What have we learnt from fifteen years of transition in Central and Eastern Europe?

Willem H. Buiter

Chief Economist, European Bank for Reconstruction and Development* **

31-05-2004

Revised 12-07-2004

Introduction

Arbitraging knowledge and insight gained from the study of one set of countries to another is a hazardous business, all the more so in view of my very limited familiarity with China, North Korea and the communist countries of South East Asia (Vietnam, Cambodia and Laos - the Asian Communist nations or AC nations for short). I know enough, however, to be impressed by the vast differences. Unlike the EBRD's countries of operation, the AC nations continue to be overwhelmingly agricultural and rural. When the AC nations started their reform processes, they were much poorer than the CEE transition countries when these launched their transitions. In all AC nations (except possibly in North Korea, a country about which it is very difficult to get any information at all), the extended family plays an important role in providing a social safety and as a source of finance and capital for micro and small enterprises. In the EBRD's region of operations we find anything even remotely comparable only in Central Asia. Again with the exception of North Korea, central planning had less time and scope to do as much damage in the AC nations as it did in the former Soviet Union. In the CEE countries, the early phase of the transition process coincided with, and would not have happened without the weakening and collapse of the Soviet Empire.

The demographics are strikingly different. With the exception of some of the Central Asian Republics, the EBRD's countries of operation have stable or declining and rapidly greying populations. In Vietnam 60 percent of the population is under thirty years old. Here and in the rest of the AC nations, the main demographic challenge is

---

* Paper prepared for the International Policy Conference on Transition Economies, 31 May and 1 June 2004, Hanoi, Vietnam. The views and opinions expressed are those of the author. They do not reflect the views and opinions of the European Bank for Reconstruction and Development. I would like to thank Simon Commander for significant input in an earlier draft of this lecture.

to educate, house and create employment opportunities for a growing young population. The problems of a rapidly greying population are a couple of generations away. Central and East European countries tend to save little, often much less than 20% of GDP. AC countries save (and invest) as much as 40 % of GDP. The AC countries, unlike the advanced Central European transition countries, have a vast reservoir of labour in low-productivity agriculture which can be shifted into high-productivity manufacturing, thus boosting measured total factor productivity growth. Unlike the Central Asian republics, the AC countries all have long (albeit occasionally interrupted) histories as nation states. Their cultures and histories are literally worlds apart from those in CEE.

With that caveat, I will now turn to some lessons that I believe may be useful for the AC nations. I divide my comments into a list of short ‘technocratic’ lessons and a slightly longer discussion of three broader political economic issues:(1) corruption; (2) the relationship between successful transition to a functioning market economy and the nature and evolution of the political system; and (3) environmental sustainability of economic development in transition economies. A focus on the political economy of transition, and especially on the links between economic and political freedom is appropriate. On June 3rd and 4th, it will be 15 years ago that the Tiananmen Square massacre took place.

1. Some specific lessons for the AC nations from the EBRD’s region of operations

Privatisation: the emphasis on the speed of privatisation is not very helpful – what matters is how you privatise. Sales or gifts to insiders may buy short run political favour but bring little - if any- new capital or expertise to the table. In the worst instance - Russia - a combination of insider and crony privatisation has resulted in a very high concentration in asset ownership (cronies) and in a weak impact on firm performance (insiders). Transparent sales procedures that do not have a bias against outsiders (including foreigners) are generally preferable. When capital markets and the market for corporate control are weak or non-existent, it is very difficult to undo through subsequent trading of ownership titles the damage caused by an initial privatisation to ineffective owners. In a world with high transaction costs, there is no ‘Coase theorem’ supporting privatisation on a first-come first-served basis: ownership and the initial allocation of property rights can have a major impact on efficiency. Fortunately for Vietnam, its state-owned enterprises were a much smaller share of the economy than was the case in the EBRD’s countries of operations. Letting the SOE sector wither away, while not first-best, may be a feasible strategy.

The political acceptability and legitimacy of the privatisation process is important in its own right and can have important consequences for the future performance of the privatised entity. The Yukos affair in Russia is a timely reminder of the vulnerability of property rights acquired through a privatisation process that lacks legitimacy. The current owners of these assets will be in endgame mode, with short horizons inimical to investment and other efforts that yield their returns mainly in the longer run.

Note: the Chinese approach of 'creeping' privatisation through the intermingling of public and party interests has had very bad consequences for governance, rent seeking and effectiveness in resource raising (access to capital markets) and so on.

