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From Sovietology to neo-institutionalism

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This article attempts to wrap up the thorny road of studies and students of systemic change in Central and Eastern Europe. It analyses how a relatively backward part of the economics profession has been confronted with issues that count among perhaps the most complex, in terms of both understanding and applications, within and for the entire academic discipline. An attempt is made to integrate some broader methodological and narrower political economy insights in the approach of sustainable development and economic theory in general.

During World War II the exiled Hungarian academic Karl Polányi (1944/1957) coined the term 'Great Transformation' in a book where he argued that the emergence of the market economy had not been a spontaneous process, as advocated/postulated by both the neoclassical and Austrian schools, and in their footprint also most textbooks in economics and business schools alike. In historical reality, he claimed and proved, the market order emerged as an outcome of a rather forcible set of state actions. Following the collapse of communism, which happened in a peaceful manner, the idea of top-down reforms therefore became a major issue, and 'making markets' came high on the agenda. But how to create markets where they had ceased to exist as major forms of coordination was by no means a trivial task. The state was just about decaying, and knowledge of the market was perfunctory.

Transitology: on the verge of constructivism and neoliberalism?

At the onset of the collapse of the Soviet empire knowledge about our subject matter was available in two unrelated areas. First and foremost, in area studies, with a heavy focus on social anthropology and security studies. Second, some representatives of the mainstream, usually originating in the region, ventured into the subject and – on an ad hoc basis – tried to apply knowledge accumulated in the mainstream to the region. While the latter was often obviously unhelpful, sometimes for political and prestige reasons that normally fall outside the scope of conventional academic analysis (Pickel 2002, Wilhelm 2003), the former suffered from a limited understanding of the market economy. In short, since the existence of command planning was considered a given, knowledge specific to the understanding of its nitty-gritty prevailed over thinking in alternative terms. The classical

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debates on models of socialism conducted in the 1920s and 1930s in Western university departments were considered to be matters of historical interest only. And when the collapse happened, the profession was largely unarmed for fighting the battles which were brought about by the imminent needs of crisis management on the ground.

In theory, useful practical knowledge of how to do this type of surgery could have been found in the international financial institutions, most prominently the World Bank, accustomed to deal with countries suffering from captive states and weak administrations. However, as could be documented in detail relatively early on (Schönfeld *et al.* 1996), the impact of IFIs against the domestic balance of forces has usually remained limited. If we take the big countries only, Russia was still a nuclear superpower dealing directly with the US government,[1] the Czech Republic was not indebted, Poland was a medium-sized country with debts to be renegotiated (thus having no access to private markets) and Hungary was conducting a policy on its own, not very deeply impressed by the IFI advice.

What we find more perplexing has been the rather weak methodological foundations of the field, the unwillingness of many authors to cope with improvements in globally available knowledge, and also the rather delayed and partial reflection of transformation-related experiences and insights in global cutting-edge research. For instance the article by Djankov *et al.* (2003), for years among the most frequently downloaded contributions to the relatively most prestigious American journal in the field, *Journal of Comparative Economics*, fails to offer more than a mere formalised presentation of some of the traditionally disputed issues. Meanwhile the authors do not even attempt to provide either an improved analytical framework for policy research or feed-back from the complexities of the empirical material to the broader mainstream methodology.

Finally, the erosion, on occasion even the collapse, of countries previously portrayed as frontrunners of transformation, such as the Baltics – most notably Estonia – but also Hungary and Bulgaria, moving away from, rather than converging to, the single currency area might well call for an overall re-launch of the entire academic enterprise. While we do *not* take *predictive power* to be the sole, or even the major, criterion of academic soundness, it is truly perplexing to observe how few wake-up calls were sounded in the community of analysts. Despite the relatively extensively researched and relatively recent experience of the 1997–99 financial crisis and contagion, one could observe how ill-prepared both the respective societies and polities have been for the rainy days. We may be astounded on at least two grounds. First, within the more technical economics profession the reign of the positive economics paradigm, declaring – perhaps inadvertently – predictive power to be the sole criterion of academic respectability, was at its height in the 1990s up until the 2007–09 global financial crisis.[2] Second, more traditional analysis combining quantitative and institutional insights proved to have been quite powerful in predicting the scale and nature of the East European slump in the 1990s (Winiecki 1986).

It is litle consolation that economics departments of top American universities and the omnipresent global financial organisations, as well as most banks and rating agencies, have also been equally taken by surprise. While banking analysts have recurringly been calling attention to the dangers of weak regulation and the ensuing risks in expanding weak banks' ending at an irresponsibly fast pace (Tamirisa and Igan 2008), these were scarcely heeded by policy makers and the business community. By the same token a Latin American type of derailment, i.e one based on the amassing of debts by private sector agents – most particularly households – in foreign currency, has been created, tolerated and by no means pre-empted by international agencies and global capital markets alike.

