

## Striving to be member of the club: when institutions become variables and outcomes become given

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### *Abstract*

*Successful, less successful and unsuccessful examples of system transformation processes leading to or trying to lead to stable democratic market economies are plentiful.*

*These developments pose a challenge to economics and political science to develop theoretical concepts that can explain the dynamics of these system transformation processes and that can suggest strategies for a successful management transition and ensure stability. We propose to take the first steps towards developing such a conceptual framework by interpreting elements of relevant economic and political theory. We shall do this by first taking a critical look at relevant theoretical concepts in political science and economics before, in part III outlining in a rather tentative and general way one proposal for an integrated approach.*

We are currently witnessing a series of most remarkable political system transformations in many parts of the world. Developments in Eastern Europe and in the former Soviet Union are probably the

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most dramatic. The disintegration of the Soviet Union and the decline of its influence on Eastern European nations where new leadership, committed to the establishment of market economies and democratic systems of government, have assumed responsibility, dramatically illustrate the wave of fundamental change that is presently sweeping Europe and which has its –probably less successful counterparts– in other parts of the world, particularly in Latin-America and South-Africa. These developments are fundamentally changing the world order that has existed since the Second World War where the super powers allowed direct confrontations only in far away and often irrelevant places (Vietnam, Afghanistan and Angola) but were able to avoid a frontal collision.

The violent conflict in what used to be Yugoslavia, the more or less peaceful «divorce» in Czechoslovakia, the latent crises in Poland and the complex problems in the Republics of the former Soviet Union illustrate clearly that these system transformation processes are and can be the source of new types and kinds of conflicts for which there will be no easy solution. Unfortunately, the political and economic sciences individually and collectively do not have the necessary theoretical and methodological *instrumentarium* to come up with clear and precise recommendations as to what strategies of change could make this transformation process stable and lead to the common goal, the establishment of a democratic system with a market economy where social justice prevails. Political and economic theory has been more concerned with explaining, either revolutionary or evolutionary change of political and economic systems. What is happening today is a combination of both: on the one hand, a radical change of the economic and political paradigm in Eastern-Europe turning from socialism to the principles of political democracy and market economies; on the other hand, the process of transforming all aspects of the social, political and economic system requires the development of new institutions, the development of new decision processes and the development of new policies – a task which cannot be accomplished overnight, a challenge which requires a truly evolutionary process in both theory and practice.

The inadequacy of economic and political theory to deal with the developments in Eastern Europe has been demonstrated by Wagner (1991).<sup>1</sup> He argues that societal systems can be categorized and subdivided in subsystems, primarily the economic, the political and the socio- cultural system and that crisis in the legitimacy in any one of these subsystems will create a crisis of the total system.

Eastern Europe is faced with a fundamental crisis of the economic and the political system and the re-emergence of old social, cultural, ethnic, religious and national identities. Between the subsystems, spillover effects, reinforcement and feed-back effects can lead to an intensification of the crisis of the whole system and endanger the stability of the transformation process. Consequently, these systems in transition are faced with the difficult task of managing system change in such a way that the inevitable instability of the transformation process can be kept at a minimum and not allowed to endanger its success. The question of how to manage a stable transformation process in subsystems and in the system as a whole is the major issue we intend to focus our attention on this investigation.

Wagner suggests that two fundamental questions have to be answered in this context:

- What were the factors that caused the change of the system and how can they be explained?
- What is the dynamic process of subsystem interdependency i.e. the dynamics of system change?

We are primarily concerned about the second question and therefore emphasize the factors that have contributed to stable transformation processes in some societies leading to new stable equilibria in and between subsystems.

Successful, less successful and unsuccessful examples of system transformation processes leading to or trying to lead to stable democratic market economies are plentiful. After the death of Franco, Spain<sup>2</sup> managed to cautiously but consistently convert political institutions that were already existing during the Franco regime to typically democratic institutions. It was not a radical revolution but an evolutionary change to democratic processes and institutions that went hand in hand with other substantive changes in the social, political and economic subsystem. Despite several attempts by the military to reverse this process, it was the strong support which the King and the vast majority of the population gave to this process of transformation that made it a success.

