united and brought together the society. Patriotism, respect for the traditions of national history have always been a source of social and economic raise in Russia. Together with the economic factors such as a stronger state regulation of the economy, the stabilization of property rights, as well as high commodities prices, this made a cumulative effect and contributed to the growth of economy in Russia.

In conclusion, I would like to emphasize the fact that globalization boosts cultural pluralism in the modern world. The reliance on national culture and traditions has become a key feature of successful modernizations in China, India and other "Asian dragons". The experience of post-communist transformation in Russia reveals the positive role of strong socio-cultural identity in the process of modernization. Despite the blurring of boundaries between countries and people in the global age, the socio-cultural identity still remains an important factor of enhancing the "blossoming complexity" in the modern world.

Innovation and technological renewal in a transforming economy

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Abstract
Over the last few decades, global competition has grown considerably, while in this competition, innovation is becoming the main trump card. The transition to a market economy in Central and Eastern Europe, including Hungary, has paved the way for participation in a global innovation competition, and new players in innovation – entrepreneurs – have also appeared. The limits of the decentralized, free initiative are no longer present, and the strong financial motivation of innovators is not limited by the equalizing behavior typical of planned economies. Therefore, the question is why the furtherance of innovation in Hungary has not been promoted by evolving market conditions? What is the reason for this anomaly? Earlier research sought the answer through the analysis of macroeconomic factors such as low levels of R&D expenditure, size and structure of the IT sector, quality of education, etc. The author tries to show that besides the better examined macroeconomic factors, hidden behavioral attitudes are also present behind the innovation-inhibiting phenomena, such as low willingness for taking risk and learning, noncompliance with contracts and rules, and other "soft factors". The weakness of innovation is also closely linked to the fact that the opportunities and incomes of market players depend heavily on the "strength" of their ties to state or government institutions.[3]
Keywords: innovation, risk aversion, learning ability, rent seeking.
JEL (Journal of Economic Literature) codes: O32, O33, O34, P10, P11, P20, P21

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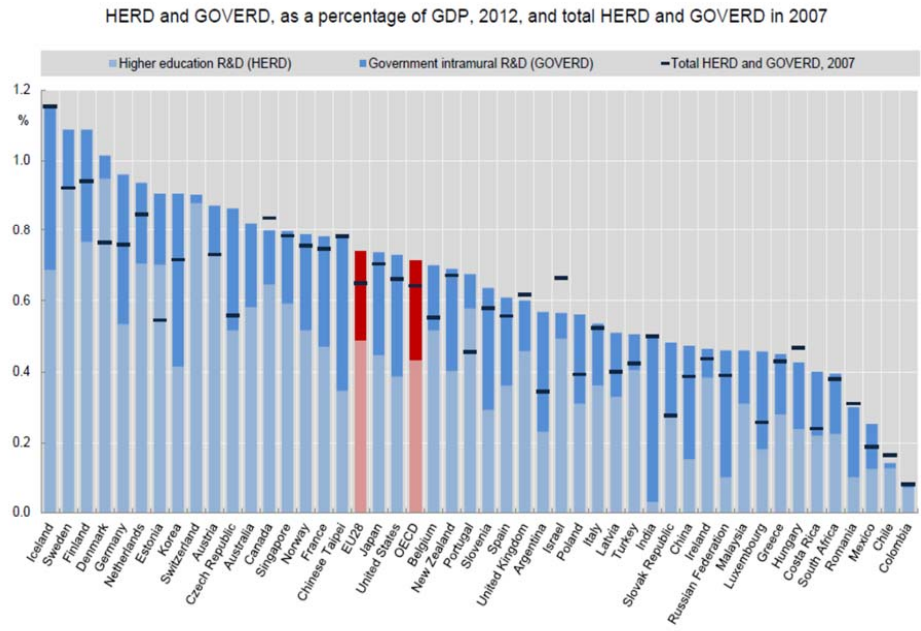
Introduction: Defining the problem

Hungary's innovation potential, considering R&D spending, is problematic comparing it not only to developed countries but to most CEE countries as well. In 2012, only in one EU country, Romania spent the state less as a proportion of GDP for innovation (including higher education). In addition, government spending on R&D (including higher education) decreased to GDP in 2012 compared to 2007, which occurred in few OECD member states. Among them, a larger fall than in Hungary happened only in one OECD country, namely Israel. However, public expenditures spent on R&D are much higher in Israel than in Hungary.[4] Reducing the ratio to GDP on R&D of government expenditure is difficult to justify, even if this improves the share of GERD and BERD[5] indicators and the weight of private expenditures within R&D expenditures – which is otherwise very low for Hungary – grows meaningfully (Figure 1).



Source: OECD Main Science and Technology Indicators Database, June 2014, www.oecd.org/sti/msti; Eurostat and UNESCO Institute of Statistics, June 2014.

4 Particularly critical is the decline in public support for innovation in an era in which the transformation of the technological bases of the economy is driven by innovations and almost every other phenomenon is due to innovation. Nowadays, in a normally functioning modern economy, especially in developed countries, innovation accounts for 60-80 percent of gross domestic product (GDP) growth. Source: OECD Main Science and Technology Indicators Database, June 2014, www.oecd.org/st/mst; Eurostat and the OECD Institute of Statistics, June 2014

5 BERD = R & D expenditures of the business sector, GERD = (Gross Domestic) R & D expenditures, GOVERD = Government R & D expenditures, HERD = R & D expenditures of higher education. BERD, measured at constant prices, has grown strongly by 9% since 2000, while in 2000 it represented 0.36% of GDP, almost doubling to 2010 when it spilled 0.69% of GDP. But the high level of BERD measured in 2010 is largely a high-tech production at foreign subsidiaries; domestic-owned firms only make little innovation. (See OECD Science, Technology and Innovation Outlook 2012, p.304.)

The small contribution of total factor productivity (TFP) to growth in Hungary is attributed to technological progress and, in this context, weaknesses in innovation, which is still very low compared to other Central and Eastern European countries. In addition, this ratio also showed a downward trend and in the period of the global crisis slid straight to the negative range.[6] Regarding competitiveness, the situation for Hungary has not improved considerably in the last fifteen years and even deteriorated in some respects: In 2001, Hungary was ranked 32nd among the countries of the World in competitiveness[7] and 41st in 2006.[8] Since then, Hungary has been sliding downwards: In 2015, it was only 63rd in the World Economic Forum ranking.[9] Again, behind the decline in competitiveness, however, we can only suspect the weakness of innovation. Therefore, even if it is not the only reason for Hungary's dramatic downturn in the ranking of competitiveness, it is definitely a decisive factor in the deterioration in this field.

The share of innovative enterprises in Hungary is the lowest in the European Union, 32%, which is about half of the similar figure in leading EU countries.[10] Moreover, an overwhelming majority of innovative companies are foreign-owned enterprises and innovation activities of SMEs are sporadic if we exclude barefoot or poor innovations that are not included in the EU, OECD or national surveys.