It is truly telling that in both the statements of officials in the respective countries, as represented by the fiscal authorities, and also the current commentary and related short and

medium-term forecasts of local central banks, one could find hardly any reflections of those concerns. Forecasts of a recession emerged *only during and after the onset of the actual contraction,* and this holds for most international observers as well. Assessing the severity of the turmoil, its causes and ramifications in 2007–09 has been by no means easier and more professional than in 1997–99. This applies not only and even primarily in the post-communist region. It still says a lot about the state of economics as a discipline how perfunctory the policy analyses, but also the most fashionable theories and financial modelling reflecting the academic output of the top journals in the profession during most of the 2000s, have proved to be, especially in hindsight.

In the following we shall address some of the focal points of transition theory. The latter has by no means been anchored in conventional textbook economics. Rather there emerged, through a truly Hayekian trial and error process of policy advice and assessment, a series of claims and counterclaims, which were gradually generalised to the level of macroeconomic analysis. Therefore we do not start from the conventional macro viewpoint but follow those major issue areas around which the debates have been revolving over the past two decades.

Gradualism, lags and unintended consequences

From the very outset one of the most emotional and politically perhaps weightiest issues has been the idea of the speed and scope of transformation, including the dilemma of simultaneity and sequencing of individual measures, as well as potential synergies across the individual measures or the lack of them. This debate has, in most countries and much of the literature in and around the region, been conducted under the misnomer of 'shock therapy versus gradualism'. This counterposition was perhaps inevitable owing to the imminent need to communicate in shorthand form, especially in the ever more powerful electronic media. However, as could be seen early on (Wagener 1993) and proved in more detail in hindsight (Popov 2007), this has lent the debate an entirely false meaning. It seemed, especially for policy makers, that changing institutions, especially informal ones, were just a matter of taste and deliberation, good or bad temper, good or bad luck. Likewise, the usual tendency to equate wholesale transformation with disinflation and fiscal stabilisation in the elementary sense has proved to be a fallacy loaded with political and economic ramifications (Kolodko 2000).

This is not to claim that matters of sequencing, speed and scope were outside the field of deliberation, in business and political, social and health care decisions alike. By the same token, economic and systemic matters may and should indeed be approached in a variety of ways, as they usually are in mature democracies and also in the international political economy of policy reforms. Still, the unfortunate spread of a misnomer has contributed to lasting misunderstanding in policy making and academe alike.

For one thing, it has been common knowledge that time and scope matter, especially if they differ for individual policy areas. At least since the changeover of the IFIs from their traditional focus on current account adjustment and supporting the conventional, narrow-focus *sectoral* adjustment loans to much more ambitious, often positively over-arching *structural* adjustment programmes, calling for institutional reforms often deeply intervening in the *modus operandi* of the social model of recipient states, it has been clear that the measures featuring in the two types of activity differ fundamentally in scale, scope, time horizon and controllability in detail. While short-term fiscal adjusment measures can and should often be controlled, if needed, week by week, as Hungary, Latvia, Ukraine and many other countries experienced in 2008–09, institutional reforms,

especially ones of a long-term nature, as in the pension and health care systems, in education or regional arrangements, may take a decade and longer.

For this reason alone, not to speak of the technical complexity and societal contestability of the measures, because of their often unforseeable side effects – which, alas, often dominate desired and planned outcomes – and certainly also owing to the major changes taking place in the overall environment, these changes often inevitably have a trial and error nature. Self-correction, including changes in the original objectives, means and financing or in the composition of the mix of these, has always been part and parcel of the exercise.[3] And while the IFIs have proved generally unsuccessful with their broader ambitions (Krueger 1998), the delineation of reforms of varying scale, scope and significance has remained a lasting concern for the construction of any economic strategy aiming at more than drifting with the changing mood of the public or fashions in the economics profession.

From the above it follows that the first steps, which by now count among the recieved wisdom on how to manage successfully the wholesale transformation of socio-economic systems, as opposed to narrow reforms within any economic order, i.e stabilisation, liberalisation, institution building and privatisation (SLIP), already entail a series of subsequent and potentially synergic steps, that cannot even in abstract terms be implemented all at once. Moreover, 'gradualism' in reality implies just the opposite to the meaning journalistic overuse has given the term: it is anything but tinkering with long overdue measures in order to avoid political conflict. Gradualism in the original sense means taking the long view, setting a timetable and dosing the measures so that the synergies could work out. For instance, abolishing trade restrictions over a period of five years or opening up the capital account for a variety of transactions with a horizon of between five and eight years count among the platitudes of economic reform policy in developing countries.

In the post-communist context the meaning of the terms became perverted. Gradualism was equated with timidity and unwillingess to change, radicalism was seen as a value in its own right. And while nobody questions that certain measures can and should be implemented by the stroke of a pen, it is perplexing, even with the benefit of hindsight, to read about proposals to, say, privatise entire industries in weeks or months. Wherever it happened, such as in Russia's infamous loans-for-shares privatisation in 1995, or the sale of the Budapest Airport Authority and Malév Hungarian Airlines in a rush a decade later, these broader systemic considerations were neglected. Therefore efficiency improvements, which in theory and practice are contingent upon observing those broader points of view, have not been forthcoming. The broader issues, known from the global literature and its normative view on good-quality privatisation, include creating competition, improving corporate governance, protecting the public coffers and ensuring transparency, not least providing a sufficient number of alternatives as well as a sustainably contestable market. The unfavorable consequences are well known by now and not even disputed by those who advocated the above measures.[4]

What is the standard?