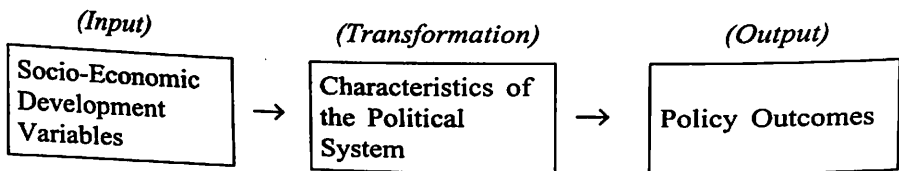
Similar developments have taken place in Portugal and in several Latin American countries<sup>3</sup>. There are also several examples where the transformation process has not been successful, where political systems have not been able to manage the transformation process in such a way that a new stable system and subsystems would emerge. Turkey is an example but also some countries in Latin America<sup>4</sup>. In

the case of South Africa the verdict is not in yet<sup>5</sup>. And of course also in Eastern Europe, despite some hopeful beginnings, it is too early to render final judgement.

These developments pose a challenge to economics and political science to develop theoretical concepts that can explain the dynamics of these system transformation processes and that can suggest strategies for a successful management transition and ensure stability. We propose to take the first steps towards developing such a conceptual framework by interpreting elements of relevant economic and political theory. We shall do this by first taking a critical look at relevant theoretical concepts in political science and economics before, in part III, outlining in a rather tentative and general way one proposal for an integrated approach.

## Part I: The Concept of the Political System and the Policy Approach

The inadequacy of current political theory to explain stable transformation processes and to suggest strategies for a successful management of change, can be illustrated by first looking at policy theory and systems theory in political science. Traditional approaches to this study of political systems treated public policies, the outcomes of the political decision processes, as the major dependent variable with socio-economic development conditions and characteristics of the political system as intervening variable. In a very simplified way this concept can be described as follows:



*Graph 1*

Clearly this model is oversimplified and political scientists have used much more complex concepts (see Fig. 2), but they have generally proceeded under the assumption that certain inputs (demands

and supports) and characteristics of social and economic development are transformed by the political system into policy outputs or public policies. For political scientists the interesting question was whether differences in political system characteristics (transformation process) could explain differences in policy outcomes i.e. the old question whether «politics matters».<sup>6</sup>

The basic elements of this «simple» model are still the same as in Figure 1. There are the inputs, the conversion or transformation mechanisms and the outputs. Added to it are impact or effects. By simply differentiating each of these four categories – for instance, differentiating inputs between system characteristics, political characteristics and problem characteristics, in the political system between policy formation process and structure, and policy implementation process and structure – the complexity is significantly increased. By introducing a differentiation in outputs between target reaction and system reaction which will lead to the eventual outcomes, complexity is further increased. Finally, by specifying the feedback loop, the policy-making system looks, at least on first sight, rather confusing. In this conception, relationships have been designated by arrows, they are not quantified – only their general direction is given. If these would be additionally included, the picture would become almost incomprehensible.

A vast literature developed on this subject matter since the 1960s in the social sciences but particularly in political science. Ever new variables, and ever new measures were used to analyze the relationship between social economic development variables, the characteristics of the political systems and policy outputs or outcomes.<sup>7</sup>

Three issues in this literature are of significance for our concern. They represent a major preoccupation of scholars who worked in this area. They are:

- An analysis of the policy process itself, i.e. how policies are made and at a later stage also how they are applied and implemented.
- The development of a typology of the major types of policies that modern states use;
- The examination of the instruments which are used to achieve the objectives of public policies.