Improving the governance of state-owned firms has been very difficult. The Vietnamese are likely to find it difficult to raise the accountability and transparancy of their SOEs. They might want to consider bolder steps to privatise as soon as an efficient, legitimate and politically acceptable method of privatisation can be worked out. Subsequently a truly arms-length relationship can be established between the privatised entity and the state. More generally, don't expect too much from privatisation and restructuring of SOEs outside the extractive sectors. Many of them are not viable under market conditions and will have to contract severely or shut down completely.

De novo firms. But emphasis on just privatisation, or even privatisation plus restructuring misses much of the story in the EBRD transition countries. Most of the growth in jobs, output and productivity has come from new private firms/start-ups. The superiority of *de novo* firms suggests that emphasis on reducing barriers to entry and exit is essential. The rationale for lowering barriers to entry is self-evident. Where incumbent inefficient (formerly) state-owned enterprises represent a significant share of the market, the absence of efficient exit mechanisms (hard budget constraints, bankruptcy laws, established procedures for conducting financial restructuring etc.) itself becomes a barrier to entry by more efficient new firms.

Barriers to entry that can be directly affected by policy include: tax rates and their degree of arbitrariness; regulation/licensing and associated costs.

Early liberalisation of entry rules for foreign firms and equal tax treatment is key in attracting FDI and in allowing foreigners to configure best the way they want to enter (greenfield, joint ventures etc).

Education: Investment in human capital is key to raising growth rates. But simply throwing resources at existing educational systems is not necessarily the solution. Experience from Eastern Europe suggests large inefficiencies and mis-allocations of resources in the existing state educational system. Reform therefore implies restructuring, including allowing in private providers, rather than allowing creeping and opaque privatisation of educational services through arbitrary charging.

Taxation: Introduction of a Personal Income Tax is highly desirable (rather than relying just on the taxation of corporates and VAT (introduced in 1999 in Vietnam). The best Personal Income Tax, for incentive reasons and for tax administration reasons, is the simplest one: a relatively low flat rate income tax with no more progressivity that was is provided by an initial zero rate band. The key is not to have exemptions and allowances. A land tax (that is, a tax on the 'unimproved' value of the land) is both efficient and fair. It raises some tax administration problems, because of the need to estimate the contribution of nature to the value of a piece of property. Unfortunately, a land tax has zero political appeal in predominantly agricultural societies.

The disincentive effects of steeply progressive taxation and the adminstrative costs of compliance and evasion/avoidance it encourages make it a poor instrument for the pursuit of redistribution and equity. Such objectives are more effectively pursued through public expenditure on public health and education.

Banking system reform: Privatisation of banks is highly desirable to reduce the scope for soft budget constraints, connected (crony) lending and other abuses. This needs to be complemented by liberalising access - in particular allowing in foreign banks with superior banking technology, capital base and so on. Providing access to branch networks and/.or incentives for creating such networks is an important consideration. Entry of foreign banks also helps raise competitive pressure on domestic institutions.

The absence of real banks (or local capital markets of any kind) , using commercial principles on both sides of their balances sheets is one reason for the bimodal distribution of firm sizes in Vietnam. Through the family capital market provided by the extended family, micro enterprises and SMEs are relatively easily financed in Vietnam. At the other end of the size distribution of enterprises we find a few larger continuing or former SOEs and some large foreign-owned enterprises or joint ventures financed largely through FDI. There is no external source of finance for medium sized enterprises, and there appear to be very few of those.

Financial sector regulation/supervision: An independent FSA is, on balance, desirable to limit scope for politicisation of the Central Bank. It is key that adequate resources be given to regulatory/supervisory authority.

In the case of foreign banks, it may be worth considering the New Zealand approach – to have these banks regulated in their country of incorporation. Another general guideline is to rely as much as possible on market based discipline/disclosure

Poverty: many CIS countries have a dismal poverty record. Thirteen years after the start of the transition, there have been few successes in limiting the increase in poverty that followed to the collapse of communism. Social programmes are underfunded and often poorly designed with weak targeting. Vietnam actually has a reasonable record in this respect (poverty rate now under 30%; it was over 60% a decade back). The key issues are better targeting and the creation of information systems and institutional reforms for more efficient delivery of transfers. In China, poverty has declines sharply also, but there has been a staggering increase in inequality. I doubt that the gains on the poverty front will prove to be sustainable, even if overall growth rates are sustained, without conscious policies to make growth more inclusive, to help the losers in the growth game and to curtail the extreme, excessive inequality of income and wealth.