The issue of measurement figures high in the methodological and thus academic soundness of any discipline, and certainly not only in the natural sciences. It is also common knowledge that measurement is not an a *priori* exercise that could or should be conducted in separation from the conceptual–analytical framework derived from broader theoretical considerations. This platitude became crowded out from much of economic analysis,

especially during the 1980s and 1990s, when formalisation in general and the refinements of mathematical methodology in particular were often considered to be the hard core of the profession. With the predominance of the positive economics paradigm measurement has become everything and interpretation next to nothing. Under these circumstances it is perhaps inevitable that in interpreting the outcomes of a one-time historical event, the wholesale transformation of an entire socio-economic order in over two dozen countries, preoccupation with numbers has also taken a pre-eminent role.

There is of course nothing wrong with trying to measure whatever is to be measured in any discipline. It is however somewhat more problematic if measurement follows habits, customs, data availability and preconceptions rather than analytical grounding in theory. As long as systemic change – the entire collapse of the Soviet empire – had taken most of the profession and the public at large by surprise, this was perhaps inevitable, despite the obvious drawbacks. For one thing, comparative economics presupposed the everlasting existence of diametrically different economic systems following their own respective irreconcilable logics. On the other hand, reform economics has also taken the defining features of the socialist system as given, such as one-party dominance, prevelance of public property and lack of capital markets and currency convertibility (Kaase *et al.* 2002). Finally, external advisers, most prominently though by no means exclusively in the IFIs, tended to downplay the complexity of the challenge. Following their truly narrow mandate, their experience and also convenience, they equated transformation with simple balance of payments adjustment at worst, and with an augmented structural adjustment programme at best.

As a result there has long been no agreement over how to measure the progress made on the road of systemic change. Although international agencies which had an immediate interest in deciding whether a country had already matured into a full market economy, such as GATT/WTO, OECD, the EU and most prominently the EBRD, developed a set of different indicators trying to underpin policy assessments, no agreement on these has emerged. Moreover, despite the remarkable progress and complexity of those developed by the EBRD and OECD, less overshadowed by immediate geopolitical concerns than, say, the *avis* of the EU Commission, these advances are yet to find their feedback in the indicators that are being used for policy assessments. In the long run, it seems, it is certainly the Human Development Indicators, as developed originally by UNCTAD and currently also in use by the World Bank, reflect accomplishments and the lack of them. It would require perhaps a monograph, joining previous ones by several authors including the present one, to present a state of the art account of those accomplishments. For the present analysis it may suffice to formulate a few remarks.

First, given that the long-term nature of systemic change was not understood properly, the tendency to rely on short-term indicators of the business cycle prevailed. While it is perhaps inevitable in journalistic reporting, there developed an element of ‘beauty contest’ across the transforming economies, and by no means only in view of their prospects for joining or not joining the EU. Short-term macroeconomic indicators, despite their well known unreliability, have been in used to evaluate lengthy processes in an extremely unprofessional manner. The conventional warnings about the much bigger than usual uncertainty of the numbers, especially of quick releases, tended to be disregarded (*cf* Winiecki 2002).

As a consequence both the media and media-led public opinion and policy makers had a tough time in working out the reality and developing rational expectations relating to the future, in part because of the limited understanding of the nature and the time scope of the exercise (Kornai 2008) and in part owing to the misleading signals that emerged from

statistics. In terms of the first task, expectations of immediate improvements and of gains without pains were widespread, often positively fuelled by political discourses. In terms of the second, a tendency to overrate recession and underrate recovery, overstate social costs and underrate improvements in consumer welfare and competition, prevailed at least for a decade.

On the other hand, it would perhaps be misleading to claim that the very large number of unintended consequences, which indeed prevailed in many cases over whatever the official rhetoric and project entailed, would be a sign of failure per se. In his broad overview of the lessons of 'transition' Ellman (2005) considers these to be prime evidence either of poor theories or of incomplete and unprofessional implementation of theories that apply under extremely restrictive conditions. However, this would hold only under the assumptions of an extreme version of constructivism, as under central planning, when unlimited human ability to shape reality according to preset/computer-constructed schedules and schemes would seem feasible. This would indeed be a case of 'fatal conceit', especially on the ruins of communist planning experience.

This situation is exacerbated by the frequently unprofessional reliance on statistics comparing the socialist period with its net material product performance to the transition period performance measured in GDP or even GNI. Likewise, in the reliance on the pre-crisis numbers fundamental features of disequilibria such as shortages or quality mismatches, lack of services etc. were neglected.

