First Session
Moderator: Philip Hanson
Discussion Leaders: Philip Hanson and Tomasz Mickiewicz
The State of Debate on Economic Systems: from Capitalism v. Communism to Varieties of Capitalism?

Philip Hanson: We are going to concentrate this morning on the question of whether we are all really under capitalism now, and if we are, whether it is different varieties of capitalism and how significant those varieties might be. My paper has been circulated and I am sure it is one of those papers you are all meant to read before but did not quite get round to before the meeting.[1]

I want to return to a subject which I for one – and I imagine several others here – used to teach: comparative economic systems, which was very much about comparing capitalism and communism and there is more to it than that, but in the Cold War period that was a fairly standard subject. I am going to talk about how times have changed and the subject matter has apparently changed with them, and then I shall come round to what I consider to be two big issues outstanding in comparative economics, and if time allows I will say something about changing institutions in Europe, the new Europe that is taking shape, the accession countries etc.

So first of all, in the old comparative economics systems courses, we used to talk about national systems, but we did not discuss, for example, differences between cities, we talked about differences between nations. The remarkable Jane Jacobs wrote some very interesting books on the whole subject of cities as the primary subject for economic analysis, but we did not do cities. We talked about countries and about the results of having different economic institutions in different countries.

We did not examine the *causes* of there being different economic institutions in different countries (although there were rare exceptions). The late Peter Wiles in his inaugural lecture at London School of Economics described Russia as the appropriate and natural place where

1 "From Capitalism versus Communism to Varieties of Capitalism"

centralised economic planning was introduced, because it was a society that was accustomed to living under authority that was 'grandiose and arbitrary'. But that was a rare excursion in trying to explain *why* there were different kinds of economic institutions in place in different countries. We were really concerned about the *results* of having those different systems, and we treated the systems as given. Very, very simply; our courses tended to simplify (one hoped in a constructive way). We talked about market capitalism, centrally planned socialism, market socialism (a little bit more problematically), self-management: we talked about some variants even then in the different capitalist systems, the Japanese economic system for example. Then we tended to look at performance criteria. We would look at efficiency, equity, growth or dynamic efficiency, stability, various properties of an economy, set those up as criteria, and now I am describing here the way a standard textbook worked. We would look then at different cases and see how those cases played out in terms of the meeting of the criteria we had set up, cases of the different kinds of systems.

For many students this was a very attractive course because it was a relief from more rigorous economics, and it was like a sort of Cook's tour of the world – with mental expeditions to different countries thrown in. Of course one drew conclusions. Sometimes one could introduce some comparative statistical analysis across a large number of countries, testing for hypotheses about how different systems affected operations in those countries and their efficiency, and their growth, but by and large it was a case-study-based course.

Most people find that when they go on teaching a subject that the subject gets larger and larger: new things are found and new phenomena develop. I think comparative economic systems was a rare case of a subject that got smaller and smaller. The different systems started dropping by the wayside. I used to teach a course in which I talked about French indicative planning, the Japanese employment system, Yugoslav self-management, Hungarian New Economic Mechanism and of course the Soviet centrally planned economy. Well, you could say now that they have all gone. I am not quite sure about the Japanese employment system but it is certainly in a much weakened state compared to its earlier condition. And one could say that comparative economic systems was almost ceasing to exist except, of course, as a historical study.

There are still, however, many people going around saying what they do is comparative economics – not talking so much perhaps about comparative economic systems but comparative economics. What were we, or what should we be comparing now? Perhaps the appropriate subject is now the study of transition, so-called transition or transformation – or mutation perhaps – in ex-communist countries. Is that simply the current form of comparative economics, a sort of dynamic form of comparative economics?

You find that many scholarly societies like the European Association for Comparative Economic Studies, for example, treat transition as a key part of their subject matter, and in the aforementioned paper that is being circulated I have a little appendix listing the prize-winning doctorates, just the titles of the prize-winning doctorates to which the EACES awarded prizes over several years. That suggested that insofar as you could judge a doctorate by its title, and I think in many cases you can get a rough idea of its content, they were often clearly regular studies in macroeconomics or microeconomics: they were not necessarily comparative – there was nothing in the title that indicated they were comparative. A lot of work on the economics of transformation, or transition, essentially, is applied macroeconomics or applied microeconomics. Fair enough: there is no reason why it should be comparative, of course, and there has been quite a lot of comparative work done in this field.

You might feel that this is a slightly arid, academic discussion whether you classify something as comparative economics or not. But I think there is a really large issue looming behind all this, which is whether we have abandoned a world of radically differing national economic systems and are either in or moving towards convergence of the differing economies into some really similar kind of economic arrangements – a similar set of economic institutions.

Now the whole subject of economic institutions was very much on the rise academically while communism was collapsing or appearing to collapse and in many ways when we were doing comparative economic systems we were studying institutions before institutions became academically fashionable.

In the paper I give a definition of economic institutions, which comes from Paul Hare and I do not think I can improve on it. I added some thoughts about it in the paper, but his definition is as follows: "Economic institutions are social arrangements that regulate economic behaviour in ways that may not coincide with short-run individual preferences. They are based on shared expectations, derived from custom, trust and law. They are best understood if economic behaviour is seen as a repeated game". I think that encapsulates an enormous amount, including of course the reference to law but also including references to trust and custom. Now, have we moved from a world in which there were entire national societies built on sets of institutions which were radically different across these different countries toward something which is becoming more uniform?

There is at least one development that suggests we are looking at a world in which nations are playing – or trying to play – the same economic game. This is the proliferation of indicators of economic institutional quality. There are some indicators that are related much more widely than just to economics: for instance, the World Bank's measures of governance, including things like voice and accountability which is virtually a measure of democratic quality, but also things like rule of law, regulatory quality, control of corruption etc. These are governance indicators. There are many more, and I think one of the most interesting ones, again associated with the World Bank, is the ease of doing business scores. These are built up on the basis of large intensive surveys and now cover 175 counties taking a whole lot of different indicators, which are essentially expected to show you something about the nature of the business environment. Is this a good place to do business? So they include things like the amount of time and the cost of setting up a new firm, how you raise credit, how you get goods and services across borders, a number of very nitty-gritty things that are quite well-based in survey evidence and are combined into a set of measures which are indicators of the ease of doing business in a particular nation.

Now having an ease of doing business indicator, or ranking system like this – it is essentially a ranking system – assumes that everybody is or should be trying to have a good business environment, and that countries can be measured according to this measure of the ease of doing business and you find the usual suspects come out on top: Finland, New Zealand, America; and the UK is fairly high. Interestingly, the Nordic countries usually do well on these scores, as they do on governance scores. So it is not everybody's idea of a free market environment by any means Still, the underlying presumption is that there is a single measure, if you like, of institutional quality and all countries are playing the same game, whereas before we were looking at communist countries, operating in a completely different way; capitalist countries and variants on them, doing somewhat different things. We could judge by more ultimate standards of efficiency, growth etc. Now, apparently, we can all be judged – more precisely, our national economic institutions can be judged – by the same yardstick.

Ranking systems like this, however, are not the only game in town. One approach which I was drawn into, in the context of a quite different conference, is the literature on varieties of capitalism. This literature comes more from political science than from economics. It offers another way of looking at things, of saying that there are indeed different viable varieties of capitalism, viable in some long run sense, that are capable of continuing to coexist and perform adequately so they do not tend to evolve towards one single variety. And these are on a scale between competition and co-ordination. Now co-ordination sounds to many of us unpleasantly reminiscent of central planning but that is not what the intention is. This varieties of capitalism story is a complex one, I am not myself by any means wholly persuaded by it as an approach to looking at different countries, but it includes looking at the differences across labour markets, the differences across capital markets: How large a role does the stock market play as opposed to the banking system, how re-distributive is the national system, to what extent are taxes re-distributive – are there high marginal rates of income tax – how large is government current spending in relation to GDP, and what is the outcome in terms of the Gini coefficient of inequality. And of course, the labour market, job security, what level of wage-bargaining, whether this a plant level, or is in some sense at a national level etc.