Unemployment: fear of unemployment leads to labour hoarding in state-owned and state-dependent enterprises. Policies to massage down the formal sector unemployment statistics can lead to rapid growth in the informal economy. Both are bad news. Vietnam has a relatively low share of its labour force in SOE employment. As restructuring occurs, job losses will mount. Financing an explicit system of fallbacks for job losers from SOEs - with a mix of passive and active (e.g. training) programmes - should be fiscally feasible and would facilitate difficult restructuring decisions. There is likely to be pressure for the generalisation of such support schemes, however, and this would not be fiscally feasible or economically desirable.

Spatial and skills mismatch are important in explaining persistence of high levels of unemployment (and/or non-participation) in many transition economies. The rural urban dimension of spatial and skills mismatch is a central problem for both China and Vietnam. Continued enforcement of administrative barriers to rural-urban migration are unlikely to be effective. Such physical constraints on labour mobility are also appallingly illiberal. Properly functioning urban land and labour markets will, through weakening urban wages and rising urban rents reduce the attractiveness of rural-urban migration. Encouraging viable non-agricultural rural employment by investing in supporting rural infrastructure and by encouraging financial intermediaries to target rural SMEs can also help. Policies to improve job matching and information, as well as lowering mobility costs, are key.

On the skills side, there has been a decline in quality of educational systems and vocational training throughout CEE, although the magnitude of the deterioration varies greatly. Evidence regarding the skill content of job creation in Eastern Europe unambiguously points to new jobs having a higher skill content than established jobs - viz. similar process of skill-biased technical change as in OECD. Absent adequate (re-)training, this risks locking significant numbers of workers into unemployment or non-participation

Substitutes for EU membership. For the 8 CEE countries that joined the EU on May 1, 2004 and for the South East European countries for whom future EU membership is a realistic prospect, the prospect of EU membership has been both an incentive to engage in more intense structural reform and a commitment device to stick with the reforms. There is nothing in prospect for Vietnam or the other CA countries to match the potent pull and push of EU membership. Nevertheless, the determined pursuit of WTO membership can offer both sticks and carrots for more intense structural reform and the more determined and effective pursuit of integration in the regional and global economy.

Trade liberalisation. Do it now. Do it comprehensively, both on the import and the export side. Do it unilaterally if necessary. If the taxation of trade is an important source of revenue that cannot be dispensed with, charge a uniform proportional tariff on all imports.

Capital account liberalisation. Free all credit related to trade financing. Liberalise FDI inflows. Liberalise portfolio outflows, to permit domestic savers (including institutional investors) to achieve the best possible combination of risk and return. Keep the remaining capital controls until they are eroded or unless their enforcement leads to massive corruption. Have free entry of foreign financial service providers, from banks to insurance companies.

2. Corruption

Corruption is any abuse of authority by an appointed or elected agent for private gain, or any or any attempt to cause such abuse.

Corruption is a global problem, not confined to developing countries, emerging markets and transition economies. The Transparency International Corruption Perceptions Index 2003 ranks Slovenia and Estonia as better than Italy; Slovenia, Estonia, Hungary and Lithuania are ranked above Greece (see Transparency International [2003]). Corruption is not, however, pervasive and systemic in every country. The scope, pervasiveness, public attitudes and legal response to corruption differ greatly across countries.

While corruption comes in a multidimensional continuum of forms and shapes, it is useful to single three broad categories: (1) private or petty corruption; (2) public or administrative corruption, that is rent selling by government officials e.g. in public procurement); and (3) grand corruption ("state capture"), the subversion of the legislature, the executive or the judiciary for private gain.

It is sometimes argued that corruption in transition countries and developing countries is not really a problem because the behaviour Westerners call corruption should, when we find it in these very different cultures, really be called 'family values'. Apart from the fact that this confuses nepotism and corruption, I believe that this view is wrong and that the attitude supporting it is patronising.

Corruption is sometimes viewed as an "efficient adaptation" to weak institutions and an inefficient economic environment, including: an overbearing, intrusive government, excessive regulation; unnecessary licensing and red tape; badly defined and poorly enforced property rights; weaknesses in the rule of law. At the micro level, when an individual bribe is paid, this may indeed, at times, well be the case. Does this mean corruption either 'just a tax like any other' or a means of lowering 'transaction costs'? Is corruption efficient?

The 'corruption is efficient' or 'corruption is just a tax' views are partial equilibrium and micro views of individual corrupt acts. It is true that corruption is a tax, but it is an arbitrary, discretionary, non-transparent, negotiated tax – a bad tax. Also, corruption is not just a tax – is does not merely involve a redistribution from the corrupter to the corruptee. Like all forms of rent-seeking, corruption wastes real resources.