In terms of growth there was a limited understanding of the inevitability of a fall in output due to the collapse of the Comecon market and to enhanced competition and monetary tightening, i.e. an outcome of the interaction of three contractionary policies (Csaba 1993). By contrast the usual reference was to post-war reconstruction and the Marshall Plan, two mistaken perceptions for substantive and political reasons (the EC being absorbed in its deepening to EU). The gap between expectations and reality could not have been bigger. In reality, much of the substance remained uncovered, as a number of favourable and unfavourable processes interacted, while data availability and systematic distortions in reporting produced a mix which is hard to decipher, even for the specialist (Kornai 1993). Therefore measuring the success of the extremely complex phenomenon of transition with the simple conventional short and even medium-term output indicators, since only these were available, was truly a fallacy, even if a lasting and recurring one in the literature.

As a consequence, the emergence of mass unemployment sooner or later in each of the countries was encountered with dismay. The latter was legitimate insofar as in the frontrunner countries unemployment rates far exceeded what could be the natural rate as defined by Phelps (1968) and should be in the range of 4%–5% in normal times. In fact it reached double digit numbers for over a decade![5] But polices, as well as the profession, were not much better prepared for this eventuality than was the public at large.

Measures to mitigate this major social problem were thus high on the agenda of most transition countries. While laggards, including the Czech Republic in 1992–98, tried to postpone structural change, with forseeable ramifications for growth and productivity, as well as export performance, frontrunners committed different mistakes. Under the threat of imminent social explosion, they instituted lavish early retirement and disability schemes, actually in most cases borrowed directly from then existing Scandinavian and continental European arrangements. It is telling that Hungary joined, as early as 1991, i.e. immediately upon its signing, the Social Charter of the Union (currently still hotly debated i.e. by Poland and the UK). As a consequence social spending in several of the countries, most notably in Hungary and Poland – but not in the Baltic states – considerably exceeds

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the EU average. Pension outlays already constitute a heavy burden on public coffers now, from 10% to 17% per year (MNB 2008). These items create a problem owing to aging, widespread tax evasion, legalised tax holidays for foreign investors and small business, and illegal work, the latter undermining registered formal employment especially in medium-sized firms.

These are only some of the reasons why conventional measures of economic success, such as general government – even less central government – deficits, explicit public debt, unemployment rate and the like tell us precious little about the actual state of the transforming economy, especially in the longer-run perspective. The fact that the Czech Republic has traditionally registered low inflation is only in part to be attributed to traditional Czech fiscal conservatism. An equally important part of the story has been delayed adjustment of administered prices to 2007–08. In fact, politically determined changes in administered prices, such as fuel and public transport, pharmaceuticals and charges for waste management, have long been shown (Mihajlek and Klau 2004) to be more decisive in determining actual rates of inflation than any productivity shock, all across the Central European region. Likewise the surge in inflation to no less than 5.5% p.a. in Slovenia immediately upon the country's joining the single currency in 2008, against the euro area average of 3.3%,[6] is a clear indication of the weigh-in syndome, i.e. of delaying some overdue price adjustment for cosmetic reasons.

If we take into account the implicit debt in the pension system, as well as the forseeable costs of covering sizable numbers of small business people via social security, and add to them the difficulty of rolling back disability and early retirement schemes (as evidenced by similar attempts in Italy and Holland), we may venture to advance a much more pessimistic overall assessment of prospects than was customary until recently, quite apart from the repercussions of the financial crisis. This applies both to sustainability of public finances and the ensuing growth potential if calculated in a realistic rather than a patriotic manner. In a way, unresolved structural or third-generation reforms are bound to exert a growth dampening effect, and that in a secular fashion, much earlier than the level of development – or in other words, the catch-up potential – of the transforming economies would imply, if unconditional convergence to EU average levels is to be our baseline scenario.

Government, finances and regulation

This issue counts among the evergreens of both growth analysis and the political economy of policy reforms. Briefly, the puzzle goes as follows. If reforms are reversed, their positive impact cannot be harvested, or at least not by the governments which committed themselves to those policies – which often entail unpopular measures such as closures, raising the retirement age or introducing co-payments for previously freely provided services across the board. By contrast, if reforms bear fruit, there might emerge the impression that further action is no longer needed, since conditions for sustaining growth have already been created and the time to enjoy the benefit of previous pain has come.

Let us add that the lull in structural reforms in the old EU has, in the current decade, created fertile ground for inaction in most of the new member states, with the exception of Slovakia (Csaba 2009). Moreover, the windfall originating in high fuel prices has created the false impression of a Russian economic miracle that seemed to be sustainable even if institutional reforms were to remain limited (Havrylyshyn 2008). While it could be seen that this illusion was false, it undoubtedly impressed policy makers in East and West alike until the last quarter of 2008.

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One of the deeper causes for the ongoing uncertainty in terms of assessing which structural reforms matter how much, and also in putting numbers on them, is the disagreement in the broader/mainstream literature on the relevance of institutions as well as over the mechanisms through which they influence growth performance in the long run (cf Paldam and Gundlach 2008). We may perhaps consider this failure as a derivative of a broader problem: in transition-related discussions the results of the above debate (could) have been crucial in deciding which institutions should come first and why. Furthermore, in both the broader and in the area-specific debate we are to a large extent moving in uncharted waters in trying to establish the size and nature of the gaps between actions and outcomes. This applies *a fortiori* to building more complex institutions and mechanisms of operation than floating a previously fixed and overvalued exchange rate.