I will not pursue the pros and cons of this particular approach but I just mention it because I think there are some of us who are unfamiliar with the various attempts to classify different existing, established capitalist economies into different categories. One variety would be Anglo-Saxon, another would be continental (like France), Mediterranean (Italy, Greece, Spain), Nordic, and so on. One that I very much like is developed by Ronald Dore which is basically a comparison of Germany and Japan on the one hand, with the Anglo-Saxon economies on the other, so it does not attempt to include everybody. His book, published in 2000, *Welfare capitalism, Shareholder capitalism: Germany and Japan versus the Anglo-Saxon*s and his division between shareholder capitalism and welfare capitalism seems to me to capture quite a lot.

Now if we agree, at least provisionally, that there are some quite different varieties of capitalism at least, leaving aside those countries which are still – in a political sense – communist, obviously China in particular, looking at the developed world there seems to be one big question: is there really only one variety of capitalism that will survive in the long-run, namely Anglo-Saxon capitalism? Even Ronald Dore, who is a Japan specialist and inclined to like many of the arrangements in Japan, and for that matter in Germany, is somewhat pessimistic about the future of what he calls 'welfare capitalism.' He provides evidence that Japan and German are themselves shifting towards more 'Anglo-Saxon' institutions.

So can these non Anglo-Saxon capitalisms survive? That would be one big question for today's students of comparative economics.

The other big question is this. If we look around the world in general, not just at developed/established capitalist countries, is the Chinese economic system something which is capable of enduring and continuing to succeed? Certainly to someone accustomed to looking at the old Soviet system, Hungary and so on, and now seeing the changes in those countries, it seems a curious arrangement, where there is still this communist party in control politically and a considerable lack of clarity, to my mind at least, about property rights. How viable is this in the long-run, or to put it more modestly, what are the strengths and vulnerabilities of this system? Well, we shall address this later on in the conference, and I look forward to hearing about that from the experts.

But to come back to Europe, the exercise that I did in the paper and take a bit further in another paper, for a volume[2] which is just coming out, is to look at the relationship between, above all, governance scores, the ranking by the World Bank and the scoring of governance; roughly speaking the quality of public administration on the one hand and the re-distributive nature of the state on the other. Mark Knell and Martin Srholec have developed a measure of redistribution, which is a compound of a country's Gini Coefficient, the highest marginal rates of income and corporate tax and the government's current spending as a share of GDP. The higher that is, the more re-distributive a country is, the lower, the less re-distributive. I took (I shall not bore you too much with details because they are in the paper) established EU countries, although the data did not include Luxembourg so it is fourteen before the enlargement of the EU in 2004. Then the eight ex-communist countries which joined the EU in 2004 plus Romania and Bulgaria who joined this year, and I have thrown in as extra observations Japan, Russia and the United States. So, in total 27 countries, and I looked at how they compared along these two main dimensions, re-distributiveness and governance. The established EU countries were all more re-distributive rather than less re-distributive, with the exception of the Republic of Ireland. Britain was very near the mid-point, but it was just on the re-distributive side. The accession 10, if you like (leaving out Malta and Cyprus), in other words, the ex-communist countries that joined the EU in 2004 and 2007, all come out as non-re-distributive despite whatever influence the accession process had on them; they come out as very non-re-distributive, except the Czech Republic and Slovenia.

Now, if you take the ease of doing business as a good – proxy measure of the prospects for an economy in the longer run, that is to say, if there is a good business environment that should be helpful – how do these factors of governance and of propensity to redistribute appear to influence the business environment? I threw in some other explanatory variables as well, using, I am afraid, very elementary and clunky multiple regression analyses, nothing very sophisticated about it. What I looked at was the relationship between these 27 nations' ease of doing business

2 Hanson, 'The European Union's Influence on the Development of Capitalism in Central Europe,' in David Lane (ed.), *The Transformation of State Socialism. System Change, Capitalism, or Something Else?* Basingstoke: Palgrave, 2007, pp. 95-113.

scores, on the one hand (as the dependent variable), and used as explanatory variables their governance scores and their re-distributive propensities – whether they were more or less re-distributive. Those two variables turned out both to be highly significant and when you incorporated them, differences in per capita gross national income did not independently have much influence, rather to my surprise, although governance is very well correlated with per capita gross national income. What you find very broadly, is that given their per capita gross national income, the accession countries, at least the first 8 who joined in 2004, all look reasonable in terms of their ease of doing business scores, but are much weaker, however, on governance than the established EU countries. Both groups have relatively high, in terms of the whole international ranking, ease of doing business scores, and being re-distributive by itself has a negative effect on the ease of business scores.

The bottom line, I suggest is this: a propensity to redistribute, as a national tendency, other things being equal, is not very good for economic prospects. But if you have a very effective public administration, which includes things like regulatory quality and rule of law, that offsets the negative influence of redistributuveness. The net result is that the established EU countries have quite an impressive – by international standards – business environment, despite being relatively re-distributive, while the new ex-communist members of the EU have relatively good business environments by virtue of being more unreconstructed, competitive and un-re-distributive, rather than on the basis of good governance. This does suggest, for at least the time being, that there may be more than one way of securing and maintaining a favourable business environment. Of course, the notion that the new member states of the EU are in some sense more Anglo-Saxon than the existing members, or at least less re-distributive, may be open to question for some of us.

I will finish with my basic conclusions. First of all, the number of systems has definitely fallen but probably not down to one. There are at least different varieties of capitalism and the differences between them may be significant. Institutional comparisons we make now are much more comparisons along a single scale as if we were all operating in the same game, but is this legitimate? The two big issues that remain are China, which we will be hearing about later, and the viability or the strengths and weaknesses of non Anglo-Saxon capitalism on which I have suggested some initial thoughts but not offering any further conclusions. At this point I would like to invite Tomasz to speak.

Tomasz Mickiewicz: I am in a difficult position because if Philip Hanson were not sitting next to me I would start by quoting his paper on comparative economic systems. I think everybody read it in our department and it summarises the main points of the theoretical discussion rather well. Knowing Phil would talk first, I tried to think about some additional questions. These are the questions I do not necessary know the answers to and I am very much interested in, and if we return to some of them during the discussion I shall be very interested to learn some of the answers.

But let me ask those questions. The first question is about the link between the economic institutions and the political institutions. This is also my reading of where the theoretical discussion is going at the moment. The second one is the question of property rights and I will explain what I mean by it. The third is the question of measurement and what focus we should take when we talk about institutions, and how to progress to the next stage, which is measurement. And finally, which Phil has already discussed a little, is the question of the winning institutional model, where ultimately all other questions converge.

I will start with the political institutions. There is very strong empirical evidence for transition countries at least, that economic reforms are conditional on democracy and political freedom. Empirically, it is a very strong relationship. The interesting practical question is why we talk so little about it. Because what is amazing is that you see some of the best papers with empirical results like that by our colleague Dr. Peter Sanfey from the EBRD, the link is observed but not discussed much. I think there are two practical problems.

The first is cross-discipline nature of this link, and I think, for anybody who attempts to talk about the link between political systems and economic systems, the risk is that it is a cross-discipline so it is also a crossfire. There are political scientists who know much more about the political institutions and there are economists who know much more about the economic institutions, and hardly anybody who knows enough about the both of those, and can provide convincing arguments of how that link works.

The second problem is that a lot of this work has been driven by international institutions like the World Bank and EBRD, and if you trace it back, the World Bank and EBRD obviously do not want to talk about political institutions because they are practically orientated. For example they want to fund the implementation of some reform programmes in Turkmenistan, but they do not want to offend Turkmenistan by talking too much about politics. This is a very real issue because it affects the research agenda. The money does not go where some of the most interesting questions are. I have to say also, that the same bias is present in anybody who is interested in implementation, in solving practical problems. The last section of "The Mystery of Capital"[3], is on implementation, and you can see the way he structures it; it is addressed to any kind of political regime. He gives a recipe to implement it in any kind of authoritarian regime, which is understandable, and I sympathise with this kind of approach, but again, we are ignoring some of the most interesting questions.