The view that corruption is an effective means of lowering transaction costs represents an unwarranted substitution of Ronald Coase's *inaudible negotiator* for Adam Smith's *invisible hand*. I elaborate on this view in the Appendix. The key point is that, whatever the immediate efficiency gains achieved through corrupt practices, the corrupt practice itself undermines society's social capital by further undermining trust in one's fellow-citizens and respect for the rule of law and trust in its impartial enforcement. This encourages more wide-spread corruption in the future. Current acts of corruption create "deferred (or dynamic) negative systemic externalities". High corruption can indeed be a feature of an individually rational equilibrium. It cannot be a feature of a socially efficient equilibrium.

From an economic perspective, corruption is a feature of a *principal-agent* problem where the agent (1) has *objectives* that are not fully aligned with those of the principal, (2) has significant *discretionary* power and (3) is subject to too little *transparency* and *accountability*. From a crime fighting perspective, tackling corruption requires removing means, motive and opportunity.

Any solution therefore involves: (1) Fewer sources of artificial administrative rents, that is, less red tape, less unnecessary regulation, fewer redundant licenses, uniform tariffs, no exemptions and allowances in the tax code; (2) Less discretion, more rules (bureaucracy, in the sense used by Max Weber [1946] may be the solution rather than the problem!); (3) Better aligned objectives of agent and principal (incentives). This includes having fewer but better paid and more highly trained civil servants, and the creation of a professional culture or civil service ethic that rejects corruption; (4) More transparency (of budgets, legal procedures etc.); (5) More accountability (free media, vocal civil society, obstreperous NGOs etc.)

The elementary point that the most cost-effective anti-corruption strategy - more effective even than making an example of a few high-profile bribe givers and bribe takers - is to eliminate wherever possible the artificial scarcity rents created by unnecessary government laws and regulations is not sufficiently appreciated by many in authority. Law makers and law enforcement agencies always call for more effective enforcement of anti-corruption legislation, for more resources to boost the fight against corruption etc. Yet discouraging the private and public parties involved in corrupt practices by waving a bigger stick is bound to be more expensive than removing the carrot. Eliminate the opportunity for crime and crime won't happen.

The same lesson, that it is always wise to minimize the artificial rents created by unnecessary government laws, rules, licensing and regulations, applies in other areas as well. At a recent (November 2003) conference on regional cooperation in Central Asia, the Uzbek government was only interested in one form of regional cooperation: better cooperation and coordination of border guards and customs and excise officials to reduce the smuggling that was rampant across the Kazakh, Khyrgyz and Tajik borders with Uzbekistan. I made the point that a more effective anti-smuggling policy would be to end the policies that result in the Uzbek producer prices for cotton to be between a third and a half of what that same cotton would fetch in Kazakhstan. This suggestion was met with a complete lack of comprehension.

3. Political Constitutional Liberalism, prosperity and the development of an effective market economy

The European Bank for Reconstruction and Development has 27 countries of operations – soon to be 28, I hope, when Mongolia qualifies. All 27 are former communist countries from central and eastern Europe and the former Soviet Union. There were significant differences between the brands of communism found in the former Soviet Union, and those found in its central and eastern European satellites, in the former Socialist Federal Republic of Yugoslavia, Romania and Albania. All practiced some form of central planning in their economic affairs, with SFR Yugoslavia and Hungary permitting the greatest degree of decentralisation in economic decision making and management. The means of production, distribution and exchange were overwhelmingly state-owned, although agricultural land could be privately owned in Poland. SFR Yugoslavia's mode of social ownership was unique.

All 27 countries of operation had totalitarian political regimes until the collapse of Soviet control and the dissolution of the Soviet Union. The communist party not only had a political monopoly position, it also dominated the economic, social and cultural spheres. This is were we started from, about 15 years ago.

What do we see today? We see that eight central and east European countries have joined the European union. All eight have functioning market economies. All eight are political democracies. All eight are growing, with average standards of living rising. Two more countries, Bulgaria and Romania are hoping to become EU members in 2007. Croatia may be granted candidate status soon, and so may Turkey. These countries too either are functioning market economies or well on the way to achieving that status. All four are political democracies.

At the other extreme, the three countries that have made least progress on the road to becoming functioning market economies, Turkmenistan, Belarus and Uzbekistan, the countries that have kept most of the trappings of central planning and the command economy, are also the three countries with the most repressive, authoritarian political systems. Turkmenistan has massive natural gas resources and stays afloat by depleting its natural resource wealth. To a lesser extent this is also true for Uzbekistan which exports mainly cotton and other minerals and is self-sufficient in oil and gas. Belarus survives on subsided natural gas provided by Russia. None of these economic strategies is sustainable. All three countries are going nowhere economically.