In some cases this should not pose a major problem. For instance, changing bankruptcy legislation or abolishing currency controls act immediately, or in weeks rather than years. By contrast, changing the civil code, setting up an independent regulatory agency in the energy sector, or instituting pension reforms definitely have a long time span and only lagged impact on the outcome. The earlier mentioned examples of the collapse of previously highly appreciated private schemes may well provide a feedback also in normative thinking over the optimal size of the risk community, or the optimal mix of private, non-profit and public provision, which in turn may change the target state which is the aim of our reform measures.

While on the general level agreement exists over the claim that 'policies matter and so do institutions', and furthermore that institutional reforms, if proper account of lags and initial conditions is taken, are positively correlated to growth in the medium and long run (Braga de Macedo and Olivera Martins 2008), on a more operational level less certainty exists. For instance, while general considerations would long have warranted the demonopolisation of the Russian oil and gas sector, reality has proved to be different. The gas sector was by and large exempt from privatisation, not least owing to social considerations and a distorted market structure. Meanwhile foreign penetration in the largely privatised oil sector remained limited and, as the ongoing wrangling with British Petroleum during 2006–08 indicated, Insider domination – and by the same token the existence of an endogenous private sector, with incumbent interest allied with parts of the administration – could effectively limit the strategic presence of even the mightiest foreign players. As long as this is the case, it is difficult to forecast and measure how much 'marketisation' can indeed take place in the largest transition economy. Even less valid claims may be advanced if someone – such as historians or policy makers – were to ask economists to quantify the impact of institutional change on Russian economic performance over the 1999–2008 decade. Rutland's (2008) assessment that the resource curse was an outcome of a deliberate strategy rejecting the open economy–open society twins and accepting weak, though interventionist, institutions seems to hold, as does the pessimistic outlook derived from this analysis.

The impact of institutional change on economic performance has often been indirect. For instance, banking crises in Latvia and Romania in the mid-1990s have not stopped either nation from growing impressively in the subsequent decade. While the causal link between finance and development remains disputed in the broader literature (Gradstein 2004), the spillover of the 2007–09 international financial crisis has only underlined the relevance of continuous institutional improvement in emerging economies, if growth is to remain sustainable and socially appreciated. The relevance of this question, in turn, cannot be regressed on growth, inflation or even the evolution of indicators of the depth of financial intermediation.

393 For these reasons we would continue to sail largely in the dark if we were to formulate
394 in a positive manner what relevance should be attributed to the improvenemt of the
395 financial sector in a latecomer transition economy in general. While in the cardinal sense
396 nobody doubts that being solid is a good, even indispensable thing, in the ordinal sense of
397 sequencing it remains an open question whether one can claim that 'without a sound
398 financial sector no growth is feasible', even if it remains a platitude in the long run. As we
399 know East asian countries were able to grow, for about three decades, without good
400 financial systems, so the urgency – as distinct from the relevance – of acting on banking
401 reform soon remains contestable.
402 Similarly, calls for a 'strong government' remain valid. Studying the African
403 economies, for example, has led the IMF (2008) to conclude that creating a functioning
404 administration is a *sine qua non* for growth to resume. Moreover, creating peace and a
405 minimally functioning government has allowed sub-Saharan Africa to grow by over 5%
406 p.a. in 1993–2008, i.e. on a par with the average of developing nations. This was achieved
407 even though structural change was mostly limited. Still, as evidenced by the Russian and
408 Central Asian cases, a strong government is not to be equated with a non-predatory
409 government committed to the public good, rather than to any vested interest group, as
410 theorised by Olson (2000). An activist government may, in reality, be the exact opposite to
411 the normative view.
412 It would be difficult to put a measure on the strength of the government. Its size –
413 expenditure as a percentage of GDP – is a good indicator in terms of showing political
414 involvement and redistributory practices. The latter of course must have an impact on
415 growth. However, this impact is rather indirect and depends to a large degree on the
416 pattern and quality of government spending. For instance, Scandinavian economies over
417 the past 15 years have substantially diminished the share of public spending – by a margin
418 of 5–15 percentage points of GDP (ECB see Note 6); however, they remain big 'tax and
419 spend' governments. Notwithstanding this fact their competitiveness, as indicated by the
420 World Economic Forum and IMD in Lausanne, has remained continuously high. This was
421 due to targeted and good quality spending, which substantially diminishes transaction
422 costs, enhances employability of persons, gives a warranty for enforcement of contracts
423 and legislation (including tax laws) and ensures transparency of operations. In other
424 words, externalities provided by the government compensate for the high tax burden.
425 What follows from the above is twofold. First, the size of the government does matter
426 and should not be considered as irrelevant, particularly if we are to measure progress from
427 a fully nationalised economy on the road to a market order. Second, while size matters, this
428 is perhaps not the whole story in our case too. It may not be entirely by chance that the
429 IFIs, otherwise following mainstream economics in trying to put numbers on everything,
430 have been converted in the current decade to the wisdom of good governance, which
431 cannot be quantified.[7] It is intentionally vague and also open to some interpretation,
432 contextuality and influence by local, cultural and historical factors, usually outside the
433 scope of economic analysis.
434 In the context of post-communist change it implies that numbers matter. The fact that
435 the Russian government centralised nearly 40% of GDP in 2008, and even the Baltic
436 States and Slovakia centralise 33–37% of their GDP, is itself *disproof* of the neoliberal
437 dogma allegedly reigning in the region. On the other hand, the Putin presidencies in
438 Russia and the practice of big government in Hungary in 2002–08 both proved *ineffectual*
439 and unable to ensure those forward-looking investments that would have been required to
440 sustain growth. The latter include investment in organs sustaining the rule of law,
441 environmental protection, physical infrastructure, human capital accumulation and the