Now, another problem which I would like to highlight, comes from the fact that sometimes the focus of our work is too narrow. The most popular database on political institutions, at least among political scientists, is the Polity IV project[4]. It is a great database but it covers about 100 years of all countries throughout the world, and it is mostly focussed on narrowly defined formal institutions. If you use it you can not explain some of the variation in political practice and implicitly some of the variations in economic performance, because there are other important dimensions which are not contained in Polity IV project. The dimensions are freedom of media, basic civic liberties and those are not well captured by some of those indicators. On one hand you may have a country which is by name a democratic country but is quite

3 Hernando De Soto, *The Mystery of Capital*, Bantam Press, London, 2000
4 See: http://www.systemicpeace.org/polity/polity4.htm.

problematic in terms of how its citizens are treated. On the other hand you may have a country which may be called authoritarian but this is a narrow, formal definition, and that country may not necessarily be a bad place to live in terms of basic individual liberties. This is a very obvious comment but this is still being neglected in empirical work. Just to give an example, yesterday I was listening to CNN and the Prime Minister of Singapore was criticising what is going on in Burma and the government troops firing at demonstrators there, which could imply that he would not be willing to do this himself, hopefully. However, Singapore would be in the category of authoritarian regimes, as understood by the formal definition. It is authoritarian but there is a whole spectrum of authoritarianism, and it is very important for such a regime to understand what kind of authoritarian regime it is.

This leads to the next interesting question, and a real problem. I think it is not a problem for democratic countries because they are typically relatively similar, from the point of view of the political institutions. As Tolstoy says, all happy families are similar and all unhappy families are different. It is almost the same with political regimes; the democracies are relatively similar but the authoritarian regimes come in all sorts of shapes. (I am more than happy to discuss this later if it provokes discussion). The reason why is maybe that in democracies, a lot is based on formal political institutions. In a democracy one wants to know who is president, who is the prime minister, who is in parliament, to know basically, who has the formal power to set the agenda and who has the authority to make decisions. And this formal power typically coincides with actual practice. One of the clearest characteristics of authoritarian regimes is that this is not necessarily the case there and we had the example of communist systems, where the political decision-making was not where the formal government was. But the same applies to many variants of authoritarian systems as they depend far less on the formal institutions and far more on informal connections. This makes analysis a little bit more difficult, which I think is the point. There is a risk in doing it and maybe I am wrong, but the point could be generalised, and applied with respect to the economic institutions. If we assume that democracy goes hand in hand with well-functioning formal economic institutions, then the analysis is easier because we can focus on formal economic institutions, whereas authoritarian regimes have less predictable environments, are less based on formal law, and based more on discretion of the ruling elite or the officials, so we learn far less by looking into the formal institutions. The informal institutions are something which people talk about, but are far more difficult to capture, because here we talk about issues like corruption. However, on the positive side we also have all the features related to culture, attitudes, again informal ways of doing things: informal rules which substitute for formal rules and may on many occasions play a positive role as well. This is far more difficult to analyse but we do need to take informal institutions into account, which maybe why I will reverse the order, and next I will talk about measurement, as it is more connected to this.

Thus, the first obvious comment is that we have to pay far more attention to informal institutions. The corruption has been well understood. There is some positive development, and again, much of that goes back to De Soto.[4] One way is to capture the actual practice, which is shaped by both formal and informal institutions, is to formulate the questions in a very narrow and practical way, such as, how much time do entrepreneurs spend doing things. The focus is on practice, and not on law, this is basically the answer. When we focus on existing practice we learn far more about how the institutions function than if we just focus on what is written in the formal written documents. I think that was all started by De Soto, and has simply been incorporated into World Bank projects, as Phil mentioned about Doing Business. Some of those indicators may be quite critical, but that is just the beginning – I shall provide an example why it is not the end of the story. At the moment I am doing some work on entrepreneurial entry and what we find out is that it is not really the barriers to entry which matter most for entrepreneurial entry. Why? Because barriers to entry correspond to a one-time 'sunk' cost, and if you have a country like France, where the barriers to entry have been quite substantial, you still may see enough entrepreneurship. The explanation for it is that when you assume that the potential entrepreneurs are forward looking, the more important thing is not what they face when they start their business, but what kind of environment they will operate in later on. So we need to understand the latter and we need to understand not just the current state of institutions, but expectations about their stability and potential change.

4 Hernando De Soto, *The Other Path*, Harper Collins, New York, 1989.

In a sense it implies returning to some basic economic assumptions and trying to look at everything from the perspective of individual economic actors: what kind of incentives an economic actor would face; to translate institutions into economic incentives. Otherwise, we use rather a random combination of institutional indicators to describe an economic system, and this is partly the problem with our colleague Mark Knell, and his paper and the problem is very well captured in Phil's second paper on Russia[5]. Before you use some of those indicators, we need more reflection of what they measure, because if we focus on Mark Knell's results, it is claimed that Russia is an economically liberal country, which anybody who knows Russia would question. Yet, you will find people who do not and there is a lot of enthusiasm, people look at some problematic indicators, and this explains why even if the country is sliding towards rather an authoritarian regime, there are many who continue being enthusiastic, because they narrowly focus on a set of indicators that does not tell the whole story.

This leads me to the last point: property rights. Russia is such an interesting example, because it demonstrates how property rights is a complex issue. There is one aspect of this discussion I shall not go into, as we will be talking about China later on. Using the Chinese example, people question that property rights are important, and one of the papers today is discussing China. Therefore, instead, I would rather return to *The Mystery of Capital*, to the discussion De Soto started six years ago, in which he says, that property rights are not given uniformly to everybody in a given country. He starts with the following example. When he started his work in Peru he went to some leading business owners, and talked to them about how difficult it is to operate their businesses there. In his work, property rights are defined very much by the freedom of contracts and safety of contracts, not only just by the safety of a registered property title. This is the freedom of contract, and safety of contract are more important than safety of registration, as without opportunities to use it, property remains 'dead capital'. When he talked to the Peruvian elite business owners, he was told that it was very simple to register the enterprise, easy to exchange, to make transfers,

5 *Russian Political Capitalism and Its Environment* by Philip Hanson and Elizabeth Teague, Varieties of Capitalism in Post Communist Countries, edited by David Lane & Martin Myant, Palgrave, 2007.

operate and so on. However, the finding, which was replicated time and again, is that in a country you may have some economic elite insiders, who are well protected, and then a large number of other people operating in the informal sector, because they simply cannot benefit from the legal protection. So you may have a question about access to property rights, or a question of privatising property rights – in a sense, making them accessible to everybody.

The reason this question is so important is that it tells us a lot about Russia as well. There may be change for the better in Russia in some respects, as there were some reforms, but the question is how well were those reforms implemented. In some of the current work we did on entrepreneurship, we argue the point that you may have a situation where there is a clear distinction between people who are inside already, that is, owners of existing businesses and outsiders.[6] The insiders may be in an environment where they can function effectively. The problem starts only when you think about newcomers, and if you define entrepreneurship mostly by the new entry, not by the number of existing businesses, then you can immediately see that there is something wrong. Because if you start to measure it empirically, in Russia, you see that significantly, new companies are started by people already in business. You do not have this connection in many countries, but it exists in a country where institutions are not functioning well, and *de facto* property rights do not cover all economic actors.

The second issue is not well captured by economists but is quite important for businesses concerned, and this is a question of legitimacy. We had this simple view of Russia; we had advocates of this, I am thinking about Shleifer for instance and his colleagues, saying that we will privatise, and then the market will sort out itself. The problem with this view is that legitimacy is an important dimension. Society's perception may be that property rights were distributed based on political favours, and in the case of Russia this was quite extreme because the major assets were distributed based on political connections. If people perceive that as not legitimate, they simply will not accept it.

6 Ruta Aidis, Saul Estrin, Tomasz Mickiewicz, "Institutions and Entrepreneurship Development in Russia: A Comparative Perspective", *Journal of Business Venturing*, 2008, forthcoming.

There is not much that can be done about it later on, and the problem is that this can affect the very support for the privatisation process; this is a real problem. And, of course, another mechanism – very well captured in a recent book by Oleh Havrylyshin[7] – is that the distribution of wealth resulting from privatisation also may matter for how liberal and how free market the country becomes. Oleh Havrylyshyn's argument is that if we have some big players and skewed distribution of wealth, it is not necessarily true that it will be in their best interests to introduce a full-scale market economy. There is a paper by Sonin in *Journal of Comparative Economics*[8] in which he asks why elites may not be in favour of strong property rights. Again, it is going back to the De Soto argument from another angle, which is that you may have a situation where the elite is well protected due to well defined rules of the game: if they do not go into politics no one will come and check their accounts and they are safe. It is also in their best interest to cut competition and prevent others from entering: limit foreign investment if it is bad for them, or to create pockets of foreign investment which can be as monopolistic as local players, and will affect the real economy little. This point is made in Phil's article: foreign direct investment is such a misleading indicator, because if it is not integrated with the rest of the economy, it will not help to solve the basic problems.

