

## **Governance in the process of economic transformation**

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## 1. Introduction

The term *economic transformation* relates to the transition from centrally planned economies towards market economies. Disregarding partial reforms within the socialist systems, which had taken place in many of today's transition countries mainly in the 1960s and 1970s, China (since 1978) and Vietnam (since 1986) were the first socialist economies to take up the challenge of creating a market-based economic order. They were soon followed by other socialist countries in Asia such as Laos and Mongolia, the latter joining the by then global shift from centrally planned to market-oriented economies that culminated in the dramatic political and economic transformation in Central and Eastern Europe (CEE) and the former Soviet Union bringing about more than two dozens further transition countries. While the Asian economies in transition essentially strove to institute new hybrid systems, so-called socialist market economies, countries in CEE as well as Russia sought to establish Western-style market economies and democratic political orders simultaneously.

Especially since 1989, when the iron curtain fell, economists quickly advised policymakers, particularly in CEE but also in the Commonwealth of Independent States, of how to transform a formerly planned into a market economy. Since neither theoretical models of systemic transformation nor appropriate role models had existed, academic studies and policy debates initially focused on what had to be done in which sequence and at which speed in order to create a Western-style market system. From a neoclassical perspective, these discussions about sequencing, timing, and pacing of transformation steps were based on the notion that replacing the state-ownership of the means of production and central planning as the main coordination mechanism by private property and a flexible system of relative prices constituted a necessary (and for some academics even a sufficient) condition for successful economic transformation. In the first years of transition, neoclassical reasoning and policy advice following the prescriptions of the Washington Consensus dominated the controversy between so-called shock therapists and gradualists. Accordingly, market-oriented economic orders had to be established as fast as possible in order to avoid a misallocation of resources, to overcome resistance to reforms, and to make the transition process irreversible. Consequently, the "holy trinity" (Kornai 2001, p. 1591), including bold macroeconomic stabilization-cum-adjustment programs, complete internal and external liberalization as well as quick privatization and creating secure property rights, dominated economic transitions throughout CEE and to some extent even in some Central Asian countries. In contrast, adherents to a gradual transition approach were chiefly dominating the practice of policymaking in East Asian transition economies.

Notably, subsequent experiences with transition have been extremely diverse: Some countries including Poland, Slovenia, and China have achieved rapid and sustained economic growth, others like Russia or Bulgaria experienced long phases of drastic economic decline and enjoyed recovery only since the second half of the 1990s. And yet others such as Tajikistan or Belarus were just trapped in economic stagnation due to missing, half-hearted, or partial reforms which did neither fully abandon the old system nor laid the basis for efficient market exchange.

A striking fact that distinguishes economies (or better: societies) in transition from (other) less developed countries or emerging markets is that their economic reforms do not take place within an existing, relatively stable institutional order which is changing only incrementally in the course of time. Instead, comprehensive policy reforms and large-scale institutional restructuring need to go hand in hand. While this challenge has been visible in

the Asian transition economies, it is much more pronounced in the economic and political transformations in CEE and large parts of the CIS. Key insights gained from these experiences have been that the initial focus on the speed of economic restructuring and transition had turned out to be extreme and that differences in economic performance of various countries over time were significantly determined by the efficacy of both old and newly crafted institutions and their interplay (Djankov et al. 2003). More recently, the notion that institutions matter has been extended. It is not only economic institutions such as secure property rights, competition rules, or bankruptcy regulation which are crucial for a functioning market economy, but political institutions such as the rule of law, federal structures, or organizational modes in public bureaucracies as well. This led scholars and policymakers as well as international organizations to argue that prescriptions for ‘good governance’ had to become a key ingredient into any transition program in order to effectively implement reform policies and to properly enforce the new rules of the game.<sup>1</sup>

Against the background of country-specific experiences, these insights, however, raise new questions: Does the shift towards flourishing markets follow a linear or a non-linear path? Are there universal policy measures to be applied as a *conditio sine qua non*? Can we identify a set of best-practice institutions which help to craft a functioning and secure market order? Is a democratic order the best political regime to secure economic transition, or does authoritarianism show advantages in bringing about radical economic change? Given a democratic system, is a parliamentary system better or a presidential one? Does a federal structure help to create competition and to find optimal policy solutions?

Today, it appears to be conventional wisdom that institutions matter and that ‘good governance’ has played a key role regarding the success cases in economic transition, whereas ‘bad governance’ has been responsible for the failure of transition programs. What, however, is far from being agreed upon is what exactly determines good governance and how can it be achieved in a highly complex political economy in which not only economic institutions but also political structures and informal constraints to individual action have become endogenous variables which are subject to significant change within a decade or less.

This paper addresses these questions. To begin with, Section 2 highlights the importance of institution building and discusses the role of the state in the context of economic transformation. Subsequently, Section 3 introduces the notion of governance and underlines its importance for effective policy and institutional reform. In Section 4, we discuss different governance structures in transition economies, and Section 5 concludes.

## **2. Economic transformation: the quest for market institutions and the role of the state**

In the decade after the fall of the Berlin Wall, people in most transition countries gained wide-ranging political and economic freedoms. Today, most goods and services are provided by the private sector and exchanged in markets. In numerous countries, free elections have taken place. Yet, in many countries the promise to introduce liberal (and not only electoral) democracies and to create economic prosperity could not be delivered to citizens. Experiences show that the transformation processes have been highly complex and time-consuming and that their costs are substantial.

The superficial controversy ‘shock therapy vs. gradualism’ could not adequately address this complexity and the inherent path dependence. The initial policy debate rather reflected the lack of generally accepted transformation models. Thus, the controversy (chiefly emphasizing problems of stabilization and liberalization) and consequently most early *economic* transformation strategies could not do justice to the *systemic* nature of

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<sup>1</sup> See, e.g., World Bank (1997 and 2000), North (1997), and Wagener (2004).

transformation, i.e. the interdependent transformation of *all* suborders of society. Furthermore, it is not only the political, the economic, the legal, and the social order which have to be accounted for by transformation policy, but also historical legacies as well as informal institutions such as norms, conventions, and ethical rules which inevitably lead to path dependence of societal development and possibly imply hysteresis effects in individual behavior.

Before World War II, e.g., the Eastern part of Central Europe was a prosperous region, while Central Asia still showed characteristics of a nomadic society. Russia itself has always been a basket case. Central and East Asian countries were essentially rural societies and considerably lagged behind in industrialization and economic as well as often social achievements. These differences had been hardly overcome under socialist rule. This implies that they may have considerable effects on the efficacy of economic reforms today. In addition, the philosophical and ideological heritage of socialism (i.e., various forms of collectivism, communalism, and authoritarianism) has not necessarily been conducive to the evolution of either market-oriented individualism or the rule of law. As Pejovich (1994, p. 520) observed for CEE: “people see the gains from exchange as a redistribution of wealth within the community rather than as rewards for creating new value“. Many people in transition economies did not regard capitalism as a system which is based on self-responsibility, initiative, and competition, but as a system that automatically generates a great variety of goods and high income without giving up so-called socialist achievements. Accordingly, Pejovich (1994, p. 522) argued that “the transition process was a crude awakening that capitalism is not merely about being rich“. These factors made the transformation process path dependent and induced hysteresis effects. As a consequence, capitalist codes of behavior – as postulated by neoclassicists – could not emerge in the short run. This also means that policy reform and institution building according to text books could not have the expected effects. Rather it induced severe resistance as the (at least temporary) political success of communist parties or the maintenance of autocratic political structures in several countries shows.