> As a concrete example, it is worth mentioning here that in one of the most dynamic regions of Central Transdanubia, researchers found only 25 companies with more significant innovation capacity (Grosz et al. 2004). Based on the 2012 Regional Innovation Scoreboard, the innovation features of Central Transdanubia are as follows:
>
> "– public R & D expenditures stagnated between 2009 and 2011, while there is a significant increase in entrepreneurial expenditures,
> – in non-R & D innovation spending over the above period there is a significant reduction in all regions except Southern Transdanubia,
> – the willingness of innovative companies to cooperate is higher than the national average, while the number of registered European patents is below average,
> – finally, due to the economic orientation of the region, in the high-tech sectors and in the knowledge intensive service sector, employment significantly exceeds the Hungarian average."[11]

According to the IUS (Innovation Union Scoreboard) 2015, almost all indicators related to innovation are below the EU average. What are the reasons behind the innovation weaknesses

6 Source: OECD (2013): OECD Economic Outlook: Statistics and Projections, December
7 Source:http://web.mit.edu/15.018/attach/Global%20Competitiveness%20Report%202000,%20part%201.pdf
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10 Hungarian Central Statistical Office (KSH): How innovative are Hungarian enterprises? http://www.szta.hu/blog/ksh-mennyire-innovativak-a-magyar-vallalkozasok/
11 Ákos Szépvölgyi, György Fekete, Gabriella Baráth: Intelligent Innovation Specialization Strategy of Central Transdanubia. Central Transdanubian Regional Innovation Agency, 2013, p. www.kormanyhivatal.hu/download/5/4a/51000/KDRIS3-1.pdf

of innovation activities? In our short analysis, we try to point out the specific institutional structure that plays a decisive role in the backwardness of the country.

Institutional determinants of innovation

Without a complex analysis of the institutional system in Hungary, we cannot answer the above question and we cannot explain why technological development and innovation did not really accelerate, and economic development – because of the above deficiencies – has not risen from time to time. Of course, in this short writing we could not carry out a thorough analysis of the functioning institutional system. Yet, we make two statements:

> Thesis 1. Formal establishment of market economy institutions – from competition rules through income taxation to strict consumer protection rules – does not imply their efficient operation. Only efficient and truly well-functioning market institutions make possible and promote innovation activities.
> Thesis 2. With regard to the complex institutional system, Hungary has not yet relinquished the institutional system that is characterized by a lack of actual competition for resources (cf. North et al., 2006).

New technologies and innovations – as many institutional economists and economic historians have convincingly demonstrated (e.g. North 1981, North 1990, Acemoglu et al. 2002, Grief 2006, Rodrik et al. 2004) – are not accidentally emerging and spreading in a society. They are rather consequences of the complexity of social relationships. It is important to emphasize that innovation is a social construction, and innovation occurs where it is allowed by the social atmosphere. According to Kornai (2010), five prerequisites are needed to make innovations and scientific achievements:

1.) A decentralized initiative, individual autonomy and freedom;
2) A huge reward for innovators, including fame and moral recognition;
3) Competition;
4) Free experimentation and acceptance of the associated failures;
5) Available funds to be invested (pp. 40-41).

All those social systems that lack these mutually interconnected elements are not suitable for further development. A number of analyses have pointed out the links between innovation and the social environment (Hollanders and Arundel, 2007, Havas, 2009, Bartha (ed.), 2007). Our approach is perhaps somewhat special in that, following Kornai and North, we do not emphasize the role of any specific factors, but rather their interactions.

> "Economists have carefully documented that there is no single factor explaining economic development – capital accumulation, human capital, resources, international trade or geographic location – to name but a few outstanding examples. Instead, it seems that the complex way in which societies structure human relationships – economic, political, religious

and other interaction-forming institutions – are the key to understanding why certain societies are capable of sustainable economic and political development" (North et al. 2006).

For example, the degree of capital accumulation or the human resources of the country alone do not explain either rapid growth or progress with a protracted crisis in any country. In the case of Hungary, almost complete system of formal market economy institutions are only vestigial realistic market economy institutions, many institutions exist only as a blank framework, which is only partially filled with real content (Sajó, 2008, Fleck 2008, Krekó – P. Kiss, 2007, Szántó-Tóth, 2008, Tátrai, 2006, Belyó, 2008). The notion of the institution is not simply a published or legal form of operating rules. According to Schotter's classic definition[12], we refer to the declared operational rules as an institution that emphasize the observable, realistic regularities of operation and not just the officially-declared rules that many rarely adhere to. Many of the "streamlined" market economy institutions introduced in Hungary during the change of regime and EU accession do not work efficiently: a significant part of these real interactions is at the crossing, partial or complete circumvention of the framework. Formal and real institutional systems have not come close to each other over the past few decades or even decades, and what is more, in some respects, they have moved away from each other.

And the point is precisely this: Behind the formal rules of behavior similar to advanced market economies, radically different behavioral patterns and regularities can be observed. If we look more closely at the reasons behind the lack of rapprochement to advanced, innovative economies, we find the following real facts and behaviors that are obviously irrelevant (see Table 1).

Table 1. Factors explaining the weak innovation of the Hungarian economy

Objective explanatory factors	**Behavioral factors**
Strong path dependence, the survival of certain features and elements of the planned economy's institutional structure (favoritism / protectionism) in distribution processes, consumer's exposure, excessive, oppressive bureaucracy, (hypertrophy of bureaucracy)	Low willingness for taking risk
Low level of social mobility. Rigidity of social structures	Low level of docility and flexibility
Corporate competitiveness is still largely determined by the relationship with the state, and less is built on productivity and innovation	Much of the companies and the population could not get away from the state
A significant part of the actual budget constraint on market players is soft.[12]	Not responsible for agreements, contracts, non-compliant rules, low pay morals
Over the past three decades, the success of the government has been loosely dependent on the successful operation of the economy.	Low tolerance level, lack of openness in the use of foreign experiences.

Source: Own editing

12 Schotter based his own definition on David Lewis' notion, which essentially was formulated for the institutions that Lewis created for conventions (see Lewis, 1969, p. 44).

13 See Dewatripont – Roland (2000).

There is no need for a specific explanation for the restrictive factors in Table 1, in most cases the link between these factors and the weakness of innovation is clear. The linkage between the different objective and subjective factors is income without performance or innovation. However, among the subjective factors, the relationship between social mobility and innovation, openness, tolerance and innovation is not so trivial, so in some sentences it is worth illuminating these relationships.

In Brenner's book (1994), he illustrates with many examples that innovations appear when people are confronted with diversity. He says that in the course of history, always the countries or regions were the "flagship" of innovation (from medieval Venice to the Netherlands to California), because of their geographic location (island or coast) natural and frequent encounters with strangers. Strangers taught locals that they were "possible in other ways" and encouraged them to depart from their routine. For this, however, there was a need for tolerance and openness towards other routines, habits, ideas. (The relationship is, of course, two-way, frequent encounter with diversity helps to develop tolerance.) In contrast, in the big continental realms (for example, in Russia), we often see examples of stagnation. Isolation makes societies balder, single-faced and rigid; encountering strangers protects them from rigidity.