Therefore, the method of privatisation matters, and there may be outcomes which may be neutral from the market point of view but not if we consider the indirect impact of some of the social outcomes on the political and economic systems. If we give all the oil assets to a few oligarchs, again there is a risk. From the purely economic point of view, it does not matter, as long as the transfers are possible, but it may affect the political outcomes, and if it creates opportunities for rents, it may create lobbies for some inefficient policies.

And finally, the question of the winning institutional model. There is some empirical work reported in *Comparative Economic Studies*, where they point out a very interesting combination of institutions, in terms of

7 Oleh Havrylyshyn, *Divergent Paths in Post-Communist* Transformation, Houndmills, Palgrave Macmillan, 2006.

8 Konstantin Sonin, "Why the Rich May Favor Poor Protection of Property Rights", *Journal of Comparative Economics*, Volume 31, Issue 4, December 2003, Pages 715-731.

the link with economic growth.[9] This institutional setup would be a liberal labour market, extensive entrepreneurial sector, and interestingly, a relatively even income distribution. And where are those countries? They are in South-East Asia, and by South-East Asia I do not mean China, I mean those nations which were successful before China – Taiwan, Singapore, Hong-Kong, Malaysia and others. By the way, the economic success in East Asia should not be traced back to China, but to a number of countries that possibly the Chinese learned something from… but let us stop, I should not be talking about China.

But East Asia, Chile and South Africa, those are the countries identified in this group of 'efficient' institutional setup, at time of that research. What I found interesting is comparing these countries with the rest of Latin America, excluding Chile. What you find in Latin America, is over-regulated labour markets, and the very strong position of trade unions. This was a trademark of South America for a very long time, and clearly this is one of the institutional elements which was not very productive. In contrast, the entrepreneurial sector is relatively small, even if again you may find some exceptions, and it differs in each country. But East Asia is characterised by a very large number of small enterprises, starting with South Korea, with a very large number of small firms. Finally, we have income distribution here, and I think that extreme inequality is not good for a liberal market economy, because it may have political implications which are dangerous, especially in an environment where institutional constraints are weak. How to avoid extreme inequality is another matter. It is not necessarily that it should be avoided by full-scale redistribution, it can also be avoided by free entrepreneurial entry, and this is the last point that I want to make. There is a work by Berkovitz and Jackson in a recent issue of the *Journal of Comparative Economics*,[10] where interestingly he demonstrates, that better social outcomes are linked to freedom of entry. You can solve social problems by various means, and not all of those means are related to the redistribution – that is my point. Clearly more work is needed, but there

9 Frederic Pryor, "Economic Systems of Developing Nations", *Comparative Economic Systems*, Volume 48, Issue 1, March 2006, Pages: 77-99.

10 Daniel Berkowitz and John E. Jackson, "Entrepreneurship and the Evolution of Income Distributions in Poland and Russia", *Journal of Comparative Economics*, Volume 34, 2006, Pages 338-356.

is some indication that a better method of income redistribution is simply by opening up possibilities for entrepreneurial entry, because entrepreneurship is one of the best ways out of poverty. If you give people resources; if you give people enough education, and you open up possibilities for them to work for themselves, this is what they want to do. Again I come back to *The Mystery of Capital* and one of De Soto's best comments:

> Marx would be surprised to see that most of the developing countries nowadays do not consist of oppressed workers but of small entrepreneurs.

Phil Hanson: Thank you very much Tomasz. Maybe we could concentrate on more general points rather than points to do with Russia…

Pascal Salin: Maybe it is just a point of language, but I am somewhat uneasy with the varieties of capitalism; why do we not speak of the varieties of state intervention? There is only one possible capitalist system, and there are many different types of state intervention. Why do I say that? Because I think that capitalism is the only coherent system imaginable when property rights are defined and respected, when the system is working well and it has a moral basis. I think this is important as regards the question about the "winning model" is a convergence between the different capitalist models, and so on. I would like to say that capitalism *ought* to win but the problem is that there is always this conflict between freedom and constraint and we never know what can happen with constraint. I should define capitalism as a system of legitimate – and I think you are quite right to stress this problem of legitimacy, which is very important – of property rights. In that sense it is a universal concept, not only an Anglo-Saxon one. So I think we have to be careful about this problem of language. Similarly, in the papers we were given, there are some concepts which are more or less normative; for instance there is conflict between liberal markets and strategy co-ordination. We do know that a market is a system of co-ordination, so we must not cause conflict between a liberal market and strategy co-ordination. In one paper there is a criterion of social cohesion, you avoided that and mentioned that it is normative, and I think the re-distributive policies are against social cohesion, because when you have a capitalist system, as I said which is coherent so there is social cohesion and redistribution and I should say maybe democracy, underpinning social cohesion. So maybe it is only a problem of language, but I hope language carries deeper meanings. I think it is important to clarify the concept and become familiar with using the concept we accept completely.

Jan Winiecki: I stopped teaching anything resembling comparative economic systems. I introduced a subject which I call *economic institutions*, or actually *institutions of the market economy*, and even if I teach transition, it is not, for me, an extension of comparative economic systems but a case of comparative economic institutions. So, what do I do there? I am defining institutions, and here I return to what Tomasz said, namely I am not confining myself to formal institutions, but also to defining informal institutions, to try to show how they interact with each other. Then move to history of economic institutions, and here is a kind of policy of communist economy, so it does not take much of my time, and does not take much attention as far as my students are concerned. Then I look at particular areas of competition.. of comparison; I look at property rights and at public choice. To look at the particular traditionally used areas of economic analysis, such as capital investment and human capital investment and I attempt to look at them from the vantage point of institutional areas. I try to explain the huge gap that exists between investment in financial, physical sense and investment, in the democratic sense and the actual economic output.

Silvana Malle: Well, on the point of convergence: other models of capitalism and convergence to this one model, I think from what we see now we could say: yes, somehow there are pressures for convergence. What we have been seeing in the last two years is a movement towards this, and these lead to international goals to best practices. As you know there is a difference especially in parliaments in advanced countries where they discuss what are the best practises in each area and so on. Sometimes it is decided on which model to try, so that such and such institution may be improved. This is a way some countries work. But, in the end, which model is going to win? There would be a single model of a market, and I think this is still an open question, as each country has its own history and political culture. We all know about economic institutions, and it is very likely that even the institution, or one very similar, does not behave the same way as its counterpart in another country. We know that in each country when an institution is adopted, there are all sorts of regulations following and influencing the performance. So if we look at certain indicators, as the speakers point out, they really do not end comparison of what institutions are. Indeed, they are adopted in different ways, so that is a problem, whichever model of capitalism emerges in the future.

On the question of redistribution, Phil makes a very interesting point, and even without Stalin we know that redistribution occurs. In France, you cannot have a political speech without mentioning *La Solidarite*; in Italy the same. It is a long way from redistribution. We cannot vote, so we are stuck with it. Apart from that, where are the pressures for redistribution coming from?

In my view, not so much from the advanced countries; nor much from the inside, because from the inside there is more opposition to this sort of solidarity. People are fed up with subsidising those who do not want to find a job, despite the opportunities. You can see what is happening now in France, they are changing the unemployment rules. I do not know how this will succeed.

But the pressure for redistribution is coming from abroad. We are going to redistribute whether we want to or not; just look at Africa. It is a very interesting thesis though ultimately gloomy. It predicts that globalisation will evolve into a monopoly and some sort of strong enterprise will dominate the world. I do not see this trend, but it seems that we will endure more problems.

On a few points raised by Phil, this relationship, or *supposed* relationship between governance, doing business and redistribution. Well Phil knows more than me, and it could be correlation: yes, but where is the causality? That is the question. Is business pushing for good governance and are there pressures from below? Or are there some good politicians who push for good governance and therefore good business conditions are created. We do not really know, but I think the two things are interrelated.

On the question of the new European Union members having an easy business environment that promotes good governance and less redistribution: yes, we can almost have this cross-country comparison, but we are always talking of different stages of development, and we should keep this in mind, because then we also have inequality in incomes, and whatever. It is difficult to compare countries without considering that they are at a particular starting point.