Is it a coincidence that well-functioning market economies tend to be political democracies – or rather, countries adhering to various forms of Political Constitutional Liberalism? I believe not.

Political Constitutional Liberalism.

I will briefly develop and propose the thesis that, in the long run, an effective market economy cannot develop and flourish in a country unless that country also develops, in the political and legal spheres, some form of Political Constitutional Liberalism. Some would use the word 'democracy' to describe what I call Political Constitutional Liberalism, but that word has, for better or worse, become tainted with too many associations.

Political Constitutional Liberalism means three things: (1) *the rule of law and equality under the law* for all – citizens, the state and its agents, the Party (there really should be more than one!), religious institutions and their representatives, or any other group; (2) an *open society*; (3) *representative government* based on *sovereignty of the people.* A case can be made that (3) is implied by (1) and (2). This presupposes checks and balances that constrain the power of any one branch of government, especially the executive.

A central, even defining, feature of the rule of law is that property rights are protected under the law. The rule of law and equality under the law can only exist when both the government and the state bureaucracy are transparent and accountable. It requires an independent judiciary. The rule of law can be established and maintained only if two conditions are satisfied. First, there is a widespread consensus that the laws – the rules of the game – are fair and that they promote social efficiency (the common good, in ordinary English). Second, they must be sufficiently 'incentive compatible', that is, their implementation and enforcement respect the instincts, passions and emotions - greed, envy, fear sympathy, compassion and love - that motivate individual and group behaviour. Any system of laws that depends for its success on the creation of a new man or a new woman is doomed to fail.

An open society in turn is defined by three characteristics. First, *individual rights and liberties*: freedom of speech and expression, including free and independent media, freedom of peaceful assembly, freedom of religion, freedom from arbitrary imprisonment, torture and intimidation. Second, a *thriving civil society* where citizens can freely come together and organise to promote a common cause and which permits the creation and flourishing of non-government associations that can effectively give voice to citizens' concerns. Civil society (the entire universe of special interest groups and associations) should complement, not replace, legitimate political institutions, mechanisms and processes, including electoral processes and parliamentary representative institutions. Third, *effective political competition.* Key to this is a level playing field between incumbent and challengers. Incumbency must be contestable in an orderly, non-destructive manner. Political competition will often take the form of majoritarian decision making through a variety of electoral mechanisms. If it does, respect for individual and minority rights must be part of the package. Unbridled dictatorship of the majority is not consistent with Constitutional Liberalism, even if the majority has been 'properly' elected.

This last property of an open society – effective political competition – gets close to what I proposed as a third defining property of Political Constitutional Liberalism – representative government based on sovereignty of the people – but does not coincide with it. It may be possible to conceive of a representative government based on sovereignty of the people without effective political competition – a sufficient degree of consensus among the citizenry about the key policy issues could produce such a state of affairs. I have to admit to being hard-pushed to find an example of such a consensus-ridden polity. Political competition could be among parties or groups that view sovereignty as being derived in the final analysis not from the people but from some other source. Religious fundamentalists (and royalist fundamentalist) view sovereignty as residing with the deity or deities they worship.

The association between a well-functioning market economy, growing and widely-shared prosperity and constitutional political liberalism is not mechanical or exact. There also is bound to be more than one causal relationship involved. There are three benchmark hypotheses. First, constitutional political liberalism is a normal or even a superior good. The demand for it increases when prosperity increases. A crude version of this is that only rich countries can afford democracy. Second, constitutional political liberalism is a necessary condition for sustained economic growth and prosperity. Third, a common factor or set of factors produces both prosperity and constitutional political liberalism (or democracy). It seems likely that all three mechanisms are at work. The dynamics of their interaction is complex and not fully understood. There is a vast political science and sociological literature on the subject, but despite the early contribution of Schumpeter [1950], economists are relative late comers to this area of enquiry in the post-World War II era (see e.g. Barro [1999], Acemoglu, Johnson and Robinson [2004] and Acemoglu, Johnson, Robinson and Yared [2004]). The most careful and convincing empirical work is that of Acemoglu, Johnson and Robinson [2004] and Acemoglu, Johnson, Robinson and Yared [2004]). They demonstrate quite convincingly that the 'prosperity brings democracy' position is not supported by the data. While I am sympathetic to their basic position that *"…the existing empirical literature fails to treat seriously the fact that income and democracy are jointly determined in a political-economic equilibrium.*" (Acemoglu, Johnson, Robinson and Yared [2004], p. 1) their conclusion that "*…different countries move onto different development paths as the results (sic) of critical junctures and historical circumstances (such as European colonialism). Different paths are supported by different sets of institutions and the nexus of* *institutions that promotes prosperity simultaneously tends to lead to democracy.*" (Acemoglu, Johnson, Robinson and Yared [2004], p. 1) is much less securely based, because the validity of their statistical tests rests on the assumed exogeneity of the institutions, critical junctures and historical circumstances that are used as conditioning variables in the econometric analysis. While the authors recognise the endogeneity problem (and the selectivity biases likely to be associated with it), they have not been able to address it effectively. Specifically, their empirical work does not contradict the following composite hypothesis: (1) certain historical/institutional developments/circumstances make both the development of democracy and prosperity more likely, but not certain; (2) without democracy (I would prefer the term political constitutional liberalism) a lasting and sustainable prosperity is highly unlikely.