While Hungary is economically one of the most open EU countries, the export activity intensity is even higher than the German economy, paradoxically, this openness does not appear in the thinking of the population. All sociological surveys show that Hungary – compared to international data – is a closed country (as far as the population's thinking is concerned), and tolerance towards foreigners is rather low (Decso-Sík, 2007). According to research carried out by TÁRKI since 1992, after the initial rapid growth of 1992-1995, the rate of xenophobia fluctuated, and since 2002, with minor fluctuations, it remains fairly stable until 2011. Compared with previous years, the proportion of hostility towards foreigners grew in 2012, and remained high in 2013 and 2014 compared to the average of the 2000s. Data from April 2015 exceeded the highest level in 2001, and the share of xenophobic respondents rose from 43% to 46% (Sík 2016).

In addition, many of the country's indicators (the proportion of foreign-language students in Hungary, the extremely low level of foreign languages compared to the majority of EU Member States) is a rather closed and less tolerant country, which does not really support innovation. Openness and tolerance are necessary not only for relations with aliens, but also for accepting and tolerating innovators and innovations. If "hard, creative people" are treated with distrust and hostility, it does not imply the "soaring" of innovations.

The lack of social mobility limits the innovation by the same logic as isolation from, and intolerance against, strangers. "Upward" people do not expect "opportunities to come to them," but are looking for them, trying to gain experience from elsewhere or from abroad, or strive to integrate into a community that is completely different from their own, from their original community (say, if they move from one part of the country to another).

Privatization that is the basis of a market economy alone does not make economic actors innovative. If producers and service providers need to innovate to gain profits, they will innovate if they have to invest, they will invest, but if they do have the benefit of merely using their own relational capital or some "well-established" monopoly, they won't feel aby motivation for innovation. If they can increase the profits of their company without

increasing the consumer surplus or without answering the market needs or even anticipating them, they will not innovate. We also know from the planned economy that the soft budget constraint or the dependence on state aid is not conducive to innovation. As many campaigns initiate to increase R&D, no matter how spectacular innovation or information strategies are being developed, any EU support is used, the innovation capacity of the economy can only be increased if the constraining factors are reduced: the budget constraint becomes harder, the role of relational capital and dependence on the state is weakened, and the willingness to take risks and mobility increases.

The limiting factors of innovation are not independent from each other, rather they form a system. Economic actors should deliver outstanding performance in building relationships to state institutions and expanding their relational capital, not in competition or innovation. If they succeed in doing so, they can get higher rents without taking any particular risk. Innovation is a high risk, and it is much more attractive to risk-averse economic actors to have a low-risk relationship with the state. Such a fruitful relationship softens the budget constraints of "friendly" companies, and thus their budget constraints are more similar to the planned economy than the hard budget constraints of a market economy. The behavior of economic actors is adapted to this situation. Flexibility and learning ability are not so much needed, on the contrary: for the beneficiary companies, maintaining the status quo is the main objective. This in itself limits the efficient functioning of the economy and innovation. State-favored groups in the interest of maintaining the status quo will do their utmost to keep everyone away from "well-founded" economic positions. To this end, they significantly restrict competition and restrict the opportunities of emerging players. It is no coincidence that tens or hundreds of thousands of enterprising Hungarians have left the country and have moved to more open economies offering better conditions for competition, especially in developed EU countries.

Some conclusions

Behind these highly intertwined factors is a social structure that restricts access to resources and opportunities within narrow boundaries, where opportunities are far from equal, and thus necessarily involve limited activities and findings in innovation.

1. In the 21st century's global competition, innovation is the key to success. Hungary's overwhelmingly reprehensible difficulties, which are repetitive in their nature, are closely linked to the limited global competitiveness of the country, which is mainly due to the low innovative ability.

2. The innovative nature of the economy is not exogenously evolving, but it can be explained by the institutional structure of the country, in other words the complexity of economic relations.

3. The implementation of the formal institutions of the market economy does not mean that these institutions also become the observable rules of real economic behavior, and their implementation alone does not guarantee their effective functioning. The same formal institutions (such as a contract) operate in a completely different way in an open society than in a place where actors have limited access to resources.

4. Real conditions and behavioral patterns and attitudes behind the formal institutional structure do not really support innovation in Hungary.

5. In improving economic innovation, in strengthening economic competitiveness, and to overcome the frequent economic difficulties that have been reproduced since the beginning of economic transformation, we can only expect sizeable progress to be achieved if these constraints are mitigated, dependence on the state is reduced, soft budget constraints harden, while tolerance and social mobility grow.

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What is populism? An institutional economics approach with reference to Hungary[1]

Zoltán Ádám[2]

Abstract
This paper conceptualizes populism in an institutional economics context. Examining the literature on populism in political science, it subscribes to the view that populism is a degraded form of democracy that holds elections in regular intervals as rituals of popular legitimation, but undermines pluralism and diminishes effective political choice. Based on the theory of transaction cost economics, the paper argues that populism is a form of government that reduces political uncertainties inherently present in liberal democracies, and hence mitigates political transaction costs. At times of crises and a mismatch between formal and informal institutions conditioning political exchange, demand for such a restricted form of democracy rises. This is what happened in Hungary towards the end of the 2000s, in a period characterized by fiscal stabilization and the socially costly impact of the global financial crisis.
JEL codes: P10, P16, P48, P51, P52

1. Introduction

This paper examines populism from an institutional economics angle. Such an approach is not unprecedented but calls for some elaboration: Why do we need an institutional economics approach to populism? My answer is because we want to understand what makes populism a rational political choice for an increasing number of people in an increasing number of countries. I assume the underlying reasons have to do with the terms of political exchange in democracies, or to use an expression found in the institutional economics literature: with political transaction costs.

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Such an exercise may serve multiple functions. First, it can shed light on the mechanisms of populism, a political technique feared by a lot of devoted democrats, and supported by a lot of others. Second, it can help understand the institutional economics of democracy by revealing the social and economic circumstances under which democracy can be expected to thrive. Third, it may enable a meaningful differentiation among versions of populism: left and right, democratic and authoritarian.

Hence, this paper lies at the intersection of two different literatures in social sciences: (i) the political science research on populism, and (ii) the economics of transaction costs. In what follows, I first present a literature review on populism, drawing on contemporary political science research in section 2. Next I elaborate on political transaction costs and their applicability to populism in section 3. I attempt at situating my theoretical arguments into the empirical case of contemporary Hungary, using Viktor Orbán's praxis in power as an example of authoritarian populism in section 4. The paper concludes in section 5.