Hence, the societal adjustment and restructuring necessities in the course of systemic transformation basically relate to *all* suborders of society and encompass particularly

- the substitution of a functioning market economy for the centrally-planned economic order;
- the abandonment of the totalitarian political system in favor of a liberal democratic order;
- the creation of a state founded on the rule of law, that puts the individual in the center of its action and provides him with secure legal protection and enforces the principles of a competitive market order;
- crafting a public administration, that no longer serves privileged elites, but the people and pursues the public interest; and
- the adaptation of market-oriented and democratic codes of behavior.

These adjustment necessities constitute the transformation-specific problem of simultaneity, which, in many countries, has been even aggravated by the search for a new statehood. This means that the systemic transformation is a complex pragmatic, but also an evolutionary process. Due to the interdependency of all sub-transformations, dialectic interrelationships evolve, which need to be taken into consideration by policymakers when they conduct their reform policies. From an economist’s perspective it follows that economic transformation, i.e. the transition towards a market system, is always embedded into the wider fabric and complexity of systemic transformation. This entails that variables such as political institutions, bureaucratic rules and organizations, social codes of conduct, or national value systems are not to be taken as given anymore. Instead they are subject to change themselves. This, however, requires that policymakers as well as economic advisors seek to anticipate that change and take it into account when designing economic transformation policies. This poses complex challenges to governments in guiding the transition process which are extremely difficult to cope with. As Wagener’s (2004, p. 142) put it: “(i)ntegral transformation of former

socialist countries is a process which comprises not only the economic, but also the legal and political system of a country. Where state and market are under reconstruction at the same time, the former will hardly be able to perform its ordering function effectively.”

This interim conclusion for CEE and CIS countries, however, does need some qualification if the perspective shifts to transition in East Asia, which has taken place within authoritarian settings. Contrary to CEE, transitions in China and Vietnam have been taking place without political democratization. Usually it is argued that these countries have escaped the dilemma of simultaneousness, because political transformation pursuing Western standards has been absent. But even in China (and to a similar extent in Vietnam), as an impetus to and a consequence of economic transition, a gradual, though far-reaching change of institutions has taken place; what Heilmann (1998) diagnosed in the Chinese case as a market-induced transformation of the Leninist state. Since the political leaders in China and in Vietnam have been able to actively steer economic transformation and institutional change without losing their authority and legitimacy, governments continued to act as ordering powers despite unprecedented institutional changes.

Thus, the question arises why some countries have been relatively successful in transforming their economies, while others have been lagging behind or have been trapped into economic stagnation and institutional sclerosis. The most successful transformers are those countries in Eastern Central Europe, which recently joined the European Union or have the prospect to EU accession in the future, as well as authoritarian East Asian countries. Wagener (2004, p. 142) argues that “(i)t seems to have been good governance – something else than a strong state and, in the end, a precondition of the latter – which is responsible for the achievement”. Before following up on that argument explicitly in the next section, it appears to be useful to briefly discuss the basic role of the state for making economic transformation succeed.

In neoclassical models, the state is exogenous to the economic reform process. It is considered a black box which (usually unsuccessfully) seeks to solve problems arising in market processes. This perspective, however, is largely inappropriate for dealing with the *paradox of the adjusting state* which aggravates the practical problems of economic reform and transformation particularly in transition countries. This paradox concerns the ambivalent role of governments during the transition from a state-led model of economic development toward an open, market-oriented economy. While the state (i.e. the central government, sub-national authorities, the legislature, and the bureaucracy) is required to withdraw from policy interventions into economic processes and to perform a more passive role, economic transition and development usually require nimble and robust political authorities to be in place, ones capable of implementing and enforcing the new market-oriented policy directives. Performing this role is even more complicated if the executive branch of government needs to assume further (market-enhancing) tasks due to existing market imperfections. Making the state more effective so that it can meet new challenges and perform new roles in facilitating private-sector coordination is of utmost importance for feasible and successful economic transformation and policy reform strategies.<sup>2</sup>

In order to conduct effective transformation policies, governments need to assume roles for which they have typically lacked the capacity and capability. Establishing the institutions which constitute a stable market-oriented economic order, introducing policy instruments to indirectly steer market processes and to effectively provide public goods, crafting effective devices to enforce market laws and regulations and to collect tax revenues, building up a meritocratic independent economic bureaucracy, and generating a transparent system of information exchange between the public and the emerging private sector – all these tasks are to be assumed by state actors. The underlying institutions do not evolve automatically but

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<sup>2</sup> This central issue, however, was not explicitly included in either the Washington Consensus or neoclassical approaches to policy reform; see, e.g., Aoki et al. (1997) and Streeten (1996).

need to be explicitly crafted and enforced by the government, whereas the government at the same time is required to reduce the scope of its activities, to overcome overstaffing, and to cope with budgetary bottlenecks.

The paradox of the adjusting state precisely reflects this lack of institutional, administrative, technical, and political capacities. Regardless of whether a government decides to follow the policy recommendations of the Washington Consensus or whether it opts for a more activist role to overcome coordination failures and other market imperfections (which occur frequently in a transition process), a complex politico-institutional structure needs to be put in place in order to make government more effective in accomplishing whatever tasks it undertakes. Such institutionalization, however, cannot be taken for granted.

Similarly, this argument also holds for economic transitions taking place within authoritarian settings such as in China, Vietnam or Laos. Even if the problem of simultaneity, which has been a constituent characteristic of systemic transformation in most countries in CEE and much of the CIS, has been largely absent in East Asian transition settings, the existing non-democratic regimes can only make use of their presumably strong states and become effective ordering powers of economic restructuring if they succeed in adjusting and reforming their political, administrative, and economic institutions in a way that helps authorities to maintain legitimacy and credibility from the standpoint of ordinary people as well as domestic and foreign investors. Thus, even in these authoritarian settings, which may basically allow to effectively conduct bold necessary, though possibly unpopular reforms without facing immediate political resistance, appropriate rules need to be introduced, organizations built up, and technocratic, administrative, and political skills accumulated which help to craft a secure and stable politico-institutional foundation of far-reaching market-oriented reforms.

### **3. Governance: overcoming the market-state dichotomy**

Effective economic transition not only requires credible commitments that political promises are actually delivered to citizens and investors. It crucially depends on the administrative capacity of state institutions, the relationships between a country's policymaking entities and wider segments of society, and the technical and political capability of policymakers of formulating and implementing the policies which the political leadership seeks to pursue. In this regard, the *governance structure* underlying the process of policymaking is of utmost importance.