Sebestyén Gorka: Just to add to Silvana's point, what was said is very true for Italy and for established EU countries, but in our neck of the woods the pressure for redistribution is internal, it is very much an expectation: the people want to hear the solidarity words, the harking back to nostalgia for the former system, so there is a very big difference for example, between Italy and Hungary.

Bernard Brscic: I think a Panglossian view of democracy has been presented, in a way that basically sorts all economic problems. In a way I do not agree with that view, I would propose two alternatives: democracy versus authoritarianism, and liberalism versus totalitarianism. My point is that it is of course possible to have a totalitarian democracy, and it is also possible to have authoritarian government working on a liberal principle. And for capitalism, actually, what it needs is not necessarily democracy, but basically liberal principles. Now, what would be the connection, what arises from democracy to liberal principles? I am not that sure because if one looks at the political landscape of Europe, one hardly sees countries that are really liberal. So the question is: can democracy, as a procedural rule, define who rules the country, can it ensure the rule of law, which is an essential condition for the functioning of markets? My view is that often democracy is an obstacle because it somehow allows people a second vote. What do I mean by a second vote? A first vote is cast in the market, so when you are involved in the exchange process, you end up with a certain endowment of goods and services at the end of production, and then suddenly through democracy, you have a second vote, which endows the losers of the market exchange with an option of redistribution. So if one is concerned for the future of capitalism, one should consider one would limit the possibilities of redistribution, which would probably include imposing certain supra-majorities on redistribution rules.

My point is that what one needs is not democracy, but a rule of law. Of course, the question then for Europe is, to what extent is the rule of law, or the *Rechsstaat* compatible with a welfare state.

Is there such a thing as a term used by the Germans in the 1950's, *Sozialrechtsstaat*? I think it is a complete contradiction in terms: either you have a rule of law or you have a welfare state and there is no such thing as social justice. As Lucian Pye, I think, correctly points out, that is a mirage. The market system is procedurally just, but the end results are to a large extent also dependent on luck, so the essential question is whether you can ensure the observance of rules. This then connects to the form of justice, or legitimacy, as you point out, of property rights. This is an essential question for all countries, whether the initial redistribution of property rights is just. And of course, in transition countries, you have a huge problem in that privatisation – to a large extent – was grand theft, a primary accumulation in marginal terms.

So you have a problem not only with equal redistribution – I do not question inequality, I question injustice – and if you have unjust property rights then you have a political problem in democratic society, because if people consider this as theft, then they want redistribution. In a way, even political theorists like Robert Nozick, at the end of *Anarchy, State and Utopia*, say that if there is an infringement of justice of transition, then certain redistribution is desirable.

Krassen Stanchev: There are issues that I would like to address from a different angle. The first is the so-called models and the second, redistribution economies. Regarding the models, I think it is basically incorrect to use the term in its nature-science connotations, as if it describes something totally independent from choices people make in exchanges and everyday life. This use of the term comes, I believe, from the development of the economic profession, which at some point needed to prove it is value free and on some next stage – perhaps after Keynes – pretended it had all the answers on how to model countries and economies.

Thus, theoretical constructions of knowledge become instruments for social engineering. The problem with any "model" is that, by its notion and etymology, it presupposes an artistic or a social position that shapes things. In the economic profession any model already assumes there is someone out there to intervene because he knows the subjects.

Pretending that some model better describes differences between countries and global markets rules of the game, other than empirically identifiable characteristics does not yet mean that some "model" was not used to modulate economies (which, studied later justify the model's objectivity).

This brings me to my second point: what distinguishes both models and countries is perhaps the degree of social engineering. What is new in the economists' profession, is the application of measurements to this phenomena. One sees such attempts in the economic freedom indexes, doing business indicators, etc.

Tomasz Mickiewicz: I will leave Russia aside, because I presume we will discuss Russia later. Inequality, redistribution, entrepreneurship. Now, there is another argument which is why entrepreneurship may be consistent with relatively flat income distribution. If I were to be asked if I worry about inequality, I would say probably "not that much" – what I worry about is mobility: social mobility and one argument supporting the view that entrepreneurship and equality may be consistent is thinking about this in dynamic terms again. The first point is about monopolies and competition. The second one is about entrepreneurial talent: what we see, for instance, in the United States, is that if you look at the most wealthy people now and the wealthiest families some time ago, they are not the same people, because entrepreneurial talent is not inherited. But a key question for performance is if entrepreneurial talent is matched by possibilities to enter and realise the potential, to use those talents. Now, from this point of view in Europe, the agenda-setting is very important, in how we define our questions. If we define them in terms of mobility, we see that the US is much better than Europe in many respects, because in Europe we have the regional dimension. There are regions which are poor in Europe and have been poor for the last sixty years. That is not the case in the US. If we take unemployment: the unemployment rate was historically higher in the US than it was in

Europe, though not now. But even then, the mobility in and out of employment was much higher in the US and it is, I think, the key issue.

In fact, I may be mistaken. I think in a global perspective, the Anglo-Saxon countries normally most associated with liberal economic institutions are not characterised by extreme income inequality. The only case which is so much discussed is the United States, but in this case it is easy to explain, if you take into account that larger countries usually have more inequality, almost by construction, simply because they are large. This is a pattern which does not only apply to the US. The critical issue is, and this is the point I wish to make is that:

a) extreme wealth inequality may be dangerous because it may create insiders who then may affect the economic institutions to create barriers and protect their interests;
b) freedom of entry is likely to make this trait less serious, and similar income distributions may be achieved by very different premises.

An example is the Czech Republic versus Hungary: if you take Gini coefficients for the Czech Republic and Hungary, they are very similar. Now, the Czech Republic is redistributing far less than Hungary, so the same outcome is achieved by very different measures. Or think about some of the more re-distributive countries in the West, France for example – but even France is changing now, so I am describing a stereotype of what we had in the past – where one of the paradoxes is that if you look at the corporate ownership in France, it is far more unequal than in the Anglo-Saxon countries. What we have in France is some families controlling significant share of business... we have basically big business, large trade unions and big government, and outsiders who are cut off. This is a caricature; France is not quite like that, but I am just trying to create this stylised point of reference – and we have outsiders who are unemployed, and have not had a chance to go to work and so on. We then have a state which is redistributing to keep those outsiders quiet. So what we have is concentrated ownership, unequal ownership of assets, a big state, large trade unions and a lot of inequality. This is also very similar to some of the Latin American countries, apart from Chile.

Philip Hanson: I will not even attempt to do justice to the points that have been raised, but perhaps we will get round to answering some of them later on. I shall just pick up on a couple of things. Much of the discussion, including from Tomasz, is centred on problems of measurement and I think that is absolutely right and it is very tempting when you have these handy, convenient indicators, rankings and so on, just to do a bit of manipulation of them because they are there. They may, in fact, be missing all sorts of important things. Now, I think one of the things, that has come up in the discussion repeatedly, is the importance of informal relationships. I do not dispute this at all: I simply draw your attention to it.

There are lots of things which existing measures are not grasping and I very much agree with Tomasz that the nearer you get to being able to measure the practical difficulties in setting up a firm, in hiring and firing labour etc., as an ease of doing business ranking, the better handle you have indirectly on important informal relations. I think there are some intriguing issues here. Nick Crafts, the economic historian, has done quite a lot of work on long-run development of informal relations, plugging into the usual growth equations, explaining differences in long-run growth, measurements like the rule of law. One of his arguments – recently amended or extended – is that what he calls 'Institutional Quality', or IQ, (just to annoy people) but countries IQs do not change very readily. Now that is a pessimistic view and it may have quite a lot to do with the phenomena we are viewing in post-communist economies. That has a lot to do with the way in which, informally, nations' economies actually operate and we are probably not getting a very good handle directly on that informality.

An interesting contrast would be the strongly interventionist character of Swedish government, for example, and some very strong (internationally) Swedish companies. The efficiency and competitiveness of many Swedish firms, despite an interventionist and re-distributive state may (I throw this out as a conjecture) be due to the heritage of Lutheranism. In other words, there may be important influences which we are not fully understanding, at least as yet.