Prior to taking a brief look at the theoretical concepts used in these three areas of policy analysis, it may be worthwhile to think briefly about what «policy» actually means. The often quoted phrase from Harry Eckstein «In political science the safe bet usually is,

that even widely used concepts are not widely understood in a uniform, unambiguous manner» applies here.<sup>8</sup>

Among the dozens of definitions that can be found in this body of literature the most useful for our purposes is that of Hecló who defines policy as «something 'bigger' than particular decisions, but 'smaller' than general social movements... at its core, policy is a course of action intended to accomplish some end».<sup>9</sup> This definition of policy suggests two important dimensions. First, policy is more than small individual political decisions, secondly, that it is a program of actions that tries to accomplish certain social, political or economic objectives. Although this definition maybe criticized or maybe unsatisfactory to some, it suffices for our purpose to narrow down our concern and specify the general field of our concerns.

### 1.1. The Policy Process

Focussing on policy and the process of policy-making marked in political science a turnaway from the prevalent legalistic and institutional orientation. Viewing politics as an intricate process of interactions between individuals and groups brought a new dynamic dimension to political analysis. The key concern were no longer such concepts as state, parliament, executive, parties, but rather actors and decision-makers who worked in a particular institutional context which channeled their actions and activities, but whose personal role and interactions with other actors were more important than the formal institutional context. Institutions were not looked upon as institutions, but as elements in the policy process according to the functions they played in this process.

This orientation in political science certainly brought new insights, but it also lead to new problems. The first problem encountered was the differentiation between the policy process and the environment (social, economic, political) in which it took place and to define this relationship. The concept «political system» was used to describe the general context in which policy processes took place. But where would one have to draw the borders of this system, particularly with respect to the «social» and «economic» system? Were «social» and «economic» actors, i.e. interest groups, associations, large enterprises, part of the political system or were they part of the environment in which the «political» policy process was taking place. The lines between the environment and the policy system proved to be very difficult to draw both theoretically and much mo-

re difficult operationally. Moreover, it was realized that a great number of actors played different roles in different situations; they had to be counted as part of the system in certain aspects of their actions and as part of the environment in others. Conceptualizing the policy process in general terms as it was done by Easton and in our own little graph on page 5, above, was relatively easy. Trying to define it, and operationalize it for research purposes proved much more difficult, and unfortunately, many scholars circumvented the problem by using –easily available– highly aggregated data and by treating the political system as a black box which transformed– somehow miraculously «input» into «output». This approach offered researchers two advantages: first, they could avoid facing the institutional issue –after all «institutions» had come out of fashion– and second, it enabled them to apply advanced statistical methods and thus gave their work the appearance of being truly «scientific».

Efforts to develop more adequate concepts of the policy processes inevitably led to a very complex reconstruction of an even more complex social process. Over time concepts of the policy process became ever more detailed and ever more complex. Figure 3 shows what the author called a «simple model» of the policy process.

Starting at the top of the cycle we begin with the policy development stage. In this stage the European Commission develops a proposal for a Legal Act. Let us say in this case, a directive. It is followed by a policy decision; in our case the Council decides to pass –usually a changed version of– this proposal. The output is a directive. In the next stage Member States are obliged to transpose the directive into the law of their countries, i.e., transpose it into national law. This will be controlled by the Commission. A feedback loop shows that according to Article 169 (EC Treaty) the Commission has to check whether the transposition has been timely and adequate. After full legal transposition Member States have to pass secondary regulations in order to make the directive applicable in practice. The Commission should –and in most cases does– check this stage in accordance with Art. 169 (also called infringement procedure). National Courts can also check the legality of the application process. The Commission also is supposed to monitor the application of national laws and evaluate this process. If problems arise, the Commission –often on requests from Member States– possibly will begin to redesign and update policy which will result in a new policy proposal to the Council and a new, or an amended directive.

An important distinction in these conceptualizations is the distinction between policy formulation and policy implementation. In the early phase of the literature the focus was primarily the process of policy formulation, i.e. the way political decisions were made, the actors that were involved, the influence they had and what the output of the policy system was. It was later realized that policy could not be fully explained without including also the stage after a policy decision had been made, when it had to be applied and implemented. Moreover, it became clear that in the process of implementation new policy choices had to be faced and that policy was not a finished «product» but that it was something that experienced change and was subject to pressures and counter-pressures in the process of implementation as well.<sup>10</sup>

The policy process literature was confronted with another difficulty: The basic structures of the concepts were linear. It was a sequence of events that were captured in the conceptual framework. Yet, policy clearly was a continuous, dynamic process. Today's political decisions are implemented tomorrow and will give rise to the necessity to make a new decision or adjust the previous decision the day after tomorrow. This dynamic aspect was not captured in the conceptual framework. Although there were always references to feedback loops; in terms of operationalization and in terms of theory these feedback lines were drawn into the graphs but not taken seriously.