2. What is populism? A literature review

Populism is a political ideology that questions the legitimacy of traditional political elites by claiming to be the true, and the only true representative of people. In consequence, populists have a tendency for undermining political plurality by questioning the legitimacy of their rivals (Müller 2016). For populists, 'people' themselves represent justice and morality (Shils 1956), hence they claim to establish a direct, non-institutionalized link between government and the electorate.[3]

Technically speaking, populism is a modernized version of charismatic rule. In Max Weber's classic treatment, a charismatic ruler "derives his authority not from an established order and enactments, as if it were an official competence, and not from custom or feudal fealty, as under patrimonialism. He gains and retains it solely by proving his powers in practice. He must work miracles, if he wants to be a prophet. He must perform heroic deeds, if he wants to be a warlord. Most of all, his divine mission must prove itself by bringing wellbeing [emphasis in the original] to his faithful followers; if they do not fare well, he obviously is not the god-sent master" (Weber 1978 [1922], p. 1114). In this sense, populist politicians are modern-day charismatic rulers, who retain power as long as they are seen to work miracles: alter social and/or international hierarchical relations, change the economic system, bring about a true sense of 'social justice' for subordinated social groups often labeled 'the people' by undermining the authority of discredited 'elites' (also see Gurov and Zankina 2013, Hawkins 2003, Tismaneanu 2000).

Theoretically speaking, populism is a 'thin-centered' political ideology attached to a broader, more established ideological appeal (Stanley 2008). Populism typically uses more elaborate and politically better established ideologies to carve out a unique selling point in

3 Direct, non-institutionalized links include leader-dominated political movements and parties, referenda and other forms of direct participation in political life by people. In Venezuela, Hugo Chavez held multi-hour long public hearings broadcasted nationally (Ellner 2012). In Russia, President Putin hold publicly broadcasted meetings with cabinet ministers questioning their record in applying public policies (White and Mcallister 2008).

the political market. In cases of rightwing populists this is typically nationalism or another form of rightwing authoritarianism. In case of leftwing populists, this is most often a version of socialism (Mudde 2004).

Yet, populism also has its own ideological trademark. As Cas Mudde argued, populism is "an ideology that considers society to be ultimately separated into two homogeneous and antagonistic groups, 'the pure people' versus 'the corrupt elite', and which argues that politics should be an expression of the volonté générale (general will) of the people" (Mudde 2004, p. 543). Hence, populisms are meant to represent the true views and interests of those sidelined and subordinated by selfish and corrupt elites. In other words, populism includes those who had been excluded by traditional elites.

Importantly, this is not necessarily a matter of democratic representation. Populists claim to be the true voice of people irrespective of the number of people they represent in terms of electoral results. After all, the volonté générale's social and political status cannot depend on the sheer number of people realizing its true and inevitable manifestation. And who decides about what the volonté générale is of course are the populists.

In a similar vein, Federico Finchelstein places populism in a context of post-totalitarianism. He argues that modern Latin American populism, most saliently embodied in Peronism[4], is the post-WWII version of totalitarianism, or "an electoral form of post-fascism" (Finchelstein 2014, p. 469). In his account, populism refuses to accept any institutionalized constraint on executive power but is reluctant to introduce explicitly totalitarian rule. Although populism embraces electoral democracy, "[i]n populism, the legitimacy of the leader is not only based in the former's ability to represent the electorate but also on the belief that the leader's will goes far beyond the mandate of political representation. […] The elected leaders act as the personification of popular sovereignty exerting a great degree of autonomy vis-à-vis the majorities that have elected them. […] As an authoritarian version of electoral democracy, populism invoked the name of the people to stress a form of vertical leadership, to downplay political dialogue, and to solve a perceived crisis of representation by suppressing democratic checks and balances" (Finchelstein 2014, p. 477).

In a similar theoretical fashion, Takis Pappas (2016) argued that populism is "democratic illiberalism", or in other words "populism is always democratic but never liberal" (pp. 28-29). This is because populists, on one hand, need to rely on popular legitimation so that they can claim to be the true and the only true voice of people. Hence, they hold elections. On the other hand, they – as the true and only true voice of people – cannot accept losing elections. As there are no better (i.e. more credible, just, morally better entitled, etc.) representatives of the people than they are, any contradicting electoral results should be outright dismissed. Cases in point are Viktor Orbán and Donald Trump: Orbán questioned the legitimacy of both the 2002 and the 2006 Hungarian parliamentary elections that he both lost, whereas Trump called the electoral process 'rigged' before the 2016 US presidential election and declared before Election Day that he would not concede defeat in case Hillary Clinton won.

As Jan-Werner Müller (2016) put it, populism is "a degraded form of democracy that promises to make good on democracy's highest ideals ('Let the people rule!')." This is to say that populism seeks to gain electoral support for an anti-liberal political agenda that aims

4 Juan Peron was President of Argentina in 1946-1955 and in 1973-1974.

at reducing the effective choice that people can make in politics. The question is, however, if political regimes built and dominated by populists can be meaningfully called democracies. Müller's answer is an emphatic *no*: Populists are anti-pluralists and anti-pluralists cannot be democrats, as democracy is per se about pluralism. This answer appears to be in line with that of Kornai (2016), who claims that democracy cannot be illiberal.

Nevertheless, an influential part of the populism literature – and some important political actors referring to it – consider populism an important democratic force. Ernesto Laclau (2005) argues that populism is instrumental in mobilizing politically and economically oppressed masses against democratically unaccountable technocratic elites, multinational companies and international institutions. Newly emerging leftwing populist parties such as Syriza in Greece and Podemos in Spain make explicit references to such views, but older, more traditional leftwing parties such as Die Linke in Germany can also be considered leftwing democratic or progressive populists. Other leading leftwing political actors such as Bernie Sanders in the US and Jeremy Corbyn in the UK can be labelled – and at times are self-proclaimed – leftwing progressive populists.

Referring to their examples and emphasizing the structural weakness of democratic legitimation in capitalism, Mudde and Kaltwasser (2017) endorse populism as a potentially progressive political force. In the fashion of Laclau, they raise the problem of democratic legitimacy with respect to such politically influential but democratically not (or in their view not sufficiently) accountable actors as multinational businesses, central banks and international organizations as the International Monetary Fund and the European Union.

In this context and understanding, populism is indeed democratic – at time almost revolutionary so. The biggest populist success of past decades from this point of view has probably been the rise of Lula da Silva and his Workers' Party that had truly transformed politics in Brazil and lifted millions of Brazilians from poverty. However, neither Lula, nor Sanders, Corbyn or Syriza leader Alexis Tsipras are populists in the sense I use the term in this paper: Neither of them can be considered anti-pluralist, seeking to restrict democratic political choice. They may pursue populist economic policies in the sense of expansionary fiscal policies that at times may well prove unsustainable, this does not render them politically illiberal, however.

Yet, authoritarian populism well might be leftwing. Classics in this brand include Juan Peron of Argentina and Hugo Chavez of Venezuela, but Rafael Correa of Ecuador is also among lead representatives (Ellner 2012, Horowitz 2012). Evo Morales of Bolivia is hovering around the edge of the category (de la Torre 2016). Europe has not seen as many leftwing populists, but according to Pappas (2014), Andreas Papandreou of Greece and his Panhellenic Socialist Movement (Pasok), established in 1974, can be considered one. Papandreou was populist, argues Pappas, for three reasons: (1) He was a highly charismatic, unconstrained party leader, with a highly nationalistic agenda, mobilizing against established elites; (2) He advocated strong government involvement in the economy and pursued unsustainable fiscal policies; and (3) He heavily relied on clientele building and government-created rents. Yet, this occurred in an institutional context characterized by a competitive electoral system and the provision of basic political rights. Hence, Papandreau does not appear to be an authoritarian populists, even if he was highly charismatic and built a clientele.