Finally I mentioned I was going to do some work on this business of institutionalisation via the European Union. It seems to me extremely striking that the new accession states of the EU appear to differ on many of these institutional characteristics. Not by any means solely for the worse but often for the better. The ease of doing business scores in all the eight 2004 accession post-communist countries are substantially better than that of Greece, for example, and most are better than Italy. Russia on the ease of doing business scores last year was 96th out of 175 countries. Well that is actually ahead of Greece and not far below Italy. So, one question I asked about the accession countries was 'how did the accession process actually mould or influence institutional quality?' and despite all this opening of 31 'chapters' and closing those chapters and working through all sorts of details about regulation and so on in order to conform with EU practice, you find that enormous institutional differences remain, which is not surprising when you consider how large the differences already were within the existing EU countries. So the people who claim that the EU is making everyone Anglo-Saxon or claiming that the EU is making countries more interventionist are quite wide of the mark. These nations have got quite strongly developed institutional characters which seem to be, at least in the medium-term, impervious that sort of process.

Ljubo Sirc: Attention should be paid to two phenomena during the transition, ie. during the change from the communist system back to the market economy. Both phenomena interfere with a successful completion of this transition.

The first interference comes from the preference of the communists for large enterprises. It is not so much that they believe in the economics of scale, but large enterprises are easier to control from above as the communist running of the economy demands. On the contrary, a return to the market requires that entrepreneurs continuously organise new enterprises which are small at the start, but grow as the economy expands and the demand for output changes. In successful economies, at least about half of the output usually comes from enterprises with a smallish workforce. It is extremely difficult to recreate such normal development when transition begins.

This difficulty is further connected with the largely political choice of managers under communism. It is impossible to replace them at the start with real entrepreneurs, people who successfully developed their own enterprises through re-investment of capital gained from profits.

There is no clear solution for the redistribution of capital so that it encourages entrepreneurship. Partly this aim can be achieved by restitution of capital to former owners, but more than this is required. The aim should be that those who run their outfits at a profit should be in charge.

Yet we have to admit that even under capitalism the link between profit making and management is becoming lost to some extent. As enterprises grow, capital owners become ever more limited by the choice of managers instead of running enterprises themselves, so that their income is determined directly by success. It is determined instead through their choice of managers, while the income of managers is determined by their contract.

Anyway, the transition back to capitalism is very difficult, the more difficult the longer the state without private ownership has lasted. I can remember Chubais saying: "We have been trying to re-distribute capital to such an extent that the return to communism will become impossible". Ten years later what now can be said about their efforts in the 1990s?

Bernard Brscic: A number of economists have contributed to this interesting typology of institutions, dividing them into informal and formal. I think it is an important contribution to new institutional economics by Douglass North, which has advanced immensely in the last twenty years and it seems we do know which institutions are essential for capitalism. Furthermore, we are increasingly aware of the importance of informal institutions, cultures, customs, habits. But a million-dollar question remains, how to change not formal institutions because this has been done, more or less successfully at the beginning of transition and it can be done in a period of say, 10 years. The question is how to change informal institutions. Basically, political scientists and mainstream neoclassical economists do not offer an explanation why Iraq or Afghanistan have different traditions. Most mainstream economists are not aware that you cannot just change people. Society is not a kind of constructed order, or to use a metaphor a watch-mechanism, and if necessary you can change the mechanism by fiat.

We have to be aware that the generations of people living under communism were happy in their youth and they have a certain way of thinking. In a way, one has to be aware that informal institutions are embedded in a society. So all this attempt of rational reconstructions of the layer of informal institutions is about to fail, because you really cannot change people. You have to deal with these informal institutions as a kind of constraint on public policy, that you deal with an older generation of the population with decisive votes, and you have to face that and not think that there is no problem. You only need philosopher kings who know the workings of society and then impose a plan of ideal society from above – no – because one has to acknowledge that informal institutions are the result of human nature, not human design. Let us be frank: it took countries like Great Britain centuries – not just decades – to develop working institutions of capitalism, and it would be naïve to expect a transplant overnight of informal institutions.

My view is that, in a way, one has to wait for a generation embedded in socialism to die out.

Sebestyén Gorka: What we have in the last seventeen years (and I talk with reference to Hungary) is a situation where yes, some of the Socialist generation are dying out but you have seventeen years of a certain system which is not a market economy. Unfortunately it suggests to the youths of the current generation to steal as much as they can because nobody will arrest you if you have the right connections. So it is a question of what are we living in right now: the nostalgia for the welfare state of old, and that capitalism is the *de facto* model, which they identify from the last seventeen years as capitalism, which it is not. It is an oligarchy; you can call it something else, a hypocrisy. But the fact is, for the average voter, they think that this is democracy and capitalism, and they do not like it. So they are looking for something else.

Krassen Stanchev: I would like to return to the question of formal and informal institutions.

When one tries to explain the failure of the impact of both formal and informal institutions, there are typical approaches. One is that, we take the past as we are accustomed to think of it and try to extrapolate and explain the present. Of the same type is the attempt to take the present and find its roots in the past. There are differences and nuances, of course, eg. from my own work in different countries in recent years, in both Central Eastern Europe and in the last five years in former Soviet Union countries (Kyrgyzstan, Russia last year and now in Kazakhstan), I find that recent backgrounds are much more important in understanding markets reforms and economic freedoms. For instance, it is possible to demonstrate (with some likelihood that we even see a causality) that Hungary, Czech Republic or Poland did somewhat better because of 1956, early start of reforms (in Hungary, in fact in the 1970's, with a humble but important restart in 1987), because of 1968, Charter '77 or Martial Law in 1980's Poland. Take rule of law, Poland's freedom of economic activities is a continuation and attempt to restrict government intervention in the spirit of the economic activities act of 1988, which aimed at decriminalisation of private business to compensate for shortages and collect budget revenues to pay the Paris Club and the Russians.

The problem and the key difference with Russia and the former Soviet Union countries is the destruction of property rights for a period of over three generations, living under this destruction. (This does not necessarily mean that there is no societal memory on the property status quo before Russia's Civil War. On the contrary, I am absolutely sure that in the Northern Caucasus, in Chechnya, Kabardino-Balkaria such memory exists and is a part of both contemporary problems and contemporary solutions. I am a firm believer in the positive outcomes of the restitution of property rights in that part of the Russian Federation.)

Explaining today's Russia by egalitarianism and authoritarianism as if embedded in the Russian culture and psyche is some sort of uninformed communist propaganda. There is an ample evidence, even in the Soviet historiography (I remember how I was surprised, reading in the mid-1970s a five-volume history of the Russian peasantry published by the Novosibirsk branch of the Soviet Academy of Sciences) that by the mid-19th century reform of the feudal rule, there were fifteen types of peasants and only a small portion of the total could strictly qualify as "*krepostniki*" (feudal servants). I regret I do not remember the exact figure. But the same point is made by the first Orthodox thinker replica to Max

Weber's *Protestant Ethics.* In 1909, Sergey Bulgakov in fact proved that even Peter the Great's subrogation of the Russian Synod to his authority did not manage to eradicate the entrepreneurial spirit of the Russian monasteries but simply moved it to Siberia. In fact, the historic research and evidence was out there before Bulgakov published his "*National Economy and Religious Personality".* I am no advocate of Russia's great history and spirit; I just want to make the point that by no means this older history is responsible for today's demons. I would not be surprised if some research proves that the impact of the ex-Soviet and ex-Soviet-republics' "KGBs" are much more relevant in explaining the economic situation of the contemporary Former Soviet Union and Russia.

Philip Hanson: So when Mikhail Khodorkovsky was sitting in his trial ostentatiously reading Pipes' *Russia Under the Old Regime*, he was doing his homework too late!

Bernard Brscic: It is not a question of who, but how. The moral problem is that the communists are setting the rules of the game, but the question is whether the property was administered justly and have they paid for that, or was that the result of their abuse of power and the privileged position at the beginning of transition.

Sebestyén Gorka? I think it muddles the question of not just who, but how.

Philip Hanson: I think that is a fair point, obviously the who gives you a good start and then you have to look more closely at how things are done.

Tomasz Mickiewicz: Maybe the issue is the Stalinist period, because in Central Europe it was so brief and in Russia the opposite. Maybe we should not talk about time under communism but time under Stalin.

Joel Anand-Samy: I want to touch on three separate issues here. There was an event that took place in the States just a couple of months ago with Dr. Andrei Illarianov who was adviser to Putin. He asked a predominantly American audience: "If you have to choose between the rule of law and a favourable business environment, and you cannot have both, which one would you choose?"