Early critics of the simplistic policy approach already had pointed to this problem.<sup>11</sup> The obvious solution was the concept of the policy cycle, where policy decision and implementation processes were not viewed as a linear sequence with possible feedback lines but as a cycle which fed into itself.<sup>12</sup> In its most simple form the policy cycle places the major phases of the policy decision implementation process in a cycle where one stage leads into the other. Policy decision making leads to policy implementation, to policy evaluation, to policy redesign and to policy reformulation or redecision (Fig. 3 gives an example for such a cycle).

The major dependent variable is a stable democratic market system characterized by stable, economic, political and socio-cultural institutions.

How this democratic system evolves and whether it evolves depends on a set of very complex interactions between three major types of variables.



- The existing *system ecology* composed of economic factors such as GDP per capita, infrastructure, political factors such as party system, the quality and competence of the existing administration and socio-cultural factors such as the social security system, education, religion, etc.
- the characteristics of the *system in transition*, composed of economic, political and socio-cultural factors and
- *policy output choices*, key policy choices in the economic, political and socio-cultural areas.

It is our argument that the most important determinant of whether and what kind of stable democratic system will emerge depends on the kind of policy choices that are the result of existing system ecology primarily and the characteristics of the political system in transition. How these factors interact, their relevance and importance, their weight and their consequences can only be answered through empirical research.

This dynamic concept provides a more systematic perspective of the policy process linking the various elements and forcing researchers to include a greater number of variables in their examinations. Policy cycles are different for different policy areas, different policy fields and different political systems. The model pictured in Fig. 3 has been designed to capture the process of European environmental policy. It shows many crucial linkages between different actors on different levels of governments.

The policy analysis literature in political science has been a revitalizing and refreshing innovation to traditional political analysis. As part of the behavioral movement, it brought new ideas, new concepts and, above all, a new concern with empirical research. It saw itself in strong contrast with the disciplines' traditional focus on institutions and legal aspects. It is understandable therefore, that it ignored the linkages between the policy process and political institutions and underestimated the importance and the restraining force of political institutional structures. Nonetheless, it provided a conceptual framework for a large number of very interesting empirical inquiries of high scientific quality. Comparative policy analysis moreover, suggested that there were significant differences between policy processes in different political systems and also with respect to different policy areas. It was necessary therefore, to develop a typology of policy areas from the perspective of a policy process point of view.

## I.2. Typologies of Policy Area

By far the most simple typology is that based on the content of a policy. One can speak therefore of social policy, economic policy, employment policy, etc. But this simple division is not very useful from an analytical point of view, because policy analysis is trying to find commonalities and significant differences across these substantive policy areas. The key question is not to differentiate according to every possible designation of substantive policy areas but to find categories that characterize certain types of policies, that point to significant differences between social policies and economic policies, etc.

Most efforts to arrive at such a typology have been more or less inspired by Theodore Lowi's typology. Principally, Lowi distinguishes only between four types of policies: distributive, regulative, constituent and redistributive.<sup>13</sup> Lowi uses the likelihood of the utilization of coercion in the application of policy. The classical theory scheme is represented in Figure 4.

The primary concern of Lowi was to relate policies to the way they are made and applied. In a sense, he was interested in the relationship between policy and politics, whereby politics for him was the dependent variable.

What has fascinated scholars with Lowi's classification scheme is not this initial concern but rather the use of this typology as a simple descriptive classification of policies. Indeed, it seemed logical to speak of

- distributive policies, where things are being given away;
- regulative policies, where restrictions, rules of conduct and sanctions are stipulated;
- redistributive policies, where resources are taken from one group of people and given to another
- constituent policies as general rules about how decisions are made, rules about the political system itself, rules about power and how it is handled.