like. Marginalising opposition is one thing, spending for externalities and the common good is another. For this reason, activist and active governmental involvement in the economy remain two different cups of tea.

For this reason both quantitative and qualitative indicators of 'rolling back the state', and the ensuing overall assessment of whether it has gone too far, far enough or not far enough can in most cases not be unambiguously presented. We need, it seems, case by case analyses to see whether – as in Hungary – governmental overextension in one area may not be coinciding with idle government in other areas, the latter often complementing the former. Activity in productive investment does not compensate for lack of strategy and spending on environmental protection, social integration of the Roma and generally improving the employability of people, especially the lower skilled, via including them in a process of lifelong learning. Tax concessions granted to foreign investors will hardly compensate for lack of deregulation and untransparent, arbitrary tax administration, both impeding the growth of the small business sector, the major provider of productive jobs (on the latter cf NGFM 2008).

The bottom line of the argument in the present section is the need for continuous and renewing/revolving analytical activity and also governance, not only by the central authorities and definitely not in a constructivist manner following a pre-set master plan. By contrast, calculability and delivery on quantitative targets, such as deficit, debt and inflation, is perhaps the best way to generate the social trust that is required for broader reforms – structural and institutional – to survive a single electoral cycle, which is often a professional minimum requirement in both normative and technical terms alike.

Joining the EU – ending transition?

While the change from communist to market economies is one that can by no means be confined to a single continent, still the majority of the cases has taken place in Europe. Furthermore, the idea of 'European-ness' and the slogan of 'return to Europe' have both proved to be formative in the perceptions of the elites.

Those perceptions have proved to be even more defining in the countries which stood a chance of joining the European Union. While the EU can by no means be equated to 'Europe' in either historical, political or even economic terms, the EU has undoubtedly been the anchor and thus the point of reference for policy makers for over 15 years. In fact, ever since the launching of the PHARE programme and signing of the trade and cooperation agreements in 1988 the EU has aspired to be an active policy enterpreneur in Central and Eastern Europe (Schimmelfenning *et al.* 2006).

This has basically been one of the major successes in the process of European integration, all the more so as it has coincided with the single currency project. Transition economies in the main went out of their way to meet the criteria set by the EU, whether or not they made sense in terms of their narrower context. For instance, balancing the budget *before* most of the SLIP agenda is over, or spending on environmental protection long *before* its broader concept and European framework materialised, might well have been seen as premature.

Studying the process of Europeanisation has shown that the perception of being a good European at one point, and the real threat of being excluded from the club at another point, might well have played decisive roles in settling domestic power struggles and also thereby in setting the trend in economic policies, as exemplified by the catch-up of Slovakia and the drift of Hungary in 1997–2008 (Győrffy 2009).

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Studying this process might be interesting in underlining a double process. On the one hand a tendency to overzealous copying of EU standards could be observed. At a deeper level, however, adjustment has often proved formal, perfunctory, and eschewing the new rules of the game has been anything but exceptional. For this reason delivery also remained rather limited. If, for example, fiscal adjustment takes place only via short-term measures, or if environmental laws are merely promulgated but not enforced, especially against business interests, the outcome is likely to be meagre. These dualities may be among the explanatory factors for the smaller than expected improvements that took place upon full EU membership. Since the political class tended to overrate those potential gains and thus public opinion expected perhaps too much in terms of individual material gain, non-delivery on 'pedestrian issues', be they lower prices or more employment, immediately contributed to disenchantment with the EU in the new member states.

While one should not for a moment be surprised to see the pre-eminence of domestic factors over European and global ones in setting outcomes in the longer run, it is still remarkable to observe how little *internalisation of EU values,* be it the spirit of cooperation or adherence to the rules of the single market, has been shaping policy practice in the new members in most of the time since accession. This observation applies to the pre-crisis period as well. In turn, it is less surprising that the new members have not come up with their own agenda in EU matters, which could well have followed a more transition-specific agenda than the customary deals reached within the Franco–German–British trio in the current decade. While complaints about the lack of attention, on occasion even of assistance, proliferate, original suggestions emanating from the region would be hard to spot over the entire 2004–09 period. On the contrary, the propensity to stick to clearly backward-looking arrangements in both cohesion and agricultural policies, with open disregard for any broader theoretical and sustainability considerations, following the narrowest possible interpretation of identifying 'the national interest' with the maximum amount of funds accessible from EU coffers,[8] has become a manifest feature of new members, including the previous reform champions Poland and Hungary.