There are many examples of countries with some of the dimensions of political democracy that are economically stagnant or declining. Argentina has had significant 'democratic interludes' since the 1920s, as well as periods of military rule, but its economic history over that eighty year period is one of persistent decline. There are also examples of countries with authoritarian political regimes that have had well-functioning market economies. Chile under Pinochet is an obvious example. Singapore under Lee Kuan Yew, Taiwan for many decades after 1949, South Korea during the first few decades following the Korean war and the PRC today are often mentioned as examples (although the PRC is not (yet) a functioning market economy). However, historical experience also supports the view that the equilibrium of an authoritarian/totalitarian political regime and a thriving market economy is not stable one. Either the totalitarian/authoritarian political regime becomes increasingly disfunctional across the board and drags the economic system down with it, or the political system evolves towards one compatible with an open, pluralistic society.

Why are the rule of law and an open society necessary for sustained and sustainable economic growth in a market economy? As regards the rule of law, the answer is simple. Market economies rest on, indeed are defined by, property rights and voluntary exchange. It is obvious that property rights require the rule of law. To take a de Soto perspective: without the rule of law, there can be no property. Property turns possessions into productive capital.[1,2] Without effective political competition, the rule of law will be eroded or will never become established. Economic liberalisation and privatisation under such conditions are likely to lead to massive corruption and clientelism and may even result in a stalled, partial reform equilibrium.

Unless voluntary exchange involves the simultaneous transfer of ownership title and physical possession of items deemed, on the basis of equal, symmetric information, to be of equivalent value by both parties, voluntary exchange requires *trust*, either private trust or public trust – in practice both. Private trust, that is, trust between private parties, is predicated on the presence of self-enforcing mechanisms (familiarity or other personal bonds between the parties to the exchange, repeated interaction, reputation or some other personal commitment mechanism). Without

[1] See de Soto [1989, 2000].
[2] The distinction between private trust (trust between the two private parties involved in a typical bilateral transaction and public trust (trust of the individual in the state) is too binary for many purposes. Individuals may accept some form of group enforcement by entities other than the state, and groups may trust larger groups or entities to enforce commitments between them.

private trust, voluntary exchange occurs only if it is underpinned by the rule of law and the threat of third-party enforcement. For the rule of law to support voluntary exchange requires public trust – trust of the private parties involved in a transaction in the ability and willingness of the state to enforce the laws pertaining to the exchange – the relevant rules of the game. Without the rule of law, the division of labour and specialisation that are at the roots of successful market economies could not have taken place.

An open society is a prerequisite for a sustainable market economy for two reasons. First, the rule of law will not last in a closed society. Second, you cannot have, for any length of time, a society whose economic system is full of thrusting, enterprising, risk-taking Schumpeterian/Hayekian entrepreneurs but whose political system treats its citizens like eunuchs. This is most obviously true for knowledge-based economies, in which human capital is the most important form of capital. It has always been the intellectuals – the educated elite - that have challenged established authority and led revolutions. The assembly lines of traditional mass-production manufacturing, the back-breaking toil of traditional agriculture and the mindless drudgery of many traditional service industries do not provide great nurseries for independent thinkers determined to challenge conventional wisdom and established authority. In post-industrial societies, where advanced education is the rule rather than the exception, totalitarian or authoritarian political systems are likely to be challenged more frequently and more effectively than in pre-industrial or industrial societies.