Moreover, some of these terms have been used in other fields of inquiry, like economics which suggested that there were indeed fundamental differences between these types of policies with respect to the policy content and process. Unfortunately, the typology is lacking precision, it is rather general including a broad range of phenomena in one category which makes it rather difficult to apply and operationalize the typology in empirical research.

Because of these difficulties, it is not surprising that others have developed alternative typologies most of which are based on the four-fold scheme of Lowi. The most interesting is that of Salisbury and Heinz.<sup>14</sup> The criteria for distinction are not any longer the use of force or coercion, but the characteristics of the decisional system and the demand pattern. Salisbury differentiated between integrated or fragmented political decision system and demand pattern (see Fig. 5). He arrives at the same four categories or types of policy, whereby constitutional policies are considered only a special case of regulative policies. In its place he uses a new type which he calls «self-regulative policy» referring to policy areas where regulation is left to those concerned themselves since the decision system is fragmented and not capable of enforcing a redistributive policy in this case. The further refinement can be found in the Salisbury/Heinz publication of 1970 where the decisional system is replaced by the concept of the «costs» involved in reaching decisions. It is not more than an interesting variation to the same theme.

Also based on Lowi's four-fold typology, Paul Sabatier tried to move further away from it by focussing more on the very content of different types of policies. He differentiates between policies which provide or allocate goods and services and policies which regulate behavior. The other dimension involves the benefits and costs of policies where he distinguishes between zero-sum policies (where clearly one group gains what another group loses) and non-zero-sum policies (where both or all participants can gain from the policy).<sup>15</sup>

It is only a small step from this typology to a typology which is more concerned with instruments of policy, i.e. the kinds of measures taken to realize certain objectives. A typology that stands somewhere between the Sabatier classification and a purely instrumental one, is the one developed by Jann which includes both the Sabatier type categories and adds typical policy instruments such as raising taxes, introducing new «programs» or «spending programs», etc.

Prior to moving to the discussion of the instrument question, we should keep in mind that particularly the Salisbury typology could potentially be very useful in working or applying or developing concepts and frameworks for analysis of political systems in transition, since one of his criteria is the nature of the political system, whether it is integrated and fragmented, although the categories are probably much too general to be directly applicable.

As interesting as these classificatory schemes of the substance of policy are, they all avoid the crucial question of the consequences

of policy content for the stabilization of political systems. They do not ask whether some type of policy is more conducive towards stabilizing institutions and others are less likely to achieve this objective. Nonetheless, some of these categories may be useful in developing our own classificatory scheme of the substance of policy.

### I.3. Instruments of Public Policy

Interestingly enough, one finds little reference to the question of policy instruments in the American literature. It is a domain which was developed primarily in Europe, above all in Germany and in the Scandinavian countries. Perhaps, this is a result partially of a stronger influence of economic theory on policy research in these countries. Perhaps, it is also a consequence of the more intensive concern in the European policy literature with concrete «programs» of public policy ranging from social programs, environmental programs to planning etc. This concern is particularly characteristic of the implementation literature in Europe.<sup>16</sup>

Although the literature is full of very detailed and highly differentiated classification schemes of policy instruments, for our purposes, the most commonly used three-fold differentiation will be sufficient:

- administrative instruments, that is rules and regulations enacted, enforced and controlled by government;
- economic instruments, the use of taxes or other levies or subsidies and incentives to achieve certain objectives;
- informational and consultative instruments, where policy provides guidance and support for citizens, e.g. employment offices, consumer offices, etc.

Basically, this typology of policy instruments distinguishes between the resources that are used in policy application and implementation, i.e. power, money, and information.

These instruments can be further refined and subdivided. Economists have developed a full array of economic instruments. In political science and in public administration a great number of subdivisions have been developed with respect to political-administrative instruments and informational instruments, where also sociology has made some contributions.