Similarly, rightwing populists are not always authoritarian. Silvio Berlusconi of Italy, although also highly charismatic and relying on a clientele built around his personal authority, did not create an authoritarian regime for the simple reason that he could not overcome all the checks and balances Italy had been endowed with. Boyko Borisov of Bulgaria can be also seen as rightwing clientele-building populist, exercising unconstrained, personality-based rule within his own political party (Zankina 2016). Andrej Babis of the Czech Republic is yet another case of unconstrained personal rule within his own party, based on clientele building and charisma. Yet, neither Borisov, nor Babis have been able to dismantle the system of checks and balances in their respective countries, in contrast to what had happened in Peron's Argentina, Chavez' Venezuela or Orbán's Hungary.

Finally, another distinction has been made in the populism literature by Rogers Brubaker (2017) who differentiates between liberal and illiberal populisms. Observing that a significant number of North-West-European (NWE) right wing populist parties have recently shifted towards a distinctively liberal direction, Brubaker argues that a new type of individualistic, secular, enlightened populism appears to be emerging. This should be seen – he claims – to be derived from the 'Pim Fortuyn moment' that placed – first in the Netherlands, than across a large part of Western Europe – populism in a new social and political context. As opposed to traditional populists, Fortuynian populists stand up for individual freedoms, including those of women and sexual minorities, whereas depicting groups of society adhering to pre-enlightenment, traditional social values to be the enemies. These are, of course, typically immigrant communities with Muslim backgrounds.

This new populism is liberal and 'civilizational' in its social values, while it defends the liberties of 'enlightened' European societies against the 'anti-liberal aggression' of non-European immigrants. The protection of individual freedoms, however, do not apply for the latter, and those claiming them individual rights and adhere to multiculturalism are regarded part of an oppressive leftwing social, political and intellectual elite exhibiting the 'dictatorship of political correctness.' Rightwing civilizational populism considers oppressing the enemies of European civilization legitimate and indeed inevitable. Elements of this quasi-liberal populism, argues Brubaker, can be traced in the Freedom Party of Austria, France's National Front, the Netherland's Party for Freedom, the Swiss People's Party, Belgium's Vlaams Belang, or the Danish People's Party. They all subscribe to secularism, individualism, equality of women and homosexuals, and the values of western enlightenment in general, whereas all express markedly negative sentiments towards immigrants and especially those of Muslim backgrounds.

In contrast, East European rightwing populists such as Viktor Orbán's Fidesz and Lech Kaczynski's PiS, do not appear to join this club. They keep distancing themselves from individualism and the values of western enlightenment, while sticking to a kind of communitarian vision of politics in which individuals are expected to subordinate themselves to the community manifested in the 'nation.' Hence, East European rightwing authoritarian populism remains to be anti-liberal, not only vis-à-vis external enemies but also within their home societies. As opposed to the 'enlightened' liberal righwing populism of Western Europe, East European rightwing populists use explicit religious references and identify themselves as protectors of Christianity. In the Polish case, this means a reference to a 'closed', illiberal version of Catholicism and an alliance with its representatives within the Polish Catholic

Church (Stanley 2016). In the Hungarian case, in turn, this has little to do with religious values or theological concepts of a good society. It is rather a secularized surrogate religion what Hungarian rightwing populism creates (Ádám and Bozóki 2016a), and hence it is also 'civilizational', although this is a considerably less individualistic, enlightenment-based and liberal civilization than the one referenced by Brubaker's NWE populists.

3. Populism and political transaction costs

The notion of transaction costs in institutional economics refers to the costs of economic exchange. These include (i) search and information costs, (ii) costs of bargaining and contracting, and (iii) costs of policing and enforcing contracts (Coase 1937, Williamson 1985). Not all types of economic transactions carry significant transaction costs, though. Recurring market transactions typically do not imply substantial uncertainties and hence neither impose large transaction costs on transacting partners (Williamson 1979). That is to say, one can buy or sell a loaf of bread in the shop around the corner with facing practically no information, bargaining and enforcing costs. Efficient financial markets also carry very low transaction costs: Information is symmetric, market participants are numerous, transactions are standardized, and completed fast and transparently.

Societies develop formal and informal institutions to mitigate transaction costs. Formal institutions include laws and mechanisms of sanctioning unlawful behavior. Informal institutions are norms and customs transacting partners adopt and obey to. The breach of informal institutions does not entail formalized sanctions yet it typically brings about severe financial and/or non-financial disadvantages (North 1991). Institutions in modern economies are capable of handling complex exchanges keeping transaction costs sufficiently low. In other words, economic quality is closely associated to institutional quality, whereas the latter depends on both formal and informal institutions and their mutual compatibility.[5]

Governance is about the management of transaction costs. In the classic treatment of Coase (1937), firms are conceptualized as organizations producing institutional mechanisms handling transaction costs of complex production processes. As producing cars, skyscrapers and collateralized corporate loans typically require the cooperation of numerous individuals who need to work together in a disciplined manner, they engage in collective action carried out in hierarchical organizations called firms. In other words, vertical integration tend to be more efficient in complex production processes than horizontal market relations. Yet, even this has been changing as new information and production technologies transform industries and loosely integrated networks become increasingly competitive vis-à-vis hierarchical firms (Hámori and Szabó 2016).

Political governance is also about the management of transaction costs. It is meant to maintain, regulate and control political exchange at reasonably low transaction costs.

5 North famously referred to the potential mismatch between formal and informal institutions. Privatization can be done overnight, but the informal institutions within which private property and other core institutions of capitalism rest takes much longer to develop, he said with reference to the process of post-communist transformation in his Nobel lecture (North 1994).

Political exchanges are social interactions influencing the allocation of power, wealth and prestige in society (cf. Downs 1957). They occur both at national and local levels, and even within particular organizations, such as political parties, parliamentary factions, ministerial bureaucracies, NGOs, sport clubs, and – for that matter – firms.[6] Political transaction costs depend on the efficiency of formal and informal institutions determining political exchange and their mutual compatibility. These institutions constitute political regimes.

I said in the last sentence of the previous section that populism seeks to establish 'de-institutionalized political regimes.' What I meant was governance without the constraints of formal institutions: a direct, informal way of political exchange between rulers and the ruled. However, such a form of governance is also based on institutions, of course.

Any routinized, recurring human interaction is based on institutions, and political governance necessarily does so. Yet, instead of formal, transparent and accountable institutions, it can rely on informal, non-transparent and non-accountable ones, in which agreements on legitimate actions are tacit and – at least to some extent – fluid, while subordination to unconstrained power-holders remains the rule. In other words, it is government not based on laws (i.e. legally defined, formal rules) but on customs, cultural preferences and the personal authority of leaders (who may or may not have Weberian charisma).