To listeners from Western democracies in his audience, including a number of senior politicians and policy experts, the question sounded like contradictory nonsense, since no favourable business environment can exist without the rule of law. But in post-communist Europe, we inhabit this contradiction, and the factor that makes this situation possible is corruption. The law exists, and in a certain sense it rules, but in the manner of its rule it is institutionally subverted. If we want economic freedom in southeast Europe – and as we learn what it truly means we discover we definitely do – then we need to reprioritise. Yes, we need to see continued efforts to make business environments more conducive to foreign and domestic investment. But we also need to address more overtly the twin legacies of communist rule: disregard for private property rights and the inheritance of institutional power by networks of corrupt government officials and their private partners in crime.

When we return to this part of the world, as Sebestyén and Bernard mentioned – Bosnia-Herzegovina, Croatia, Serbia, Slovenia, Hungary – yes it will a robust effort and to bring about positive changes. I think those are some of the key issues that we have in this region.

In regard to what I have noticed in Croatia, Bosnia, even in Serbia, the European Union is pushing for and trying to liberalise the market by stressing market liberalisation, you've got to privatise, you've got to open markets.

However, when you look at privatisation and how it is taking place in these countries, we notice state capitalism promoted by Germany and Austria. In the sense that you have telecommunications companies that push for privatisation in post-communist. You have Germany's Deutsche Telecom or Austria's banking industry – both being much involved in this region. So do you really have free enterprise, or is it disguised in state capitalism, as some would term it? It is certainly state capitalism and creative state involvement from the west that creates serious problems for individuals who are citizens and taxpayers of the region, who then question this whole process of capitalism or state capitalism.

For young people in the region the choices for their future are quite few. What would you like to accomplish in the future as it relates to career or vocation? Would you like to be an entrepreneur and strive toward financial independence or join large state sponsored enterprises headquartered in Berlin or Vienna? The very definition of privatisation in post-communist nations ought to be re-visited, especially as it pertains to southeast Europe.

Dragan Lakicevic: The point is the former directors took over the enterprises very cheaply. They became owners and did this in a very interesting way. First, they did so by removing capital from the firms. Their signature was decisive.

Pascal Salin: I would like to go back to this distinction between formal and informal restitution and democracy. The problem is what we can do to change informal institutions? I think I have the answer. People are very flexible and can address to very different formal institutions. Just take an American going to the U.S. and New York, to a new culture, a new set of institutions. Or just take the former communist countries: I am amazed to see how rapidly people have created new enterprises. It means that what we call culture is actually the outcome of formal institutions. So we have to focus on formal institutions. There is a danger if you stress too much the role of informal institutions, you may say it is difficult to change informal institutions – countries are different and people are different etc – so it will never change. But we know that formal institutions can be changed with rapid effects, for example, progressive or flat tax. It is quite obvious that you have completely different results with the flat tax and the progressive tax. Or let me give you an example from education, in France it has always been said that we have a *nomenklatura* which is in charge of the government and the private sector. This *nomenklatura* exists because there are two high schools, polytechnic and Economic. So I think that we have to be very cautious when we speak of informal institutions, there is a risk we overestimate them.

Philip Hanson: I agree very much with this. There is a very conspicuous example of changes in formal rules, informal rules and informal behaviour: the UK: Mrs Thatcher changed a great deal about what we thought of as informal attitudes in Britain, not just making formal changes. As a result of formal changes – and that was exactly the aspiration of people like Chubais, as Silvana was saying – reformers give people different opportunities and incentives and their patterns of behaviour may change. Of course, not everybody will change with great flexibility, but there is a very considerable influence from new formal rules to changes in informal rules. There is no other way that I know of, outside the educational system, which shows you the informal patterns of behaviour.

Bernard Brscic: There is an important contribution from Jan Winiecki and Steve Pejovic called the interaction thesis, which postulates that there should be a compatibility between formal and informal institutions. There has been an enormous effort by the World Bank to transplant legal institutions from developed to developing countries. They have transplanted the USA constitution and economic legislation to various Latin American and African countries and yet these transplants have been an utter failure. Why? Because there is incommensurability between formal and informal institutions and I agree that incentives matter and you can change incentives through formal institutions to some extent. But I think that this example of formal and informal institutions is deficient. Because the distinction between pragmatic and organic institutions is more informative, in the sense that it points to the extent that you can change in a way that organic institutions are the result of spontaneous evolution; pragmatic institutions are those that are the result of human design and can be easily changed. I would disagree that it is an easy task to just transplant formal institutions and then people will adapt.

Tomasz Mickiewicz: I would mention Mancur Olson[11] in this context, because what triggers change in formal institutions is when we have countries which face a deep crisis. People clearly see that the combination of formal and informal institutions led to the crisis and then there is a change which cuts across the inherited social structure. The obvious examples are Japan and Germany, where something enforced from outside led to success, but the prerequisite for that was that there was a crisis and people learn from experience. There is a whole question of imitation: as long as the US is successful, and we have opened the global

11 Mancur Olson, *The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities*, Yale University Press*The Logic of Collective Action* , 1982.?

economy, there will be an element of imitation.

However, I still feel that there is this continuity in informal institutions. Change comes from above: a change in formal institutions may work but there must be a precondition for that. In the UK, the change in formal institutions worked because the British culture was not really that much affected by the 1970s and the period of big government. There was much in the British culture that was receptive to this kind of change. Unfortunately, what we can see now, if you ask British young people what is their preferred career path, it is to become a civil servant. This is linked to another interesting problem that we face, which is that an entrepreneurial career is not a good one, because so much risk involved. In rich countries there is this kind of paradox, that people do not take risk.

Is that the change in institutions comes from above? Probably, it worked in the UK because there was this culture there already. In Russia, I am far more sceptical. For me, a better predictor of what will happen is to look at the values that exist in popular culture, social culture. For instance, entrepreneurship regulations were liberalised over the last several years, but certain research shows that it did not work very well, because it went to the local bureaucracy and it simply was not as effective as it should have been.[12]

Sebestyén Gorka: I want to respond to what Pascal said, which follows on from John's discussion of informal institutions. I completely disagree with the example about going to America, being flexible and surviving. The fact that you put on an entirely different coat does not mean that the character changes. There is a difference between human flexibility in the pragmatic sense, and the individual's character. We can all see in Central Europe this unchanged character of the masses. They are flexible now that they know that they have to work in a quasi-capitalist system but their character, their expectations from the state remains huge. Their character that they will bodge everything as they bodged everything under communism has not changed, so we have to separate

12 Ruta Aidis, Julia Korosteleva and Tomasz Mickiewicz, "Entrepreneurship in Russia", Centre for the Study of Economic and Social Change in Europe, Working Paper No. 88, April 2008.

pragmatic flexibility, which is endless, with the question of character. According to my expertise, the best examples are the 9/11 hijackers. These are people who managed completely to function in Western society. They were not illegal immigrants; they were legal residents of the US with visas and jobs. And they functioned in US society but at the same time were planning to destroy it. So their character was anathema to where they were living, but they functioned within it. Therefore, let us separate the two different aspects.

Bob Reilly: Do you mean culture, by 'informal institutions'?

Philip Hanson: There is one very specific context on which there is a growing literature on Russia in particular, without any claims that it necessarily applies elsewhere. I associate this with Alena Ledeneva, her contention being that one way that informal rules work in Russia is on the basis of suspended punishment. Now, formal rules are inconsistent. If you implement all the tax laws, for example, everybody would be in trouble. This situation is set up, so the authorities (in this case the Kremlin) actually – we infer – wish this inconsistency to exist. It gives you the situation where any person of any social consequence can be called in for something. Everybody, of necessity, is in breach of some formal rule or other. It is breaking the *informal* rules, which decide who gets in trouble. So the formal rules are not actually viable when fully implemented, and you have, as a result, this situation where you choose on an informal basis, whether to create problems for people or not. What landed Khordokovsky in prison was a set of actions. Even if the alleged crimes were correct, the same charges could have been brought against many other people and were not. Informal rules, in that context, were things like, do not assert any independence on an important subject that the central authorities do not want you to do. You have magnates, tycoons in Russia now who have absorbed this message, that if you transgress in this manner – which can only be defined as an informal rule, you will be in trouble. So you carry on business in a normal way, but if the central authorities want you to do something, then you do it even if it is not commercially in your best interests. And that is how many of the more successful Russian tycoons operate now.