In conclusion, it also should be emphasized that specific policies or political programs may employ a whole range of these instru-

ments and their effectiveness and success often depends on a specific mix of political-administrative, economic and informational policy instruments.

#### I.4. An Intermediate Conclusion

Policy analysis in political science is primarily concerned with answering the question of how things are done, how policies are made, how they are implemented, how they are applied. It has only in a few exceptions focused on another important question, namely on what is policy or what should policy be, i.e. the material dimension of policy. This was left by and large to the specialists from other fields, to the economists, to the educational people, to the social policy people, etc. At the same time policy analysis would be an ideal area where the process and the structure oriented scholars would work together with those interested in the what question, the material dimension.

Another weakness of the policy literature has been identified as its failure to link up with institutions, with the structures in which policies take place, in which policies are decided and are implemented. It is also reflected in the very limited discussion of policy instruments, where particularly the relationship between material content, objectives and instruments, involving an economic, political scientist and public management perspective, is virtually absent. If, as we are trying to do, one wants to develop a conceptual framework for political systems in transition, for systems in search of stable democratic institutions, we need to provide these linkages. We need to integrate economic and political science theory, we need to integrate the question of the substance of policy, its relationship to policy process and the actors involved in it and to the institutions that provide the framework for policy making and implementation. In most stable systems these are given and analysts need not ask these questions. Change is taking place slowly, institutional consequences of policy choices and policy processes can be at best observed over long periods of time. In systems in transition the opposite is the case; it is a crucial question and time is a scarce commodity.

This is particularly urgent when the timetable of accession to the European Union dictates the agenda of domestic policy. In fact, there is an umbrella effect, since even those states not now being active candidates but preparing to become candidates, anticipate the requirement to absorb the *acquis communautaire*. In addition, the um-

brella also extends to their traditional trading partners who absorb the acquis, more or less successfully, in order to be associated. The role of the Council of Europe in this should not be overlooked either. Witness the recent decision of the Republic of Romania to abolish the death penalty (April 2003).

## Part II: The transition to a social market economy and a democratic political institution as an economic problem

The sudden demise of the state socialist economies in Eastern Europe has caught most professional economists in the West by surprise. Within months, however, a stream of literature began to flow and economists of all kinds of persuasions tried to apply their analytical tools to the new phenomenon. While the profession functioned effectively in addressing a newly urgent problem, it did not in systematically building on the extant work on economic systems that had accompanied the rise and development of the market economies for about the middle of this century.

Three instances highlight this point.

1. János Kornai has certainly established himself as one of the leading authorities in the economics of transitions from one system to the other. In a nutshell, his *The Road to a Free Economy* (1990)<sup>17</sup> can be summarized in the sequence of steps outlined in his pages 39-40:
  1. Freedom to establish a firm; free entry into the production sphere.
  2. Free prices, based on a free contract between the buyer and the seller.
  3. Unrestricted right to rent out privately owned assets, again on the basis of a free contract between the lessor and the lessee. Among other things, these transactions should include the free renting out of privately owned apartments or real estate, with the rental freely agreed upon between the lessor and the lessee.
  4. Unrestricted right to employ people in all cases where the employer belongs to the private sector household or privately owned firm. The employer and the employee must be free to agree on wages.

5. Unrestricted right to accumulate, sell, or buy any article of value (e.g., rare metal).
6. Unrestricted right to accumulate, sell, or buy foreign currency through transactions within the private sector and between Hungarian and foreign citizens.
7. Unrestricted right to take out and bring in domestic and foreign currencies.
8. Free foreign trade activity, in which the member of the private sector has the unrestricted right to export and import.
9. Unrestricted right to lend money, with credit terms freely agreed upon between the creditor and the debtor.
10. Freedom of financial investment in the private ventures of other individuals.
11. Freedom to sell and buy, at free prices, any privately owned apartment, real estate, or other asset.