When does such a populist form of governance become socially dominant and accepted as a legitimate form of government (i.e. socially institutionalized)? My answer is whenever formal and informal institutions of political rule do not match, and the formally institutionalized course of actions by governments are not any more embedded in a web of informal, culturally defined norms and convictions. In other words, when liberal democracy with its entire apparatus of mutually constraining, formalistic, impersonal rule breaks down, and political transaction costs of democracy rise too high. Then the moment of populism arrives, and authoritarian populists can start slashing political transaction costs by reducing political choice. They do this various ways, among which I present two widely used political techniques: the left—right divide and ingroup-outgroup mechanisms.

3.1. Left- and rightwing populisms

Populism is about slashing political transaction costs by reducing the number of effective political alternatives. It is a degraded version of democracy because it constrains genuinely free democratic choice. This can be done in distinctively different ways, and populist, depending on their ideological orientation and institutional environment, offer different political alternatives.

One common distinction is the left—right divide. The camp of leftwing populists consist of Juan Peron of Argentina, Hugo Chavez of Venezuela, Rafael Correa of Ecuador and Evo Morales of Bolivia in Latin America (de la Torre 2016, Ellner 2012, Horowitz 2012). In contrast, Europe has not seen too many leftwing populists, but according to Pappas (2014), Andreas

6 The institutional economics literature conventionally refers to the costs of setting up and maintaining social and political organizations such as political parties and state bureaucracies as political transaction costs (Furubotn – Richter, 2005, pp. 55-57). On the other hand, very few political scientists use the notion of political transaction costs in their scholarship. One notable exception is Zankina (2016).

Papandreou of Greece and his Panhellenic Socialist Movement (Pasok), established in 1974, can be considered one.

Pasok was populist, argues Pappas, for three reasons: (1) Papandreou was a highly charismatic, unconstrained party leader; Pasok advocated strong government involvement in the economy and pursued economic policies characterized by unsustainable fiscal provisions; and (3) Papandreou heavily relied on clientele building and the creation and stabilization of an us—them social cleavage.

Other European parties that can be potentially considered leftwing populist are Die Linke in Germany, Syriza in Greece and Podemos in Spain, but neither of them are leader-dominated and rely on clientele building and the creation of social cleavages as much as Pasok did. Regulating markets and redistributing to the benefit of the poor does not in itself constitute populism as it does not necessarily imply an illiberal approach to power. Hence, Jeremy Corbyn of the UK and Bernie Sanders of the US are not populists either in this sense: They might be labeled democratic or progressive populists, and they well might be skeptical of capitalism, but they cannot be accused of political illiberalism.

Rightwing populists typically employ authoritarian policies, such as infringing on media freedoms and building clienteles through the usage of public resources, and they also tend to form leader dominated parties. In contrast to leftwing populists, they typically do not pursue pro-poor policies, and a large part of their vote is recruited from the middle classes, whom they assist in retaining their social and economic status. Carlos Menem of Argentina, Victor Paz Estenssoro of Bolivia, Alberto Fujimori of Peru, and Carlos Salinas de Gortari of Mexico are Latin American examples of such policies (Stein 2012, Weyland 1998, Gibson 1997). European rightwing populists often exhibit a pro-middle class bias, create leader-dominated parties, and seek to deepen social cleavages. Jean-Marie and Marine Le Pen of France, Silvio Berlusconi and Umberto Bossi of Italy, Geert Wilders of the Netherlands, Albert Rösti of Switzerland and Nigel Farage of the UK are examples in Western Europe. Viktor Orbán of Hungary and Jaroslaw Kaczynski of Poland are both rightwing populists in the Eastern part of the EU. In a sense, Vladimir Putin of Russia and Recep Tayyip Erdogan of Turkey can be also considered rightwing populist as they both rely on democratic legitimacy while pursuing distinctively illiberal policies, although their conduct of power appears significantly more oppressive than usual in authoritarian populism, and hence their respective political regimes gravitate towards outright dictatorship.

3.2. Exclusion and inclusion by populists

Both left- and rightwing populists seek to reduce political transaction costs by undermining the viability of their opposition, hence limiting effective political choice. This way, they create political and economic rents that mutually reinforce each other. As such government-sponsored rents are difficult to cut back, populist leaders may stay in office for protracted periods, in some cases for decades. Populists in power tend to become increasingly authoritarian, as the cases of Orbán, Putin and Erdogan demonstrate. However, there is an inevitable trade-off all authoritarian leaders face: The less democratic their political regime becomes, the lower the genuine popular legitimation they can claim. Although political exchange gets simpler and hence political transaction costs decrease as the regime gets increasingly authoritarian, the

costs of oppression rise and long-term economic performance tends to deteriorate (Acemoglu and Robinson 2000, 2012). Populists, just as any other autocrats, employ ingroup-outgroup mechanisms to mitigate this problem.

In fact, governance always includes and excludes. Political actions in general and public policies in particular inevitably prefer some groups in comparison to others. Given the relative lack of institutionalized constraints on their rule, populist governments are inclined to employ ingroup-outgroup mechanisms by which they build political clientele and insure the political support of their favored electorate.

Preferential treatment can include various policies related to jobs, incomes, wealth or prices. As leftwing populists tend to constrain markets and intensify government involvement in the economy, this can manifest itself in job creation and price regulation. Those preferred by such policies can be considered ingroups vis-à-vis the regime. Rightwing populists, in turn, typically cut taxes on wealth and/or income, and provide beneficial public procurement contracts to their business cronies.[7]

Populists redistribute for those included and extract from those excluded. Most typically those included are politically associated with the 'people', but their socioeconomic characteristics depend on the left—right character of the regime. Leftwing populists tend to include the relative poor (although not necessarily the poorest who typically lack any form of politically relevant social capital) and exclude some of the rich. Rightwing populists typically apply an ethnic and/or religious criteria in their ingroup-outgroup distinction, often provide beneficial treatment for middle classes organized into their clienteles.

Inclusion by the regime always mean a deal. Operation of formal political institutions is of secondary importance only, as being member of the clientele is more important than norms and actions of an impersonal democratic rule. Those who accept informal rules of the regime (that at some point might actually be formalized) typically will not protest even if they perceive the mechanisms of redistribution unfair and normatively problematic. That is why corruption scandals do not work in populist regimes: all those included are 'corrupted' in some sense. Corruption is not the normatively unacceptable exception but the socially implicitly or explicitly approved way of survival in an informally governed, authoritarian regime. Hence, it simply does not necessarily make much sense to draw attention to its existence. Of course, it exists; this is how the entire society gets by.

Exclusion and inclusion help cut political transaction costs as they reduce effective political choice. Those who vote and make other political decisions are controlled through reallocation of resources, including information, money and power, by those above them in the power pyramid. Hence, society gets re-feudalized, although rituals of mass-approval of power remain in place.

7 Political practices of leftwing and rightwing populists are of course not mutually exclusive but well might be mixed by actual populists, whether on the left or the right.