Recent research on governance and its impact on economic performance significantly increased our understanding of the constituent characteristics of such a politico-institutional foundation of policy formulation and implementation.<sup>3</sup> Country experiences as well as empirical cross-country studies showed that it is not the regime type per se (i.e., democracy or authoritarian regime) which is the key to successful economic transition and growth. Rather the quality of institutions and their interplay as well as the interrelations between state and private actors proved to be crucial determinants for economic transformation. Overcoming the pretended dichotomy between markets and states, numerous scholars perceive institutional variety as an integral element of policymaking that links the activities of public and private actors.<sup>4</sup> This implies that public goods, including institutions crafted and enforced by the state as well as public policies, are the outcome of the interrelation and exchange of multiple actors. Furthermore, North (1990, 1997) and his followers have convincingly argued that it is primarily institutions which provide individuals with specific incentives for their action and

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<sup>3</sup> See, e.g., Kaufman et al. (1999, 2003) and Ahrens (2002).

<sup>4</sup> See, e.g., Dutt et al. (1994), Klitgaard (1991), Root and Weingast (1996), Streeten (1993), Stiglitz (1999), and World Bank (1997).

affect political and economic exchange. Institutional arrangements also determine the formation and implementation of policies. From that perspective, a proper understanding of governance, that relates to policymaking and economic performance, needs to go beyond the narrower conceptions of either corporate governance or public governance. While corporate governance in a *Williamsonian* understanding relates to a microperspective on the firm and on private ordering, and public governance is frequently limited to public sector management, the following considerations are based on a concept in which governance is defined as “the capacity of the institutional matrix (in which individual actors, organizations and policy makers interact) to implement public policies, enforce rules and regulations, and to improve private-sector coordination”.<sup>5</sup>

Hence, governance is *not* a synonym for government. Rather, it relates to institutions associated with governability and accounts for institutional variety as well as its importance for state capacity in conducting policy reform (Ebner 2005). In this context, governance clearly focuses on the quality of public policy and its impact on economic performance and transformation. Thus, a country’s governance structure consists of institutional arrangements and political processes of formulating and implementing policy goals and applying appropriate instruments, thereby relying on the coordination of diverse actors in the public as well as the private sector. From that perspective, a governance structure exhibits characteristics of a collective good. It is provided by various actors which influence public policymaking in a top-down as well as a bottom-up manner. These actors include public and private domestic organizations such as government agencies, administrative units or companies and trade associations. They also comprise external actors like the International Monetary Fund (IMF), the World Trade Organization (WTO) or foreign governments. The interaction of these actors affects institution building and enforcement in different areas including the management of the public sector, the interface of the public realm and the private sector, the formation of economic institutions as well as the institutional design which determines how a country is integrated into international structures. All of these areas are important for the initiation, formulation and implementation of transformation policies (see Figure 1). These actors’ activities are linked through formal and informal institutional arrangements for cooperation, coordination, and consultation. Usually, the state is the main and most powerful actor due to its coercive power and its capacities for institution building and enforcement. In addition, the *political and administrative institutions* of a governance structure play a key role, because they determine how different actors are involved in political processes and what kinds of economic reforms are politically feasible. But the state is not a monolithic entity – it is itself a complex, multifaceted organization the internal structure of which represents a complicated nexus of institutions which provide incentives (and disincentives) for political decision makers and bureaucrats to formulate and implement public policies (Ahrens 2002, Ebner 2005).

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<sup>5</sup> Ahrens (2002, p. 128); regarding these considerations see further Williamson (1985, 1995), Ebner (2005), and Kaul (2001).

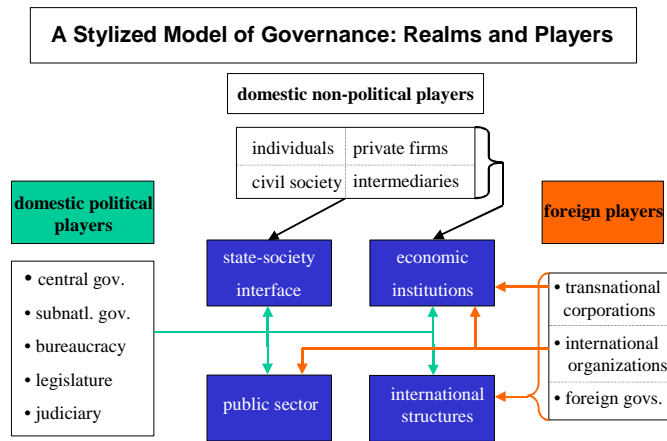


Figure 1: A stylized model of governance: realms and players

### *Governance dimensions*

Actual governance structures are based on countless formal and informal institutional mechanisms that guide policy formation and implementation.<sup>6</sup> Since the number of relevant mechanisms is extremely large and various mechanisms are of different importance in different countries, conceptual approaches and cross-country studies need to rely on relatively broad dimensions to assess the efficacy of a country's governance structure in a comparative way. In order to systematically find basic governance dimensions, the complexity of actual governance structures can be reduced by identifying distinct characteristics reflecting the quality of a country's institutions. Therefore, we start with the premise that rules, which ought to enhance the quality of policymaking, need to show the following characteristics: (1) they must be clearly defined and economic agents must be confident that they are properly enforced; (2) political and economic actors must know and understand the rules and be able to recognize whether or not they are observed; (3) the set of rules must be sufficiently flexible to allow for institutional change if preferences, technological conditions, or specific societal needs change over time. This also presupposes the existence of various channels through which individual actors or groups can initiate and contribute to institutional reforms; and (4) institutional safeguards must be in place that hinder powerful political and economic actors to arbitrarily circumvent or change existing rules at the expense of other actors or society as a whole.

These four characteristics can be subsumed under four dimensions of governance that comprise *predictability*, *transparency*, *participation*, and *accountability*. These fundamental principles can be used to characterize institutions which guide the strategic interactions among public officials and between policymakers, private businesses, and intermediate organizations. The better these principles are realized in a country's governance structure, the better the government is prepared to ensure a sound management of public resources, an enabling environment for emerging private-sector activities and a productive exchange of information between the public and the private sector.<sup>7</sup> In addition, *credibility* could be viewed as the overarching principle constituting effective governance. As numerous theoretical and empirical studies indicate, without commitments that are credible on the part of the policymakers neither effective policy reform nor sustained economic growth can be

<sup>6</sup> The following arguments are taken from Ahrens and Meurers (2002).

<sup>7</sup> For a discussion of these principles and imperatives for institution building see Ahrens (2002).

expected (Borner et al. 1995) (see Figure 2). After all, a governance structure is *effective and market-enhancing* if it ensures that government policies are properly implemented, that private businesses can thrive within a given legal and regulatory framework and that the adaptive efficiency of both the polity and the economy is enhanced.<sup>8</sup>

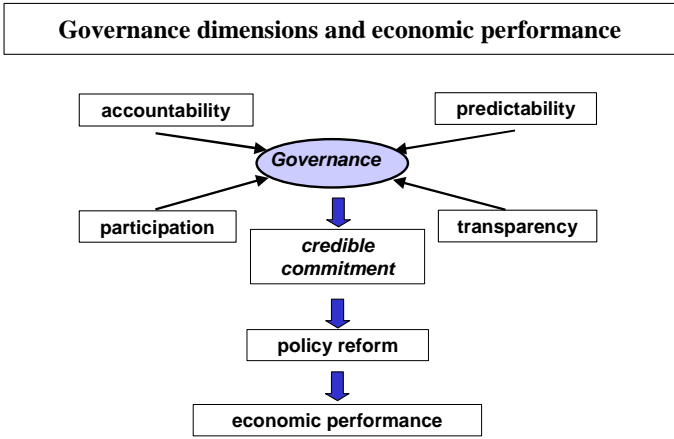


Figure 2: Governance dimensions and economic performance

The multi-faceted concept of governance is not only of crucial relevance for the formulation of overall economic transformation and development strategies, but also for policy implementation in single policy areas. Using a governance approach to strengthen, e.g., innovation policy appears to be promising because a governance perspective helps to account for the systemic character of a national innovation framework and hence contributes to avoid the creation of islands of excellence within the system, that would emerge if policies seek to strengthen the components of the system one by one.