For a mathematical proof, the sequence in which particular conditions are ordered makes no difference. For a process of transition, the sequence does indeed make a difference. It is obvious that the sequence indicated by Kornai is by no means an intended sequence. It is simply a random compilation of different conditions a particular system has to respond to. Alternatively, one could think of the preconditions to be met for a market economy to evolve in a step-wise manner.

There is still no generally agreed upon theory of the transformation of economic systems from central planning in physical units to decentral market coordination. Yet there is agreement that a number of institutional prerequisites are necessary for the operation of a market economy; and additional prerequisite institutions are needed if the market economy towards which transformation is proceeding is to be embedded into a social welfare state. Both political and economic considerations will determine the best possible path of the transformation and, in particular, the sequence of institutional reform measures as they will have to be implemented one after and building on the other.

The simplest and most basic transformation scenario might consist of at least the following six steps:

1. Establish a property rights regime supported by the three basic guarantees of private property, freedom of contract, and liability.
2. Define a transformation path in a politically binding way.
3. Facilitate the introduction of a free monetary system by granting

- citizens the freedom to choose whichever currency or other medium of exchange they prefer for their own transactions.
4. Define in a legally binding way the assignment of property rights in the economy and society in order to provide a starting point for the transformation path.
  5. Establish a financially sound and independent system of social security which is kept separate from the state budget; as a funding source, this system could receive the exclusive right to levy a sales or value added tax.
  6. Stabilize the public finances.

This is an example of how a sequence could be developed that builds on the institutional preconditions to go from step  $n$  to step  $n+1$ .

2. A second example may be drawn from an outstanding journal now primarily devoted to economic change in Eastern Europe. Alfred Steinherr's «Essential Ingredients for Reform in Eastern Europe» surprises the reader with statements like these: «Because flexible exchange rates generate too much instability and exert too little constraint on domestic policies, the exchange rate must be fixed (most usefully in terms of the ECU). Convertibility may then remain limited to current account transactions (p.5). And again, «Radical reforms have the intuitive appeal of not rocking the boat and tackling problems measure for measure in a logical order. Experience shows, however, that such a logical ordering is not possible in that, during the transition from one system to another, contradictions developed which may deteriorate performance even further and reinforce conservative forces.» (p. 7 – a reference to the experience of partial price reform in Hungary follows in order to collaborate the point). Note that his statement in favor of the big bang approach rests on the unproved assumption that there is no logical order to the sequence of reform steps.
3. The third example is a bibliography kindly shared with me by an official from the Deutsche Bundesbank in Frankfurt. The bibliography is entitled (in my translation): Transformation of the Economic Order of the Former DDR: Economic restructuring in Eastern Germany: a Guide to the Literature. The part super-scribed «basic literature on the transformation of economic systems» running from pages 13 through page 28 contains none of the leading works in German language economic theory on the subject.



Let me give a few hints to this literature in the second part of this appendix.

1. Although the pre-Smithian Cameralist literature already established a number of important criteria to be met by successful plans for transforming agricultural into market economies (to the benefit of the Cameralist' state), the Smithian inquiry into the nature and *causes* of the Wealth of Nations set of a new wave on inquiry in the continental countries. They were faced with different conditions, since sea faring trade and the conquering of natural resources and the establishment of monopolies of international trade were not at their disposal<sup>18</sup>. In the German language countries, the Smithian heritage had to be translated into different institutional structures and consequently into different political responses or programs. Most challenging was the task met by the German professors in Russia, since here, they were unable to use fairly stressing reform instruments while facing a particularly underdeveloped economy. This clash of high-powered knowledge with arcane economic processes may serve as a backdrop for our contemporarily political and academic challenge<sup>19</sup>. The leading authority in this group is obviously Heinrich von Storch, who combined his economic reform strategy, taken up from Smith, but adapted it to the Russian circumstances with a theory of civilization, or a theory of the political circumstances under which, under the conditions of his Russian environment, a market economy might have a chance to evolve.
2. The second great classic in the theory of transitions from system to system is the man who actually introduced the term «economic systems» into the discipline of economics. Werner Sombart in his monumental *Modern Capitalism*<sup>20</sup> carefully traced the development from precapitalism to early capitalism, mature capitalism, high capitalism and late (regulated) capitalism by indicating precisely the institutional conditions at the path leading from system to the other. However, he did not systematically introduce the political element; following Pareto's advise, it seems he shied back from a systematic integration of the political element, which he left to his friend Max Weber. Pareto, on the other hand, in his «Les Systemes Socialistes» and later in his «Trattato di Sociologia generale» gives a number of conditions for successful transitions from one system to the other.