Orderly but effective, transparent political competition is a necessary condition for institutionalising good economic practice. Sustained unchallenged rule by a single leader or party breeds corruption. The scope for such corruption is widest and the magnitude of its adverse economic consequences is most serious in over-regulated, heavily distorted, non-transparent unfinished (or half-baked?) market economies where the private returns to all forms of rent-seeking tend to exceed the private returns to honest hard work and enterprise. This problem is not restricted to the transition economies. We have seen it in Italy during the many decades of Christian Democratic rule in Italy during the post World-War II period, in Mexico during the 70-odd years of PRI rule and in Japan during the many decades of LDP rule.

Extreme examples of pathological forms of capitalism that thrive in the absence of effective political competition were the crony capitalism and kleptocratic states of the Philippines under Marcos and Indonesia under Suharto. We have many (somewhat milder) examples of this in our countries of operation – throughout the CIS and SEE. Russia under Yeltsin was a classical example of a 'stalled reform equilibrium' where corruption flourished in all its forms, from the petty corruption of individual minor officials, via corrupt procurement practices involving hundreds of millions of dollars to state capture by a small group of oligarchs. The (unexpected arrival) of a stronger leader, untainted by Yeltsin era corruption has been good news for economic reform in Russia. However, unless Russia can institutionalise decision-making processes that are conducive to the design and implementation of good economic policies, these gains will not survive the incumbent.

Finally, a thriving civil society is a key safeguard for the protection of environmental and political public goods. This brings me to the last topic of this lecture.

4. Environmental sustainability

The legacy of central planning and communism.
Among the most serious challenges to former centrally planned economies making a transition to a capitalist market economy is the need to address the environmental challenges facing them. Centrally planned economies with totalitarian political systems have, across the world, left a disastrous environmental legacy. This should not come as a surprise.

As a part of misdirected social and industrial policies, central planning under-priced energy and natural resources generally. The result was excessive energy consumption- waste - by households and industrial users alike. Much the same applied to the exploitation, extraction and consumption of other non-renewable or slowly renewable resources. It is not just centrally planned economies that underprice energy and other scarce resources. In India, three states recently announced that they would provide free electric power to the agricultural sector. In California, scarce water is made available at zero marginal cost to the agricultural sector for irrigation. Such policies deliver the following vicious trinity: they undermine the financial viability of the provider of the resource; they encourage excessive and environmentally damaging use of the resource; and they tend to be regressive, because they benefit the large producers/users much more than the small ones.

An important political check on environmental excesses is ‘voice’ - the public dissemination of relevant information, even if deemed politically inconvenient, and the public expression of dissent by civil society. Civil society is suppressed by authoritarian and totalitarian regimes everywhere. Communist totalitarian regimes were no exception. Thus an important check on and safeguard against policies and actions resulting in unnecessary, avoidable environmental degradation is eliminated, at great long-run social cost to the society at large.

Bridled capitalism and the environment
When a former centrally planned economy moves towards a form of market capitalism, but retains its totalitarian or authoritarian political character, the plight of the environment need not improve. Unbridled capitalism without the checks and balances of a vocal civil society will not pay any attention to the social costs of economic activity unless these social costs are also reflected in private costs, in market prices and thus in the bottom line of the profit and loss accounts of profit-seeking enterprises. A market economy can only properly price scarce resources where there are well-defined and enforced property rights. Access to and use of the ‘environmental commons’ such as surface water and ground water is underpriced or not priced at all. To prevent potentially catastrophic overgrazing of the environmental commons, some form of collective intervention is required. Where possible, this should be through the careful definition, assignment and enforcement of property rights. Where this is not possible, Pigovian taxes or subsidies are indicated. If this too fails, administrative controls are indicated. Of course, non-price rationing creates rents and opportunities for rent-seeking, administrative discretion and corruption.

Where will the political pressure for environmentally sustainable policies come from? In totalitarian and authoritarian societies, all one can do is hope that environmental sustainability figures, for whatever reason, on the agenda of the ruling elite. Judging by results, this channel is unlikely to be effective. In monolithic bureaucratic capitalist societies, well-organised and well-connected producer interests (representing the major polluters) have more clout than the dispersed victims of environmental degradation. Civil society is a key channel through which effective pressure to take action to compel the internalisation of the environmental externalities can be brought to bear on the state and its agents, and on the polluters directly. In a quite different context, Amartya Sen [1982] has shown that in democratic societies and in societies with free media famines do not happen when there is enough food to go around in aggregate. The political mechanism at work is the same as in the environmental field. The absence or severe underdevelopment of civil society in totalitarian or authoritarian transition economies is likely to result in distorted, environmentally damaging and unsustainable growth. The evidence that this concern is real is accumulating daily through the unrestrained pollution of the atmosphere, water and soil in the economically most dynamic regions of China. China's economic miracle is shadowed by an impending environmental and ecological disaster, whose public health implications are already becoming apparent.