A *market-enhancing governance structure* (MEGS) allows for a high degree of policy adaptability, is based on an adaptively efficient institutional matrix, and yields innovative and growth-promoting outcomes. A MEGS shows comparatively high degrees of accountability, participation, predictability, and transparency resulting from interdependent and mutually reinforcing institutional and organizational arrangements. These include a high degree of state capability as a precondition to protect property rights, enforce contracts, and conduct stabilization, innovation and other policies, capacity building in the public and private sector as a precondition for technically, administratively, and politically implementing public policies, the establishment of key economic institutions for enhancing and sustaining markets, and the creation of a public-private interface that improves cooperation, coordination, and consultation between policymakers, research organizations, and private firms.

*The pillars of a market-enhancing governance structure*

Four pillars constituting a MEGS can be distinguished<sup>9</sup>: First, the state needs to be sufficiently strong to implement policies and protect property rights and to prevent state capture by particularistic interests; secondly, the state needs to be adequately limited to prevent predatory behavior, rent seeking and corruption, of politicians and public officials; thirdly, particularly in transition economies it is also important that the public sector is subject

<sup>8</sup> Regarding the notion of adaptive efficiency see North (1990).  
<sup>9</sup> For a detailed discussion of these pillars, see Ahrens (2002) and the references therein.

to sustained capacity building in order to create appropriate technical and administrative skills to implement policies; and fourthly, principal economic institutions have to be established which constitute market exchange and foster economic growth.

### *Creating a strong state*

In many transition economies, the state has lacked the capacity to implement policies and to (impartially) enforce laws and regulations. In addition, it has not been frequently capable of preventing public officials from corruptive behavior and influential pressure groups from rent-seeking and distorting economic policies. Such a state is weak in Myrdal's (1989) sense.<sup>10</sup> Moreover, in order to exploit specialization advantages and to cope with the complexity of structural reforms, the government needs to delegate authority to the public administration, subnational jurisdictions, and private actors. This, in turn, creates principal-agent problems. Delegation causes information asymmetries and bears the risk that the agents do not act in the interest of the principal (the government) and pursue their own interests. Without a systematic control over public officials, policy and institutional reforms might be implemented by one bureau while another one counteracts them. As a consequence, economic agents would no longer trust in the government's ability to implement and enforce the policies according to its announcements. This may result in a system in which corruption and nepotism prevail so that the weak state might turn to become a predatory one (Root 2001). Therefore, a strong state is required that ensures stable, transparent, and predictable policymaking. Within a strong state apparatus, government officials and policymakers show a high degree of autonomy, i.e. they act sufficiently unaffected by vested interests of private actors. A further important factor is the establishment of a highly capable Weberian-type public administration acting relatively autonomously (Evans 1995).

### *Limiting the state*

"The fundamental political dilemma of an economic system" (Weingast 1995, p. 1) is that a strong government which guarantees citizens' rights is also able to violate those rights. In order to mitigate the problems arising from this dilemma, a strong state must be limited.<sup>11</sup> The state needs to be sufficiently strong to protect the rights of investors, workers, and consumers, but at the same time it must be constitutionally or otherwise restricted from infringing upon these rights. This presupposes institutional safeguards which tie policymakers' hands when narrow interests seek to alter laws and regulations at the expense of society. Such a binding mechanism should be designed so that limits are not only imposed on the present, but also on future governments. This is achieved by designing political institutions in a way that incentive structures for politicians and public officials are established which ensure that it is less costly for them to stick to the rules of the game than violating them (Root 2001). This appears as an unalterable precondition to secure a credible commitment of a government to sustained market-oriented policy reform.

In order to avoid predatory behavior and to reduce opportunism of government officials and bureaucrats, horizontal institutional checks (e.g., in the form of separation of powers) as well as vertical institutional checks (including decentralization and federalism) have to be promoted. With respect to the former, the agenda control of one agency may be limited by giving veto power to at least one other public or private organization. In addition, an

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<sup>10</sup> Regarding these deficiencies in numerous PSCs, see, e.g., the recent Transition Reports of the European Bank of Reconstruction and Development.

<sup>11</sup> This is in line with McIntyre's observation of a U-shape relation between institutional configuration and governance which means that both a centralized and a fragmented political framework are unfavourable for good governance, see McIntyre (2003), p. 160-62.

independent judicial system can contribute to make governments and bureaucrats stick to the rules of the game. Institutions that establish the rule of law contribute to lower transaction costs if they foster transparent and predictable economic and political processes and limit corruption and rent-seeking. In addition, independent watchdog organizations may contribute to enhance government accountability. With respect to vertical institutional checks and balances, the concept of market-preserving federalism (MPF) is expedient. Finally, the exposure of the domestic economy to competition on world markets as well as membership in international organizations such as the IMF or the WTO can help to limit the power of governments (Qian 1999a, Ahrens 2002).

### *Creating capacity for policy implementation and rule enforcement*

A further key constituent of a MEGS is capacity building. While narrow definitions interpret capacity building as improving the skills of public servants, broad definitions risk blurring the edges between the notions of capacity building and governance (World Bank 2000). For the purpose of this study, capacity building encompasses those activities which enhance the public sector's accountability, participation, predictability, and transparency. Capacity building is a major means to improve the effectiveness and efficiency of governmental activities and include institutional reform, organizational strengthening, and human resource development. Institution building refers to replacing existing institutions with more efficient ones; organizational change relates to altering organizational structures to better suit the new set of institutions; and human resource development refers to training people to act in line with new institutions and organizational structures (Grindle 1997). The objective of capacity building is to enhance the credibility of the public sector through the creation of a professional public administration that ideally establishes, complies with, and secures the economic order and its legal and regulatory framework, dissipates relevant information, and effectively pursues the tasks it has been given authority to do. Essential institutional arrangements, including the introduction of hard budget constraints and meritocratic elements within the bureaucracy, are to be prioritized contingent on country-specific necessities when conducting institutional reform (Ahrens 2002).

### *Building economic institutions*

Formal economic institutions constitute the fourth pillar of a MEGS, because they determine the incentives for economic activity in a country. Therefore, the answer to the question as to why some countries are more developed than others is closely related to the set and the quality of a country's economic institutions (Acemoglu et al. 2004).