4. The Orbán regime

A prime example of current populist governance is Viktor Orbán's Hungary. Having served as prime minister in 1998-2002, Orbán took over government in 2010 for the second time. As his rightwing populist Fidesz party took two-third of parliamentary seats, Orbán could alter the entire constitutional system as an unconstrained populist leader (Ádám and Bozóki 2016b). Note that a two-third majority was relatively easy to attain in the individual constituency based Hungarian electoral system, in which the majority principle has dominated since 1990. In consequence, a majoritarian approach to power, generally characterizing populist parties and leaders, has been present in Hungary since the regime change, and prevailed both within individual political parties and the entire political system (Ádám 2018).

In 2010-14, Orbán made the constitutional system even more majority-based, effectively dismantling all checks and balances on government power (Tóth 2012, Kornai 2015). In 2014, Fidesz was reelected, and Orbán continued to govern. At the time of writing, he is set to gain yet another overwhelming electoral victory at the spring 2018 general elections, and Hungary is expected to remain governed by him for at least four more years. His success was based on a characteristically authoritarian populist policy mix: He has centralized power, made government economically more active, built an extensive clientele, and heavily reallocated resources to the benefit of his supporter base. State ownership expanded, income inequalities grew, while fiscal redistribution stayed as high as it was before, with significantly less redistribution from the rich to the poor, though.

4.1. Left- or right? Right

Although their policies have exhibited a number of leftwing characteristics, Orbán's governments have pursued an explicitly rightwing version of authoritarian populism. Ideologically they are nationalistic and define the political community on an ethno-cultural basis. Their self-identification has been manifestly rightwing, allegedly standing up for conservative and religious values, even if in actual terms this has rather been a secular pseudo-religion than Christianity and religious conservatism (Ádám and Bozóki 2016a).

Orbán's policies explicitly prefer middle class economic interests. First, this is again a manifestly declared policy goal: Strengthening an ethno-culturally defined Hungarian middle class that supports national interests embodied in local (as opposed to global or foreign) political initiatives carries a high priority in Orbán's political discourse. Second, redistribution policies, including policies on taxation and social benefits, have been also characterized by strong middle class biases.

Since 2010, Orbán has introduced a flat income tax that brought about a large reduction in tax burden of average and higher incomes whereas it increased the tax burden on low incomes. In addition, generous income tax holidays after children made tax burden of middle class families particularly low. In contrast, lower income big families simply do not have enough revenues to claim these benefits. In the meantime, child benefits, paid after children regardless of family income, have not risen but lost part of their real value, particularly hitting low income big families, many of them being Roma (Inglot et al. 2012). Generous housing finance schemes have been also introduced to the benefit of high income families, able to buy

or build new houses. Finally, the polarization of state-administered pensions, started in the pre-2010 period, continued as a high replacement ratio and undifferentiated pension hikes made middle class pensions grow faster than pensions of lower income earners (Ádám and Simonovits 2017).

Some of Orbán's policies have exhibited a less explicit pro-middle class bias. Importantly, utility prices have been administratively cut by the government in 2012-14, significantly boosting the popularity of the regime and the reelection chances of Orbán in 2014. Cutting utility prices at first sight appears a pro-poor measure, and to some extent it indeed is. However, middle classes also enjoy lower utility prices, especially those having a large house. Moreover, the utility price cut was part of Orbán's scheme of redistributing markets of utility industries: These were privatized in the 1990s for large foreign firms by the then governing Socialists and Liberals, whereas Orbán partly renationalized them after 2010. Cutting utility prices was an incentive for foreign firms to withdraw from the market and relinquish their previous investments in a formerly friendly, recently hostile-turned business environment (Ámon and Deák 2015, pp. 95-96).

Orbán also levied special industry-specific taxes on banking, energy provision, telecommunication and food retail trade. Apart from raising additional budgetary revenues, these taxes also gave incentives for large foreign companies to leave the Hungarian market, and let the government control it directly through regulation, nationalization and – in some cases – re-privatization to friendly businesses. The policy goal was to strengthen local capital accumulation and support government-sponsored business clienteles through the allocation of market shares and preferential government provisions, often at – or beyond – the edge of legalized corruption (cf. Fazekas and Tóth 2016, CRCB 2016).[8]

4.2. Dynamics of inclusion and exclusion

Successive Orbán governments – like any other authoritarian populists – have always made explicit who were 'us' and who were 'them' from their perspective. Orbán has always placed a great political emphasis on creating deep social divisions between his camp and their opposition. He has acted like a feudal landlord among his subjects, always appreciating loyalty and punishing individualism. Traditionally, the dividing characteristics he used were attitudes to the communist past, to the outside world, to national identity and to Christianism.

Ideologically, Orbán's 'us' were the non-communist, ethno-culturally Hungarian, Christian, 'civic' (i.e. non-proletarian) Hungarians. Upon losing the 2002 elections to the Socialists, however, he revised this basis of identification by incorporating more plebeian-populist elements. He changed his dress-code and, to some extent, even his language, to appear and sound more authentically identical with the people. Eventually, in the wake of the global financial crisis and the ensuing fiscal stabilization by the then governing center left, Orbán made this kind of inclusive 'us', consisting both plebeian and aristocratic elements, victorious.

Another important economic and social policy measure playing a major role in creating ingroup-outgroup dynamics has been the expansion of public work programs. In these,

8 Another form of providing government secured rents for friendly businesses was the creation of local tobacco retail sales monopolies that were typically allocated among Fidesz-friendly local businesses.

hundreds of thousands of people have been included who otherwise would have typically stayed economically inactive. They have earned miserable wages but still enjoyed some degree of income stability. To make the program more attractive, the government reduced social benefits of those out of work, including both the unemployed and those who had been out of the labor market on a permanent basis.

Public work programs seldom make participants economically more competitive. Instead, participants often get stuck in these programs (Cseres-Gergely and Molnár 2015), making them dependent on government policies and, in particular, local authorities who directly employ them in most public work scheme. Especially in villages and small towns this can contribute to the re-feudalization of power relations, while at the same time responding to the negative stereotypes of the public about the scores of 'lazy inactive' people, among whom the Roma are overrepresented (Kertesi and Kézdi 2011). Hence, public work programs have been instrumental in making the distinction between included and excluded sections of society salient and tangible, and creating a hierarchical relationship between the two.

Nevertheless, inclusion-exclusion dynamics have been restructured by Orbán since the last general elections. The 2014 elections were to a significant extent won by Orbán through utility price cuts that symbolized the regulation of markets and the emphasis on living conditions. The message was that ordinary people were not any more at the mercy of businesses but were protected by the government, delivering tangible financial gains to them at the cost of foreign investors.

Importantly and interestingly, Orbán has formulated a new message since then. With the start of the European migrant and refugee crisis in 2015, he gained an opportunity to redefine ingroup—outgroup dynamics along ideologically determined ethno-national lines. Fencing Hungary both ideologically and physically, Orbán was able to offer ingroup membership to all prepared to accept the boundaries of 'us' he proposed, and recognize him as the leader of the nation. He went against the EU and identified Hungary as a no-refugee zone, refusing to adhere to the principles of international human rights and EU law. This way, an ethno-culturally constructed ideological differentiation became the basis of new ingroup-outgroup dynamics.