5. Conclusion

I have been privileged to spend this past week in China and Vietnam, two countries whose recent economic achievements are, by any measure, little short of staggering. It is not my intention to rain on their parade. The achievements are undeniable and the obstacles that had to be overcome, and were successfully overcome, were daunting indeed.

I do, however, question whether the kind of economic gains we have seen theses past 20 years in China and these past 15 years in Vietnam are politically and environmentally sustainable. I hope that the experiment that would prove me right will not be performed: this would be a continuation of the existing economic policy agenda without political liberalisation and without serious attention to the environmental costs of runaway economic growth. I hope that I will come back here in 25 years time to find a prosperous, open and green society.

Appendix: A simple typology of bribes

I will expand briefly on the point that the view that bribery and corruption represent a socially efficient adaptation to an N^{th} best world is based on Panglossian myopia. For simplicity I assume that any act of bribery/corruption is individually rational for both all parties directly involved.

Corruption can involve bribing an official:

- to do what he ought to do (on legal and/or efficiency grounds)
- to do what he ought not to do (on legal and/or efficiency grounds)
- not to do what he ought not to do (on legal and/or efficiency grounds)
- Not to do what he ought to do (on legal and/or efficiency grounds)

This suggests the following eight category taxonomy of bribe types:

	Legal		Illegal	
	Will happen	Won't happen	Will happen	Won't happen
Efficient	Bribe to ensure least cost procurement (+ , +)	Bribe to prevent enforcement of anti-monopoly laws (- , -)	Bribe to ignore store closing hours or rent control (+ , -)	Bribe to strengthen enforcement of immigration laws (-,+)
Inefficient	Bribe to enhance enforcement of silly store closing hours laws or of rent control. (- , +)	Bribe to avoid punitive import duties or to prevent legal dumping of toxic waste (+,-)	Bribe to prevent least cost procurement . (condone illegal abuse of monopoly power) (-,-)	Bribe to prevent illegal dumping of toxic waste (+,+)

The Coasian theory of bribery asserts that only (directly) efficiency-enhancing bribes will be paid, that is, only the four entries in the bribe matrix with positive first element (the green and black entries) will ever occur. However, two of these four efficiency-enhancing bribes involve encouraging an illegal act. If any illegal act encouraged by bribery undermines social capital (trust among citizens and trust of the citizen in the state), then only the (+,+) orange entries are socially efficient. If any bribe or other corrupt act, even if it encourages an act that is both efficient and legal undermines social capital, then the argument that bribes are efficiency enhancing requires, even in the (+,+) case, a cost-benefit analysis that allows for these dynamic negative systemic externalities through the social capital decumulation channel.

The argument that only directly efficiency-enhancing bribes will be paid is itself contestable also. None of the eight ‘boxes’ in the corruption typology of Table 1 is empty in the real world. One reason the bribe bargain fails to be efficient (even if we ignore the social capital decumulation channel) is that it is impossible (or prohibitively costly) to bring together all parties affected by the act the bribe aims to encourage or discourage.

References

Acemoglu, D., S. Johnson and J. A. Robinson [2004], *Institutional Roots of Prosperity*, the 2004 Lionel Robbins Lectures to be published by MIT Press.

Acemoglu, D., S. Johnson and J. A. Robinson and P. Yared [2004], “Revisiting the Determinants of Democracy, MIT Department of Economics, Mimeo, May 2004.

Barro, R. J. [1999] .The Determinants of Democracy, *Journal of Political Economy*, 107, S158-S183.

Coase, R. H. [1960], "The Problem of Social Cost", *Journal of Law and Economics* 3 , October, pp. 1-44.

De Soto, H. [1989], *The Other Path*, Basic Books.

De Soto, H. [2000], *The Mystery of Capital*, Basic Books.

Schumpeter, Joseph A. [1950], *Capitalism, Socialism and Democracy*, New York, Harper & Brothers.

Sen A. [1982], *Poverty and Famines: An Essay on Entitlement and Deprivation*, Oxford University Press, Oxford.

Transparency International [2003]”Corruption Perceptions Index”, http://www.transparency.org

Weber, Max. [1946], "Bureaucracy", *From Max Weber: Essays in Sociology*, H.H. Gerth and C. Wright Mills, editors. Oxford University Press, Inc. 1946. Chapter 8.