The German *ordo-liberal* school analyzes the institutional framework of a market economy according to distinct constituent principles, all of which support the functioning of a market-price system as an economy's main allocation mechanism (Streit and Wohlgemuth 1997; Wagener 2004). The constitutive properties comprise the protection of private property rights, the guarantee of free market entry and exit (open markets), the freedom of contract, the stability of the monetary system, liability for economic actions, and the steadiness and predictability of economic policymaking (Eucken 1952/1990). The state should only intervene in the market if the intervention is market compatible and does not harm the price mechanism. In order to maintain a functioning economic and social order, regulating principles complement the constituent ones. Market failures are to be corrected through anti-trust institutions or interventions in order to guarantee the functioning of the price mechanism. In order to maintain social peace, income distribution needs to be corrected, social safety nets to be installed and employee rights to be protected (*ibid.*).

With regard to economic institution building, policymakers can basically follow two

different strategies. First, the government adopts the economic institutional matrix from a ‘best-practice country’. Such a strategy has often failed in history, because social norms, values, and beliefs change more slowly than formal economic and political institutions and thus impede a big bang approach of institutional change (Roland 2004). Alternatively, governments may use local knowledge to build economic institutions in a more gradual process. This might, on the one hand, meet country-specific needs and be compatible with persisting informal institutions. But on the other hand, it does only to a limited extent capitalize on experiences of developed nations with institution building.

The four pillars of a market-enhancing governance structure (see Figure 3) are usually not perfectly built in any country. And, in fact, there are no blueprints regarding single institutional components of each pillar and with respect to the process of developing such institutions. The history of today’s most advanced economies in Europe and North America as well as contemporary experiences of successful transition economies reveal that effective governance is highly country- and time-specific. This also implies that MEGS cannot be completely crafted by governments, political advisors, or international organizations. As will be argued in the next section, the most successful transition economies in CEE and East Asia managed to craft governance structures which basically fit into the governance concept introduced above, but show distinct country specificities.

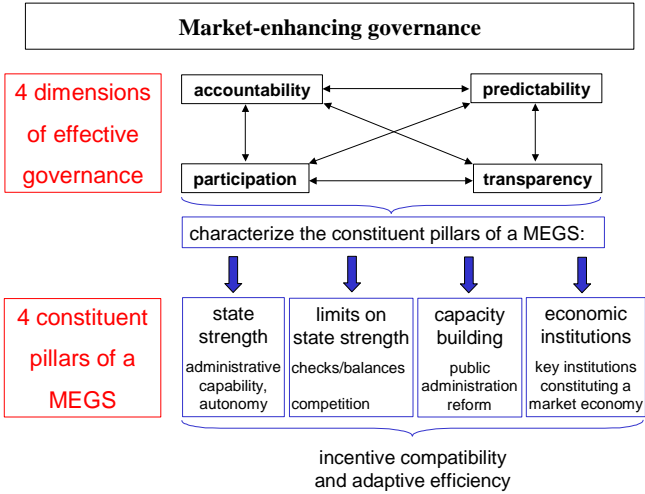


Figure 3: The pillars of a market-enhancing governance structure

**4. Governance in transition economies**

*4.1 Towards best-practice governance?*

Basically, there are many institutional arrangements which can help to form a MEGS. Different institutions, e.g., can contribute to bring about a strong state or to limit a strong government. Regarding the former, one may think of anti-corruption agencies, meritocratic recruitment and promotion rules in the public sector, centralized economic planning boards among others; with respect to the latter participatory policymaking as well as general, free, and secret elections as in a Western-style democracy come to mind. Moreover, regarding capacity building in the public sector, many scholars usually think of introducing new management rules or market-oriented procurement regulation into the public administration,

and finally with respect to economic institutions private property rights and competition rules range high on the to-do list of transformation policy.

Due to the complex task of systemic transformation, scholars as well as policymakers are inclined to search for best-practice experiences from other successful countries. This was true at the beginning of the 1990s when the so-called Washington Consensus (originally compiled for debt-ridden countries in Latin America in the 1980s) was sought to be applied to most if not all transition economies. Several years later, new insights emerged due to the experiences in the early phase of transition. In fact, the Washington Consensus type of policies emphasized essential policy measures in an era of transition (such as stabilization and liberalization), but they neglected institution building (except for private property rights). However, especially the failure of IMF-led transition programs in countries such as Russia revealed that liberalization-cum-privatization approaches did not automatically bring about efficient and sustainable market structures. Without consideration of political and societal conditions as well as institutional restrictions, an efficient and politically feasible transformation policy could not be implemented.<sup>12</sup> This was taken into account during the subsequent debate about so-called second-generation reforms, when institutions were considered essential also from the viewpoint of analysts with a more neoclassical background. The next step was to identify best-practice institutions in order to make policy reform effective, market forces work, and eventually overcome state failure. An emerging consensus among scholars of economic development and transition as well as international organizations suggests that a distinct set of core institutions can be identified which spur economic growth and sustained development.<sup>13</sup> According to this view, key institutions, which should be crafted as quickly as possible, include, among others, the rule of law, private property rights, an independent judiciary enforcing private contracts impartially, thorough regulation to safeguard economic competition, sound corporate governance structures and a transparent financial architecture, undistorted markets characterized by low rents, social insurance, democratic accountability and participation rules, checks and balances, and strengthening civil society (Khan 2002, Bardhan 2003).

Basically, these Western-style best-practice institutions may represent a useful reference point for less developed countries and transition economies. However, economists advising governments on institution building have often neglected the *processes* of how these institutions are developed, agreed upon, and enforced. Frequently, initial conditions persisting in a country are ignored and policy advice is driven by the presumed desirable goal of transition (i.e., Western-style best-practice institutions), and not by the search for a politically feasible path towards that goal (Qian 2003). In particular, it is hardly discussed that institution building needs to be driven by political actors in numerous cases and, hence, that it must be in the interest of these actors to craft those institutions.

The “liberal-market consensus” (Khan 2002) appears to suggest a benchmark for institution building which is to be achieved in a straightforward linear trajectory of institutional reform as quickly as possible. What is more, yet another consensus began to emerge even more recently which goes beyond institutions. Since it is not single rules but the interplay of economic and political institutions which is crucial for economic performance, scholars and practitioners came to agree that governance matters. And again, we observe a

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<sup>12</sup> Of course, some scholars had already taken those difficulties in policy formulation and implementation into consideration in early stages of transition. Some scholars questioned the Washington Consensus approach per se, whereas others postulated an explicit evolutionary-institutional transition concept which focused on microeconomic aspects such as asymmetric information and agency problems among others; see, e.g., Roland (2000) or Murrell (1995). This strand of analysis and policy advice, however, did not gain significant influence in the policymaking circles of CEE.