Impact of the financial crisis of 2007–09

While it is anything but surprising to see that transition economies are confronted with a series of stresses coming from their embeddednes in the global arena (Kolodko 2005), it would be difficult not to see that the spillover of the 2007–09 financial crisis has entailed new challenges too. First, all countries were confronted with sizable declines in their output, with Russia, Hungary and the Baltic States falling into recession. This fact alone has uncovered how shaky the foundations of economic growth in the 2000s have been, and how vulnerable the financial systems of those countries have remained, despite considerable improvements in the preceding decade (Pálosi-Németh 2008); integration in the global capital markets remained one-sided and evolution of local capital markets and their regulation has been lagging behind in qualitative terms.

The collapse of the Baltic Miracle, as well as Bulgaria's struggle to exit the currency board at times when external disequilibria would have called for devaluation, have clearly shown how ephemeral short-cut solutions in economic policy may be. Saving the laborious task of institution building and regulation has nonethless helped in the short and medium run to anchor expectations and create price stability. However, when things have become more complex, with the passage of time the lack of regulatory instruments in fiscal and monetary policy has backfired. A consumption boom fuelled basically by domestic

markets and financed by households in foreign currency could not be counteracted by timely pre-emptive action by the authorities.

Hungary and some other countries have also experienced the drawbacks of an entirely globalised banking system, with the financial institutions of the eurozone protecting themselves but letting their affiliates sink. While up until recently foreign strategic ownership counted as an asset, now it turned out to be a liability. This is yet another major strategic issue to be reassessed for the theory of transition and development.

When one speculates about how much the EU could or should have done in terms of regulation as well as in terms of crisis management in warding off the global crisis in the financial sector, it is difficult to distinguish the responsibility of the old members from that of the new ones. The former failed to agree over elementary joint supervision as suggested by the Lamfalussy Committee back in 2001. The new ones, for their part, thought that regulation on the EU level could be outsourced to the old members, while the sunny days of cheap external finance and the general expectation of quick adoption of the euro would take care of everything, in terms of ensuring solidity in their domestic financial institutions. It is difficult to comprehend, but such *naiveté* has indeed been prevailing, often in the strongholds of self-professed committment to pure rationality, as on the financial markets and in diplomatic services. In the former, trust in the ablity of financial innovation to eliminate literally all risk, in the latter belief in the possibility of hammering out compromises that do not hurt anybody and still secure longer-term sustainability of outcomes, even in a large diverse community, have indeed been moulding much of the 1999–2008 decade.

Implications for broader economics

One of the most emotional debates, especially though not exclusively in political science, has been on whether and when transition can be declared to be over. It goes without saying that Europeanisation is not meant to homogenise, nor does it deliver in terms of standardisation, despite recurring attempts by the bureaucracy to benchmark and regulate a number of issues, from the nature of chocolate to airline security, whether or not the competences have already been transferred to Brussels. Ireland and Finland are likely to remain two rather distinct models of the European economy on any plane one cares to mention (Sapir 2006).

If this is the case there is no easy textbook answer to our question, as we can always wonder whether the present stage is already the terminus or not. In the current literature two major approaches emerged. In one, it is by and large over, since despite continuing structural dissimilarities the institutional set-up is everywhere congruous with mature market economies. The mere fact of joining all institutions which by their statute and mission must take care of the quality of the market, such as the WTO, the EU and not least the OECD, could render academic speculation about a potentially different, 'Eastern' type of market economy sterile and backward-looking at best. On the other hand, others may also have a point in highlighting that the current crisis is yet another indicator of the incompleteness of institutional and regulatory change, often termed third-generation reforms. Welfare systems in general and pension systems in particular are far from sustainable. If we adopt the second line, transition is not yet over (Keren and Ofer 2007).

What have we learned from the experience of the past two decades? We have tried to rely on some of the more powerful propositions and assessments represented in the global literature. Most of the self-reflective assessments go in the direction of openly

589 acknowledging limitations rather than posing triumphantly over the excellent delivery of
590 the mainstream, which alas has since become the mainstay in most of our university
591 curricula. This holds increasingly also for 'new Europe', irrespective of its professed and
592 manifold limitations in assisting the management of the historic challenge of transition. By
593 and large major shortcomings of the new classical mainstream as an immediate policy
594 panacea have been underlined, and the relevance of institution building, the informal
595 sector and property rights highlighted (Ellman 2009, p. 15). In a similar vein, the
596 predominant role of property rights needs to be complemented with the study of other
597 institutional factors, such as the level of criminalisation and the spread and (in)efficiency
598 of a (captive) state in deciding the actual outcomes of ownership change (Katz and Owen
599 2009). Interestingly, both *ex post* insights underline and echo the relevance of much earlier
600 insights by Ludwig von Mises (1978), having pinpointed the limitations of the then
601 emerging mainstream in general and its capability of understanding (post) socialist change
602 in particular.