5. Conclusions

In this paper I argued that populism is a degraded form of democratic politics that seeks to eliminate its political rivals while maintaining popular legitimation through multiparty elections. Whether on the left or the right side of the political spectrum, populism is always illiberal. It projects a unidimensional political space in which populist contenders represent themselves as the true and only true representatives of the people, rejecting the legitimacy of any other claim to power. This way, populists simplify complicated social and political reality, and seek to reduce effective political choice. Hence, they reduce political transaction costs.

Political transaction costs, I argued, are the costs of conducting horizontal political exchange among autonomous political actors. Being the legitimate representatives of their own convictions and interests without being institutionally subordinated to any other political actors, members of democratic societies impose significant political transaction costs on

each other by making political exchange unpredictable, situated in a multidimensional social space. As societies cannot always afford to bear these costs, populism appears to be in need from time to time even in rich, developed, first world countries.

I also argued that leftwing populists tend to redistribute to the benefit of the poor and use socialism or Marxism as an ideological basis. Rightwing populists, in turn, typically redistribute less, and place political emphasis on ethno-cultural nationalism. Both left- and rightwing populists tend to be anti-liberal and authoritarian, as a number of examples in Latin America and elsewhere suggest. A new type of North-Western European rightwing populism tends to exhibit an increasingly liberal worldview with respect to individual freedoms – as long as the freedom of migrants and refugees are not concerned.

Apart from the left-right political divide, populists – as many other anti-liberal political regime – apply ingroup-outgroup dynamics to structure political space. Members of ingroups are preferred by redistributive policies (and often also by symbolic politics). They are part of the official 'us', and they are meant to be the social core of the regime. Their interests are served by the regime and their systematic advantages are presented as legitimate politically. That is why corruption charges often remain non-effective against populist regimes: They are of course corrupt in the sense of systematically preferring particular groups of society, but this is a quasi-legitimate political pattern as long as they prefer members of the ingroup.

Both the left-right divide and the ingroup-outgroup divide reduce political transaction costs by conditioning political exchange and reducing effective political choice. This way, redistributive patterns get stabilized and the allocation of power may remain unchanged over a protracted period of time. Importantly, this is not to say that predictability of political actions increases from the point of view of individual political or business actors.[9] The rule of law, in fact, deteriorates. What becomes more predictable and hence eliminates a considerable amount of uncertainties surrounding political exchange is the survival of the regime with its patterns of redistribution and allocation of power. In societies characterized by a limited capacity of people to hold their government accountable and impose checks on power, such political stability appears attractive as opposed to its alternative, which is essentially anarchy.[10] In other words, societies that lack formal and informal institutions and their mutual reinforcement necessary for maintaining liberal democracy, populism becomes a viable political option of maintaining a 'degraded form of democracy' – and hence avoiding outright dictatorship.

I argued that this is what precisely happened in Hungary after 2010. Having experienced a deepening political and economic crisis of liberal democratic governance in the late 2000s, Hungarians identified Vikor Orbán's illiberal approach to power as a promising alternative of a more stable and predictable political regime. Orbán's reign well might be corrupt, redistributing to the benefit of a business clientele at a mass scale, yet it provides a sufficient amount of benefits for a sufficient number of people in a stable and predictable manner so that it has a fair chance to survive the 2018 elections.

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9 I am grateful to the participants of the departmental seminar of CEU's Department of Political Science, especially Zsolt Enyedi, for drawing my attention to this point.

10 Weingast (1997) associate the capability of people to hold their government accountable and curb governmental transgressions with the existence of 'focal solutions' to the problem of collective action.

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Balázs Hámori was born and educated in Hungary. He got his master's degree in Economics from the Karl Marx University of Economic Sciences (Budapest, Hungary; today's Corvinus University of Budapest) in 1969 and his Ph.D. in economics from the Hungarian Academy of Sciences (HAS) in 1985. He was granted the title of doctor of sciences of HAS (so called "grand doctorate") in 2015. He collaborated with the graduate programs of various universities, including Indiana University, Purdue University and Washington University (St. Louis) in the US as well as the University of Tuebingen and the University of Bamberg in Germany. He is a professor of economics at his alma mater. He has been formerly head of department for comparative economics, general director of the Management Development Center, dean for postgraduate studies, and vice rector (pro-vice chancellor). He has been member of numerous bodies of the HAS and has served in national and international research funds' boards. He is also on the editorial boards of numerous journals. He has served as visiting professor or visiting research fellow at Purdue University, (West Lafayette, IN), Purdue University North Central (Westville, IN), Indiana University, (Bloomington, IN), the University of Redlands

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Dragana Mitrovic, PhD, is full professor at the University of Belgrade, Faculty of Political Sciences (FPS), and a leading Serbian expert for economy, politics and security of modern China and East Asia. She is the founder and director of the Institute for Asian Studies and editor of the Asian Issues, an annual journal. Prof. Mitrovic has a full university career from an assistant position to the current one. She also served one term in Foreign Service at the Embassy of the FR Yugoslavia in Beijing, as Counsellor for Political Affairs (2001, 2002) and at the Embassy of Serbia and Montenegro as Minister Counsellor for Economic and Political Affairs (2003, 2004). Professor Mitrovic teaches Political Economy, International Political Economy, Political Economy of the PR China and East Asia, Geopolitics and Geoeconomics. She is the head of the Regional Asian Studies master course at the FPS. Prof. Mitrović is the author of three books and more than fifty papers. From 2008 she has been a member of the Board of Economic Science of the Serbian Academy of Arts and Sciences. She has regularly been invited by domestic and foreign electronic media to interpret current processes and events within the area of her expertise.

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Katalin Szabó (1944-2017) was Professor Emerita of Economics at the Department of Comparative Economics of the Corvinus University of Budapest. She received her Master's degree in Economics (1966) from Karl Marx University of Economic Sciences in Budapest (today's Corvinus University of Budapest and her PhD in Economics from the Hungarian Academy of Sciences (HAS, 1976). She became Doctor of HAS in 1988. Besides teaching, in 1986-2010 she also served as Editor-in-Chief of *Közgazdasági Szemle* (Economic Review), the main Hungarian periodical in the field of economics. She has been a member of the Department of Economic and Law Sciences of the Hungarian Academy of Sciences with consulting rights, and member of the editorial board of several journals. She participated in collaborative projects at Washington University (St. Louis, US), University of Tuebingen (Germany) and University of Bamberg (Germany). She served as Visiting Professor or Visiting

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Marko Tmusic is teaching associate at the Department of Political Economy and Finance, Faculty of Political Sciences in Belgrade. He graduated at the Faculty of Political Sciences in Belgrade in 2007. Master academic studies Political violence and the state ended in 2008 at the same faculty. He also attended the specialized academic studies - Regional Asian Studies. He is a PhD candidate at the Faculty of Economics, University of Belgrade, with a registered PhD thesis topic "The impact of institutional quality on economic development and the effects of privatization in Serbia." He is also a member of the editorial board of "Asian Issues" published by IAS. His fields of research are: institutional economics, institutions and economic growth, privatization, political and economic transition, public finances. He has authored several scientific papers in these areas of research.

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