<sup>13</sup> Note in this context, that policy advisors as well as the international donor community may be also adaptive to new experiences and insights. The World Bank (2000), e.g., explicitly concedes that so-called best-practice models regarding governance and institution building may not be feasible.

new quest – this time for best-practice governance structures. Against the background of the liberal-market consensus, which still dominates numerous policy circles, think tanks, and academia, a governance structure, which is argued to be a precondition to structural change and sustained economic growth, ought to be modelled according to a Western-style governance model. This view is frequently supported by the fact that numerous people see a liberal democracy with particular social, economic, and environmental standards of advanced economies not only as an instrument fostering economic development, but as an end in itself.<sup>14</sup>

The following sub-sections explicitly portray the emerging governance structures of two different success cases in economic transition – the group of EU accession countries in Central and Eastern Europe as well as China. It is argued that best-practice governance structures cannot be defined due to different initial conditions faced by transition countries, different economic structures and stages of economic development, different political interests and different societal preferences. Instead, in CEE and in China (as well as in other transition countries) distinct governance structures have been emerging. In the successful cases of the EU accession countries and China, the emerging governance structures have proved to be market-enhancing and, hence, served as catalysts to economic transition. In both cases, these MEGS contributed to positively affect the respective government's credibility and improved the attraction of these countries as a destination of investment and production despite completely different initial conditions and economic transformation strategies. Although both cases differed from one another, both fit into the analytical comparative concept of governance outlined above. Even if none of the countries was able to bring about a perfect MEGS, governance-related institutions in all countries scored comparatively high according to the four dimensions of governance – 'comparatively' relating to a comparison with other countries at a similar stage of economic development or in a similar phase of transition. Also, the relatively good performance in terms of institutional quality has not necessarily related to all pillars of a MEGS equally. But in sum, the emerging governance structures have been conceived to be growth-enhancing and sustainable over time from the viewpoint of foreign and domestic investors, and the respective governments proved to be able to credibly commit to honor investors' rights and to foster long-term growth.

#### *4.2 EU accession countries: institutional shock-therapy and Western-style governance*

An institutional shock therapy according to the liberal-market consensus was in fact only implemented in the case of German unification, i.e. with respect to the transformation of the economic and political system of the former German Democratic Republic. But even in the case of the EU accession countries from CEE, institutional restructuring has been relatively fast and smooth. This could work in those advanced transition economies, because they had the clear vision to return to Europe from the very beginning of their systemic transformation process. Although the eight transition economies which joined the EU in 2004 have shown considerable differences in economic structures, political interests, societal preferences, and historical experiences, they are viewed as a group in this context. The reason is that all countries shared a similar cultural background, had historically not too distant experiences with market processes, and enjoyed the open-door policy of the EU. Furthermore, the early prospects of becoming a full EU member within a relatively short period of time helped to accelerate economic and political transition. The firm expectation of EU membership helped to form and reinforce a societal consensus for democratization and market-oriented policy

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<sup>14</sup> See, e.g., the arguments in Khan (2002), Feng (2003), and Kaufman et al. (2003).

reform, facilitated the implementation of structural and institutional reforms, and promoted the consolidation of the overall reform process.

In virtually all countries, the emerging broad consensus among policymakers, the business sector, and the electorate regarding the general direction of reform and transition favored relatively fast institutional transition. In addition, the EU served as an effective external anchor to economic, political and administrative reform providing forceful guidance through the so-called Copenhagen Criteria and the *acquis communautaire*, which was to be completely adopted according to a well-specified and commonly agreed timetable. In addition, the promise of EU membership clearly enhanced the credibility of domestic policymakers, and the attached conditionality gave them effective leverage to implement market-oriented reforms (see Figure 4).

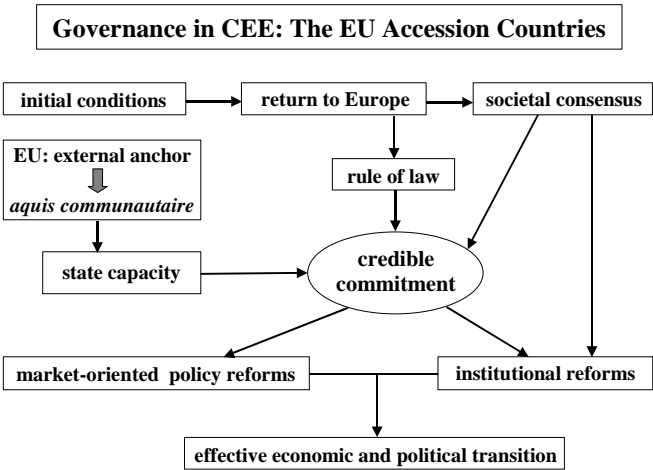


Figure 4: Governance in CEE: The EU Accession Countries

More specifically, governments in the EU accession countries increased their credibility through crafting appropriate institutions signaling commitment, changing incentives in the public sector and reducing the opportunities for discretionary politics.<sup>15</sup> First of all, EU integration involved governments signaling their determination to achieve their own goals as well as committing themselves to institutional integration. Second, the obligations originating from the new institutions reduced opportunism of policymakers and their potential propensity to arbitrarily undertake policy changes. Third, these obligations and the potential sanctions imposed for non-compliance altered the incentive structures of policymakers. The adoption of institutions which were consistent with EU standards, entailed that governments tied their own hands and committed themselves to pursuing sound institutional and economic policies (e.g., maintaining open domestic markets for economic transactions within the EU). This eventually helped delimit the influence of national vested interest groups (Piazolo 1998). The Association Agreements with the EU and the following membership negotiations considerably enhanced the credible commitment to institutional and policy reform and made public policymaking more predictable and transparent, because non-compliance would have implied a loss of benefits resulting from the Europe Agreements and postponement or even denial of EU membership. Finally, increased credibility further accelerated the pace and the efficacy of reforms, because investors had a stronger trust in political announcements and acted accordingly. EU membership will continue to play a key role as a supranational anchor to further improving governance quality, especially in public sector management, and overcoming *ex post* constraints to structural and institutional reforms, especially at a time

<sup>15</sup> The following considerations are taken from Ahrens (2002).

when more civic organizations emerge and vested interests are increasingly better organized and hence able to articulate their opposition to further reforms which they fear will bring about a further loss of rents and privileges. The experiences of the EU accession countries clearly illustrate that favorable geopolitical factors can reinforce transformation policies (once *ex post* constraints are increasingly binding), help enhance government capacities, and support the emergence of strong but limited governments. Hence, the existence of an external anchor to transition policies can considerably support the emergence of a MEGS.

In fact, the liberal-market consensus has quickly started to materialize in many CEE countries. An important reason for this is that policymakers could actually deliver many of their promises to citizens so that many expectations of the private sector have not been disappointed. Wagener (2004, p. 142), however, adds a further important aspect to this discussion by arguing that

“(j)oining the European Union is linked to certain minimum standards of good governance and at the same time accession candidates have to adopt a whole body of formal rules which will import covertly certain mental models, too. Nevertheless, countries like Bulgaria and Romania, officially recognised accession candidates, show much lower governance qualities than the Eastern Central European candidates and therefore cannot fulfil the Copenhagen conditions. That is to say, a possible short run positive EU effect cannot fully compensate for long run cultural conditioning.”

This finding clearly reminds us of the importance of informal institutions as well as path dependence in the process of economic and political transition. Effective governance cannot be completely crafted by enlightened policymakers (if they exist). Emerging governance structures will be always shaped by cultural belief systems, ethical norms, and conventions as well. This points to the limits of an external anchor as a catalyst of economic transition and capacity building in the public and private sectors and emphasizes the evolutionary character of governance structures.