Ljubo Sirc: There can hardly be a comparison between the original development of capitalism, then the deliberate change to capitalism and now the attempt to restore capitalism.

Markets developed through human interaction without anybody designing them. As productivity grew, specialisation emerged and, as a consequence, widespread exchanges of goods. The ownership of the means of production and of their products had to become firmly established and the rest followed.

On the contrary, the communist economic system was an attempt at deliberately designing a system thought out in detail. Necessarily much improvisation followed, but the foundations were deliberate, detailed rules. In the case of Yugoslavia, including Slovenia, these rules were again deliberately altered when central planning was replaced by self-management after Stalin's political exclusion of Tito from COMECON.

The return from these designed systems to spontaneously developed markets as transition demands, is encountering considerable difficulties. It is not just that new rules, in reality manners of behaviour, are needed, remnants of communist thinking constantly cause difficulties and it is not immediately clear how to get rid of them.

The original more or less spontaneous development of the markets proves impossible to copy. It will nonetheless prevail in the end, precisely because it is fundamentally spontaneous, providing the remnants of communism are kept at bay.

Silvana Malle: We are talking about the rule of law in transition countries but in Italy, we have a judicial system that is absolutely rotten, and everybody knows that. We have magistrates and judges who act politically.

In Russia, it is not all doom and gloom. In fact, in many ways I think it is a miracle. Just look at the Internet, people are freely criticising Putin, in a way that you would not find in Italy. You find that liberal ideas are being disseminated in many places such as the Higher School of Economics in Moscow. It is not a sclerotic society: things are changing so we need not be so negative. Formal institutions matter because they provide people with access to structures, such as legal systems, particularly with regard to property rights.

Dragan Lakicevic: I suggest it is a paradox: social engineering to create a spontaneous market! Is it possible that social engineering can produce the opposite of what is natural? And the moral question is whether it can ever produce a good result?

Philip Hanson: Karl Popper was interviewed by George Urban, at the time of these wholesale changes away from communism. He was asked whether this was too much of an artificial imposition from above, the sort of action he had criticised the enemies of freedom. And he said yes, he thought it was. Other people have voiced that particular qualm. There must be a question mark at least about the rapidity with which this has happened.

I should like to come back the rule of law issues, particularly in Russia. I broadly agree with Silvana. I think it is useful to think of Russia now as a curate's egg[13] – parts which are very different in quality. The position you have now is that there are some sectors of the economy which the central authorities have taken control of for all sorts of reasons, including simple greed, and they have used all sorts of crude, non-due process methods (to put it mildly) to get what they want. They have put forward Gazprom and Rosneft as the two, national, state-sponsored champions of the oil and gas sector; but it is very interesting to ask whether those very obvious rule of law weaknesses apply across the board in Russia. I have heard the manager of an American owned investment management fund operating in Russia say that he would rather go to a court in Moscow than in New York. I am just talking about Russia here: when the central authorities do not have a powerful interest and concern that things should be done a certain way, due process is reasonably likely to take place.

13 From an 1895 Punch cartoon. The bishop says, "I'm afraid you've got a bad egg, Mr Jones". Apparently trying to avoid offence or curry favour, the curate replies, "Oh, no, my Lord, I assure you that parts of it are excellent!" Modern usage tends to imply that something has a mix of good and bad qualities.

One of the great weaknesses in terms of Russian development, is that we have no idea what the limits are to the sectors where the central authorities have interests. They do appear to be gas, and since 2003 the oil industry. They appear not to include the metals industry, which is striking since it is a very important part of the natural resource sector. They appear to include a lot of things related to defence production, clearly the Russian authorities do not want to have privately controlled defence contractors, but there is a very large chunk of the Russian economy in which these particular interventions appear not to be happening. I think the behaviour of business people, both Western and Russian, indicates a belief, and this comes back to informal rules, that, informally at least, they will be able to operate in a "normal manner" in those particular activities. Foreign direct investment in the oil industry is being eroded by the state, while increasing in the services, consumer goods and the banking sector. Maybe all these business people are quite misguided, but I suspect that they have a shrewd perception that this is something they can do, they can operate in an entrepreneurial way, even in Russia.

Sebestyén Gorka: I think it is too easy to take a rosy view of what is going on in Russia. The fact that the curate's egg obtains, that it is good in parts, is completely irrelevant. It is only good in the parts where the controlling force of the state is not interested. As soon as you become a threat to the personal interests of the oligarchy, you will be attacked. The fact that you have political assassination in Russia to this very day, or may be locked away on a tax charge, and the key thrown away, that is the measure. If someone in the metals industry starts becoming politically active, he is going to be hammered. The fact that you have nice little islands of normalcy is irrelevant.

Philip Hanson: I am not painting a rosy picture of Russia. I have very considerable doubts about what is happening: much of it is extremely unpleasant, and things have got worse since 2003. What we need to be aware of, if we are looking solely at the economy and its prospects, there are substantial parts – not just little islands – of the economy which seem to be in a normal way. But that is important. Even if what Edwin Bacon calls "Snatch-squad authoritarianism" is still there in the background; the authorities in Russia want to be in a position – and are in a position

– as you say, where they can intervene and grab anyone regardless of due process.

I certainly do not want to paint a black and white picture of it. This is of course, a pretty nasty situation – I do not deny that. However, it is also a situation where a lot of business development goes ahead, a lot of people become better off, and as Silvana says, there is in fact a great deal of open discussion, despite all this looming in the background. It is not going back to anything resembling the old communist system: it is a very peculiar mixture and I think it is very dangerous and misleading to put it in all-black category. I am certainly not putting it all in an all-white category.

Silvana Malle: In Russia of course anything could happen. It is under state control. We have this in China and other developing economies where the state wants keep control. It happened in Italy and France in the 60s, and could again in the future.

Sebestyén Gorka: I do not think this can be compared with Italy and France in the 1950s and 1960s. The issue for me is political assassinations. Look what has happened in the last five years in Russia. That is very different from what happens in Europe. It is a huge difference. It is when the state gets involved and what tools it uses: is it protectionist-Gaullist or is it actually killing people? At a CRCE colloquium I think we must recognize the difference.

Silvana Malle: I understand your point, but perhaps around this table we should decide what we are talking about. I am an economist who is trying to see how institutions and people's attitudes are changing and moving ahead.

Philip Hanson: I think one should be careful when discussing anything to do with popular attitudes. I am referring to Russia. The Levada Centre conducted a poll in October or November last year, which was shortly after Yukos had been bankrupted. As far as I am aware there was a reasonable sample of people interviewed. They were asked why did Yukos go bankrupt, and were given two main options: was it because it could not pay its debts, or was it so that companies closely linked to the

Kremlin could get its assets cheap? About 9% said it was because it could not pay its debts and nearly 40% said it was a way to get the assets transferred to crony companies. There were a large number of ‘don’t knows’. The attitude is very important; there is this complete cynicism. It is not as if people believe that the state is doing this for their sake or getting back at these awful rich people.

The other question that was asked in the Levada survey was about Khordakovsky: is he in gaol because he committed tax offences, or is it because he refused to do a deal with the Kremlin? Again, the same substantial plurality; a clear majority if you exclude the ‘don’t knows’, said it was because he refused to do a deal with the Kremlin – as simple as that. So people are not fooled by what is going on.

Sebestyén Gorka: I think you have hit the nail on the head; the cynicism is there, but the question is what to do with it. The important phrase is civil society, and in Hungary we all know how corrupt all political parties are, but is anyone doing anything about it? No, because they do not think they can. That is the measure of how dysfunctional the transition is. It is not the cynicism but what it drives you to do. Does it mean you avoid paying your taxes even more, or perhaps try and create a political party to do something about it? That is the real issue.

Tomasz Mickiewicz: The question of legitimacy: there are actually surveys from Russia; there is some empirical evidence. The oligarchs are not legitimate, that is clear, and the state itself is not legitimate, as we have been discussing. There is a very deep crisis of legitimacy. The market economy in the end is based on people co-operating and part of this co-operation are institutions that ideally should be decentralised. If you have state administration people do not believe in the state; they do not believe in market democracy or believe in anything remotely close to liberalism: either political or economic. You have a group of young people; government promoting liberal economy which is excellent. However, if the culture does not believe in it then it will not work. That is my concern. I hope I am wrong.

Philip Hanson: Thank you all for contributing to this discussion.