603 The 'Great Transformation', a term we borrowed from Polányi (1944), has thus
604 acquired a double meaning. First, it has proved once again a valid claim that creating
605 markets *does* require state action and construction – this was the original insight.
606 However, experience has also taught us to be more wary of constructivism of the type
607 postulated not only by Polányi but by many of the professional transitologists. The impact
608 of man-made projects and especially their impact assessment is a much more complex task
609 than was percieved two decades ago by the global economics profession.

610 Neo-institutionalism in this perspective implies an attempt to combine quantitative and
611 qualitative insights. In order to be meaningful, one does need to put numbers on everything
612 that is capable of measurement. However, as Török (2010) suggests in his perceptive
613 review of more recent contributions to mainstream journals, integrating competing
614 paradigms might be an uphill struggle, leading to meaningless numbers whose use may
615 actually make things worse than having no numbers at all.[9]

616 Sustainability studies can thus help bring about more efficient arrangements for public
617 finance and the pension system, two fields notoriously neglected in the second decade of
618 transition. On the other hand, softer approaches that reflect the subtleties of change, such as
619 good governance, or creating and preserving trust in society, or caring about the regional,
620 gender and generational aspects of poverty and environmental protection, all might be
621 needed. If pursued in a synergic fashion, these might yield more in terms of development
622 than the narrow focus on quantitative material expansion alone would have it.

623 In conclusion it is reassuring to see the return of broader approaches to the study of
624 transformation as a subject of economic theory. If area specialists analyse issues which
625 qualified as exotic and, by definition, beyond the boundaries of economic analysis, such as
626 subjective assessment of the 'hard facts' and 'measurable outcomes' (e.g. Guriev and
627 Zhuravskaia 2009), these pieces now a days often gain access to the top journals of the
628 profession. It is reassuring to observe that our citation is not accidental, based on casual
629 observation, but follows what we find in the lead article of that flagship of the economics
630 profession, *The Journal of Economic Literature* (DellaVigna 2009). This broad survey
631 shows in great detail the need to feed back into economic theory those insights which the
632 neoclassical mainstream tended to shrug off and even positively exclude from the field, by
633 means of appropriately chosen axioms and analytical tools. In so doing we may observe,
634 together with leading authorities on the history of economic thought (Backhouse and
635 Medema 2009), the return of pluralism and the cyclical downturn of methodological
636 exclusionism, which has sought to limit the subject matter as well as the methodology of
637 economic inquiry. The failure of those, 'exclusively scientific' approaches when tested on

638 the ground, in our case the historic process of systemic change from communism to free
639 market, allows us to hope that committment to pluralism will remain a lasting feature of
640 the global economics profession in the long run.
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644 Useful comments by G.W. Kolodko and D. Győrffy on the previous version of this article are
645 appreciated, with the usual caveats.
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Notes

648 1. On the eruption of the open crisis of 19 August 1998, while the IMF delegation was still in
649 Moscow, President El'tsin sent his special envoy, Anatolii Chubais, directly to the Treasury and
650 State Departments in Washington to micromanage the issue, with considerable success.
651 2. It is perhaps a sign of backwardness of the mainstream with its science appeal, as nuclear physics,
652 genetics, biology, chemistry and most other social sciences have long given up the nineteenth
653 century quest for exact numerical predictions in favour of stochastic, probabilistic forecasts, those
being only one of the many other criteria of success.
654 3. For instance, the collapse of several major financial institutions has resulted in the loss of pension
655 provision for millions of employees in the US and elswhere. These included not only those
656 employed in those corporations, where private provision mostly implied investment in the
657 corporation, but also of those completely ignorant future pensioners whose pension funds, public
658 or private, invested in paper of the financial institutions that eventually collapsed. Likewise the
659 problem of millions of small business owners, who owe their fortunes to lax taxation in the
660 Thatcher period in the UK countries but now find themselves inadequately covered, has reached
661 social dimensions. The replication of the same in 'new Europe' boasting flat tax experimentation
will be hard to avoid in the future.
662 4. In the case of both examples cited above the rush to secure government revenue in a short period
663 of time resulted in what is to be expected if an individual aims to sell a flat in a day.
664 5. Certainly the actual level of the natural rate is a dependent variable, derived *inter alia* from
665 production capacity. As the perceptive analysis of Bagin and Osakovsky (2005) has
666 demonstrated, the natural rate in Russia, during the steep fall of output in 1994–97, could be
in the range of 13%–13.5%, while a decade later, following recovery, it stood at 7.1%.
667 6. ECB, *Statistics Pocket Book,* June 2009, Frankfurt/M., p. 38.
668 7. This is a focal idea in the perceptive book by Fukuyama (2004).
669 8. While it may sound axiomatic, deeper analysis of the old members (Boltho 2000) has long
670 established that the inflow of funds may, and often does, form an *inverse* relationship to economic
growth, if it helps sustaining inefficient, often corrupt practices.
671 9. One of his examples is that talking about the length of Ottoman conquest as a variable is
672 meaningless, since the Turks colonised some areas while allowing locals quasi-independent
673 conduct of the economy in others.
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