#### *4.3 China: governance and transition with special characteristics*

The postulate of an institutional shock therapy has not played any role in the economic transition processes in East Asia, where transition has taken place in an authoritarian setting. In China, Vietnam, and Laos, the communist party enjoys a monopoly of power and is not willing to give up or share the political leadership with other political forces. Nevertheless, especially governments in China and Vietnam started genuine market-oriented reforms. Recognizing that political power can be only maintained in the course of time if sustained economic growth is achieved which benefits not only the political elite and big business but all strata of society, marketization and economic growth have become key policy objectives to gain political legitimacy.

The following considerations focus on China, a successful transformer and the fastest growing economy over more than the last two decades, and seek to identify basic features of the underlying governance structure. From the viewpoint of orthodox economic theory, China's success, particularly compared with other advanced transition economies, implies two puzzling observations: First, China did not apply theoretically-derived policy recommendations. On the contrary, Chinese authorities followed a gradual, pragmatic approach to reform, decentralize, and eventually transform the economy. Theoretical approaches which could explain why non-orthodox policy measures worked effectively in China were developed *after* it had become apparent to academics and policy analysts that these measures materialized and contributed to realize a long-term, sustained growth trajectory. Notable examples of these non-orthodox ingredients to the Chinese transition process include the dual-track approach to industrial restructuring, the establishment of

special economic zones, or the priority given to create competitive structures while postponing large-scale privatization of state-owned enterprises (SOEs).

Secondly and contrary to transition economies in CEE, the Chinese transition has been taking place without political democratization. Not having had to cope with an economic and political transformation at the same time, it is usually argued that China has escaped the dilemma of simultaneousness. In fact, a democratization process according to Western standards has been absent in China. But it has to be noted that even in China, as an impetus to and a consequence of economic transition, a gradual, though far-reaching change of institutions has taken place – a market-induced transformation of the Leninist state (Heilmann 1998) and hence the emergence of a post-socialist transition order. This change entailed substantial alterations of the country's governance structure.

China's economic transition process has not yet come to an end. So far, two major phases can be distinguished: The first phase (1978-1993) was characterized by gradual reforms which aimed to realize efficiency gains through reforms of the command economy. The second phase started with the decision of the Third Plenum of the 14<sup>th</sup> Party Congress in September 1993 to transform China's economy into a *socialist market economy*. Since then building market institutions and creating a rule-based market economy have become key objectives of transition policymaking (Qian 1999a).

During the first phase, political authorities developed and maintained their capacity to formulate and implement policy and institutional reforms despite increasing corruption and cleavages within the Chinese Communist Party (CCP). In the course of time, although being the ultimate power in Chinese politics, the central government managed to credibly limit its own power through decentralization, anonymous banking, and increasing openness vis-à-vis other economies. In this context, the incentive compatibility of policymakers at the national and the subnational levels has been of particular importance. In the absence of the rule of law and private property rights, economic growth could be propelled via increasing competition and distinct *transitional institutions* which proved viable in this particular environment. These institutions were not influenced by theoretical models, but relied rather on innovation and experimentation which was a major trait of early Chinese reforms (Qian 1999a).

An important step in the early phase of transition was the gradual reform of the agricultural sector through the introduction of the household responsibility system (i.e., a shift from collective to individual production and ownership) and a partial liberalization of certain goods markets. This helped to develop a nascent, but increasingly flourishing private sector at a time when restructuring of the state sector was off limits especially for ideological reasons. Another key characteristic of the Chinese transition process has been the gradual opening up of the economy. This did not only relate to foreign trade flows, but also to the attraction of foreign direct investment in special economic zones. This implied an infusion of new capital, technology, and skills into parts of the Chinese economy without exposing the whole economy to international competition from the very beginning. In addition, competition on domestic markets was strengthened and the power of the central government limited through decentralization and the emergence of a so-called system of market-preserving federalism, Chinese-style (Montinola et al. 1995). This system provided regional and local governments with relatively hard budget constraints, but also with incentives and means to conduct their own economic policies and to claim the residuals of so-called Township-Village Enterprises (TVEs), while the central government sought to hinder subnational governments to erect trade barriers and to preserve the common market.

In this period of reforms, TVEs contributed substantially to economic growth, while genuine private companies played an insignificant role. In advanced market economies, (local) government ownership would be less efficient than private ownership due to the costs associated with interventions in the market mechanism. However, in the special Chinese institutional setting, various reasons explain why ownership by local governments dominated

private ownership. Local governments were capable of protecting TVEs against ideologically motivated anti-private-property programs<sup>16</sup>, and it was easier for TVEs to receive bank credits.<sup>17</sup> As TVEs were governmentally owned, managers could be monitored and sanctioned by the local government, thus reducing principal-agent problems. But a major precondition for the emergence and success of TVEs was decentralization leading to market-preserving federalism. This system provided local governments with authority over local economic development and gave them the right to retain most of the local tax revenues.<sup>18</sup> But as the ideology against private property rights became less restrictive over time, the advantages of local government ownership were reduced. Consequently, local governments transformed more and more TVEs into individual shareholdings (Che 2002).

In the second period of transition, the gap to a MEGS has been further narrowed. The political process has become more institutionalized, although major decisions within the CCP are still made in informal bargaining arenas and the nomenklatura system has remained in place. But particularly the accession to the WTO confirmed the commitment of the Chinese government to gradually invigorate the rule of law as an additional limiting factor to its power. Moving closer to a rule-based economy, economic institutions have been more consistently enforced during the second period (particularly through the privatization of SOEs and the restructuring of the financial sector). This helped to enhance authorities' credibility and reliability from the viewpoint of economic actors including foreign investors, governments, and international organizations.

Summing up, it can be recognized that China gradually improved the quality of its governance structure, which favored the unfolding of market forces more effectively than governance structures in other transition economies or less developed countries (see Figure 5). Market-enhancing governance, Chinese-style, has neither followed a straightforward theoretical imperative nor has it yielded clear-cut lessons for other countries at the same stage of economic development. The Chinese case reinforces the view that institutions and governance matter, but that a best-practice approach, which fits all countries, does not exist. Basic principles such as accountability, participation, predictability, and transparency play a key role in China, too. Of course, these principles are not realized as they are in advanced democratic Western economies. Accountability of the political leadership, e.g., can hardly be observed with respect to citizens. But relatively effective monitoring devices help to hold the public administration accountable vis-à-vis the central government, and the institution of MPF in combination with a comparatively autonomous economic bureaucracy also contribute to enhance accountability and incentive-compatibility within the public sector as well as the participation of lower-level governments in economic policymaking. Moreover, policy choices faced by Chinese policymakers at the national as well as the regional level appear to be comparatively transparent and predictable. Since it is in the interest of most, if not all, political actors concerned with economic policymaking to foster overall growth and development, due to the competitive character of the MPF system and due to the openness of

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<sup>16</sup> Che and Qian (1998a and b) argue that local governments were less likely to be expropriated than private owners as the local government used TVE rents for improving the provision of local goods. Thus, the interests between central and local governments were better aligned than the interests between the central government and private owners.