3. The archetypal researcher into transition processes from one economic system to the other was, of course, Gustav Schmoller, whose concept of economics involved the emphasis on the socio-economic conditions for particular economic systems to develop. He did not shy away from designing political economic systems (such as the Modern Welfare State with the three pillars of social insurance) if he could, by way of historical or comparative research, establish viable institutions that had served similar purposes in similar societies. His *Grundriss der Allgemeinen Volkswirtschaftslehre* is replete with catalogues of conditions for the various steps of transition paths from one stage of socio-economic development to the other.

## Conclusion

Our hypothesis is that the substance of specific social and economic policies will shape if not determine the type of new institutions in the three subsystems that will evolve in a transformation process. We are assuming that there are some policies that are «better» than others in helping in the establishment of democratic institutions, of course depending on crucial existing conditions in the system (system ecology). If it is possible to identify «successful» policies and how they are related to institutional change in the desired direction, it should be possible to develop a strategy for managing a stable system transformation. The elements for such a conceptual framework are presented –again highly oversimplified– in graph 6.

The major shortcoming of graph 6 lies in the fact that the graph does not help in elucidating the dynamic structure of the transitional process. As we emphasized earlier, the main weakness of the naive literature on transitional processes lies in the fact that conditions are listed without giving the logical sequence of their introduction. We correct this weakness by indicating one conceivable scenario by way of example. The scenario indicated is shocking and baffling to most practitioners, because it flies in the face of textbook wisdom. Yet, this textbook wisdom is irrelevant, as it does not address systems in transition. E.g. one of the participants in the conference in Bad Homburg, where the papers combined in this volume were discussed, was upset by the proposal to fund the social security system with the proceeds of a sales tax and thereby wresting this po-

werful tax from government, probably with the result of reducing the government's ability to lay a credible claim on resources in that economy.

Every transitional process that we have so far studied not only shows us that the textbook conditions were never met even in the most successful cases. The most important results not addressed in the literature we have so far been able to survey is the fact that transitional processes need transitional institutions which will be created and then disappear. The Treuhand Anstalt is just one and very specific an example for such a transitional institution. More specifically, we hypothesize that a successful transformation strategy will involve the sequential creation of institutions which by their own design can not survive.

The basic rationale of this hypothesis is by no means new. A prototype can be found in Friedrich List's<sup>21</sup> *Developmental Strategy of Industrialization*. The often-misunderstood argument for a protective tariff was carefully drafted in such a way, that the tariff would have to be revoked in the case of both possible outcomes. If the protected industry did not develop according to plans, the tariff had to be revoked as it was too expensive in terms of tariff expenditures or revenue lost. In case it succeeded, the tariff would have to be repealed by virtue of its insignificance from a revenue point of view, and most likely also because it would prove to be a political liability. This variant of constitutional political economy, which emphasizes the design of self-enforcing institutions which as their best strategy have an incentive to complete the task assigned and then devolve, has not been emphasized much after List pioneered it. It is here where much more work will remain to be done, once enough reliable information is available about successful transformation processes.

## Bibliography

It is common practice in English publishing to insist on a one to one relationship between one of a piece of literature and one source and vice versa. While we are always glad to give credit to our colleagues and the sources we have been allowed to draw upon, in this case we face an embarrassment of richness. The discussions that led to this corporate piece were informed by what we know ourselves

through travel and extensive consulting and the references we cite. But not every item in the list of references resurfaces in the list. In this ..., we insist on couraging the entire referee list, without a one to one relationship; we simply cannot properly credit some of our ideas, but we have an idea about the common stock of knowledge on which we draw.

## Notes

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