<sup>17</sup> First, banks were exposed to less risk when lending to TVEs as the local government could bear some of the banks' risk due to cross-subsidization among its various TVEs. In addition, the fact that the local government protected the TVE's property reduced default risk. Second, local governments capitalized on their personal relationships to state-owned bank managers; see Qian (1999a).

<sup>18</sup> Qian (1999a) argues that the local government founded their own business rather than taxed private businesses as it was cheaper to extract rents from the own business. Following the same argument, the central government faced difficulties to take away proceeds from TVEs; in addition, Krug and Hendrischke (2004) argue that a high amount of social capital might have facilitated the emergence of entrepreneurship in China in the absence of secure property rights.

the overall Chinese economy, private economic actors tend to have relatively stable expectations regarding the course of economic policymaking in the short as well as the long run, although authorities still tend to intervene selectively particularly into processes of distinct branches of the economy such as the financial sector.

Furthermore, the political leadership managed to enhance its legitimacy and its credibility from the viewpoint of citizens through its distinct approach to economic restructuring. The introduction of market forces, initially mainly through partial liberalization of agricultural and other goods markets and the establishment of the household responsibility system, allowed the rural population to gain from market exchange. In addition, the dual-track approach applied in the context of industrial restructuring introduced market elements, but also maintained basic rules of central planning. The former provided incentives to use and benefit from the market, while the latter (at least temporary) helped to preserve rents for those who may be negatively affected by the shift towards a market system. Taken together, the household responsibility system and the dual-track approach provided a new kind of wealth sharing mechanism that helped to reduce the number of losers from market-oriented reforms. This, in turn, contributed to political stability and thus indirectly supported economic growth processes (Lau et al. 2001).

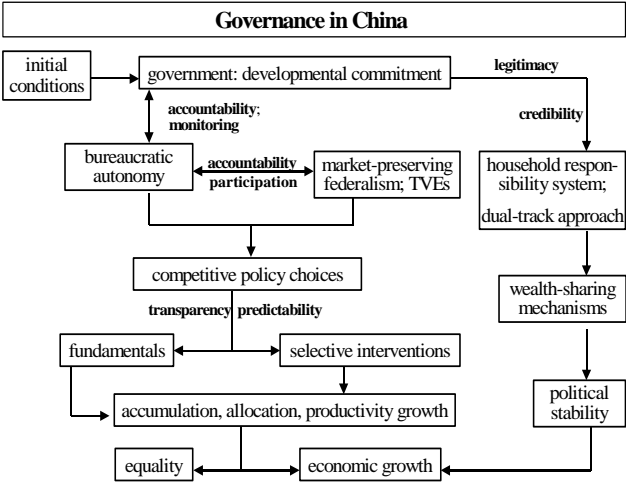


Figure 5: Governance in China

The Chinese experiences indicate that governance quality is a relative as well as a dynamic factor: It is relative because the quality needs to be assessed with respect to the country’s stage of development and regarding the governance quality of other economies which may compete for mobile factors of production. It is dynamic because different stages of economic development, varying international environments, and changing political side conditions may render hitherto effective governance structures obsolete and demand new institutional arrangements which are suitable to cope with these new challenges to policymaking.

While the Chinese governance structure has performed comparatively well according to key governance dimensions, the transitional institutions such as the dual-track approach, SEZs, and TVEs, which constituted this governance structure, can hardly serve as the foundation for future development. Therefore, the way to sustainably improve the market-enhancing characteristics of the Chinese governance structure in a globalizing world is complicated and demanding. Particularly, the lacking accountability of the central government, the still weak rule of law, the vulnerable financial system, and the restructuring of the SOEs need to be addressed in order to establish a sustainable, development-promoting MEGS in the future.

## 5. Conclusion

How to craft a market-enhancing governance structure that is suitable as a politico-institutional foundation of effective economic transition? The preceding considerations showed that basic elements of governance structures can be manipulated or crafted by political means. However, policymakers, bureaucrats or other actors affecting the design of a governance structure can never completely anticipate all future contingencies. Furthermore, numerous actors affect governance structures, either through comprehensive reforms such as restructuring a country's system of health insurance, or through smaller changes, e.g., firm-specific labor-market regulation. Usually, it is extremely difficult to ensure proper coordination of all actors, sometimes actors may actually not be interested in cooperating at all. This implies that certain changes in a country's governance structure can be consciously planned, but that the governance structure as a whole is subject to evolutionary change. It also follows that looking for best-practice governance or transferring governance structures from one country to another will be doomed to fail; the more so as such a transfer could not account for existing cultural endowments and the stock of social capital.

Even in the successful transformation countries, governance structures are not perfect. But in each case, they exhibit key characteristics which help to enhance government commitment to economic growth and development. In all those countries, numerous institutions underlying the governance structure score comparatively high according to the four governance dimensions; either because countries such as the new EU member states have sought to implement Western best-practice institutions (which in their cases materialized) or, as in the case of China, because effective transitional institutions could be crafted which represented functional equivalents to orthodox market institutions.

Moreover, singular events (such as Deng Xiaoping's tour through South China in 1992 which gave the transition process a new, maybe a critical impetus) or the historical moment in which a country finds itself (such as the breakdown of the Berlin Wall and the option for many countries in CEE to return to Europe) may crucially affect a society's development trajectory. Even in those situations, which may be basically favorable to economic transition and development, success is far from clear. Singular events and favorable historical moments may serve as trigger or catalyst, but they cannot substitute for good institutions and determined political leadership. The existence of policymakers who seize those opportunities and seek to craft a politico-institutional foundation, which helps to make effective market-oriented reforms a viable policy choice, are an unalterable precondition to successful transition.

Finally, the main findings of the preceding considerations can be synthesized as follows: First, governance can be viewed as a dynamic process, and policymakers need to take care that policies match institutions et vice versa. MEGS are subject to change over time; they require permanent fine tuning and adapting institutions as well as policy solutions to changing social, economic, and political environments.

Second, the capability of crafting and adopting country- and time-specific institutional structures is as important to effective governance as the formulation of policies. Which institutions are suitable depends on the stage of economic and political development as well as on persisting informal institutions.

Third, political legitimacy is an indispensable prerequisite for an emerging societal consensus in favor of distinct transition strategies.

Fourth, credibility, an independent, but accountable administration, and social consensus favor the emergence of a strong but limited government that guarantees political stability and increased governance capacity.

Fifth, a Western-style democracy is *not* a universal model of development or a precondition to economic transition; effective governance is independent of the form of government.

Sixth, while the initiation of policy and institutional reform can be facilitated by discretionary authority of policymakers and political institutions which shield policymaking from the influences of vested interests, their consolidation presupposes stable expectations with respect to the new institutional matrix underpinning the market system, and private actors must be confident that these rules cannot be arbitrarily changed or violated by the government and its agents.

These considerations illustrate again that a universal MEGS does not exist. But the ultimate objective of crafting flexible governance structures is the same in all countries, namely to establish strong but limited governments which are embedded in institutional structures that are conducive to promoting the quality of the core dimensions of effective governance.

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