

Conference to mark the 90th birthday of Prof. János Kornai, Budapest, 21st and 22nd February 2018

Theme: Importance of Kornai's research for understanding the role of the state in the economy.

Title of Paper: State-Building for the Market Economy in Eastern Europe

(by Paul Hare, Emeritus Professor of Economics, Heriot-Watt University, Edinburgh, UK;

e-mail: paulhare10@gmail.com and p.g.hare@hw.ac.uk)

DRAFT, January 2018

Author bio

Professor of Economics at Heriot-Watt University since 1985, now officially retired and mainly working as an international consultant, mostly in the Caribbean, but also recently in Tajikistan, Kuwait and North Korea. Worked on transition economies since 1990, with many research grants, consultancy contracts, and publications. Author of *Vodka and Pickled Cabbage* (2012); co-editor of, and contributor to *Handbook of the Economics and Political Economy of Transition* (2013).

Abstract of Paper

Kornai's earlier works like *Overcentralization in Economic Administration* and *Economics of Shortage* embody the idea that state institutions form a system with a strong tendency to reproduce itself, and hence to resist minor reforms. This is why at the end of socialism/communism, huge changes were needed in politics, economics, the law, etc., to build a new system oriented towards the market-type economy, which would again be stable and self-reinforcing (in other words, it was not supposed to slip back to communism). The interesting question now, given recent events in Hungary and Poland, is whether we have succeeded in building such a new system. More precisely, we thought we were promoting the development of new states/economies in Eastern Europe that conformed to the Copenhagen criteria for EU accession. Were we too hasty in thinking we had succeeded? Now, the new systems may not be slipping back to communism, and for the time being there is no sign that the basic norms of a market-type economy are being set aside, but there are concerns – and indeed some quite difficult conceptual issues – arising at the interface between politics, law and economics. Some of this falls under the heading 'rule of law', some concerns the nature and role of the state, and a third area is the interactions between parliament, the executive and perhaps even the forces of law and order (police, army, etc.). Unavoidably, there is also an interesting international dimension here, represented by the shift from the Warsaw Pact and Comecon to NATO and the EU. This paper explores these issues in the light of some of Kornai's recent analysis of developments in Hungary, while also drawing on his very insightful earlier works.

JEL: N14, P30

Keywords: socialism, capitalism, transition, EU accession, rule of law

State-building for the Market Economy in Eastern Europe

1. Introduction

Already by the 1970s, and quite certainly by the 1980s, it was apparent that economically, the countries of Central and Eastern Europe (and also, indeed, the then Soviet Union) were lagging further and further behind the countries of Western Europe. The economic model of central planning, with varying degrees of partial reform in the different countries, was no longer delivering much growth, despite quite high rates of fixed capital investment; living standards were low and not improving; and shortages were endemic. As part of the system, most foreign trade took place *within* the socialist world under the auspices of Comecon, and in most of the region almost all property was in state ownership. Underpinning the economic framework was the established system of one-party, communist rule, over which the Politburo of the Soviet Union maintained close surveillance, severely limiting the possibilities for real change, either political or economic.

But change did finally come, starting in 1989 in the CEE countries, 1991 in the Soviet Union itself. Reaching this point was not easy, and political change was widely perceived as extremely risky, given the history of Soviet intervention in the region: Hungary in 1956; Czechoslovakia in 1968; Poland in 1981 (martial law imposed, under pressure from Moscow). Though by the mid-1980s, Gorbachev was stating repeatedly that the socialist countries should be free to choose their own paths of development, why would the partner countries trust the Soviet Union? Eventually, economic crisis and political mobilisation (led by the still officially banned Solidarity Trade Union under Lech Wałęsa) led Poland to make the first move. Round Table talks over two months (February to April 1989) created the office of President (separate from the communist party), a bicameral parliament (lower house, the Sejm; and a new upper house, the Senate) and agreed to hold free elections in June 1989. However, in this first free election, 65% of the seats in the Sejm were reserved for communist party representatives, reflecting the caution and nervousness that prevailed then: the Soviet Union could still invade to block these changes, many feared that it would do so; there was widespread relief when it opted not to intervene.

Following the Polish example, nascent Hungarian political parties and the communists engaged in their own Round Table talks from March 1989. In October that year the communist party (MSzMP – Hungarian Socialist Workers Party) reconstituted itself as the Hungarian Socialist Party (MSzP), establishing a new democratic Constitution and calling for completely free elections; these took place in March 1990. Other countries in the region rapidly followed the Polish and Hungarian examples, including the former East Germany (German Democratic Republic), with the Berlin Wall opening in November 1989, German reunification taking place in late 1990 – this required the acquiescence of Gorbachev, in exchange for some financial aid from Germany to the Soviet Union. In response to these momentous events across Eastern Europe, there was neither political nor military intervention from the Soviet Union, no attempt to prop up the failing communist regimes.

By bringing their periods of communist government to an end, mostly over a very dramatic few months in 1989 and early 1990, the CEE countries were clear that this also implied an end to Soviet-style economic management through central planning, and hence required a rapid transition to market-type economic systems. Successfully managing this transition was more easily said than

done, but the main elements of what came to be regarded as a standard transition 'policy package' were quickly understood, as follows:

- Macroeconomic stabilisation
- Price and trade liberalisation
- Privatisation and enterprise restructuring
- Extensive institutional change.

Naturally, different countries, depending on their precise initial conditions and the quality of their initial post-communist leadership, followed quite diverse paths of reform, with varying success. There was extensive debate both about the *pace of reform* and about the most appropriate *reform sequencing* (Gros and Steinherr, 2004; Turley and Luke, 2011; Portes, 1991; Dewatripont and Roland, 1995).

Even more interesting, from my standpoint, was the enormous emphasis given to institutional reforms across all areas of economic life. Having received a quite conventional training in economics, we mostly took for granted the institutions that enabled a market-type economy to function and flourish. True, I had worked for a long time on systems of central planning, so was well aware of an alternative institutional and political framework for managing an economy, and through the works of Kornai among others, also understood its shortcomings and failings. Despite my background, it still took some time for me to understand the sorts of institution a market economy needed in order to work properly. Without pretending to completeness, a preliminary list would include:

- Dismantling most of the administration associated with central planning, so ending price and trade controls, ending the issuing of plan instructions to enterprises (even before their privatisation), ending the practice where banks only provided loans for investment projects 'in the plan'. [Strictly speaking, this does not involve any new institution – but clearly, for a market-type economy to function at all, much of the old plan system had to be ended].
- Legal reforms; allowing private sector activity and new firm formation; property rights, business contracts, types of firm, bankruptcy rules, arrangements for settling business disputes, etc.
- Establishing the 'normal' arrangements for managing monetary policy, fiscal policy, including a more rational and conventional tax system (replacing a system where much tax revenue came from above-plan surpluses of state-owned enterprises), and including provisions for a social safety net.
- Establishing an institutional framework to manage privatisation (since clearly, the British approach with a separate Act of Parliament for each firm privatised was completely unworkable in the CEE countries).
- Numerous technical provisions, often sounding seriously boring but of great economic importance. Thus the establishment of property registers (who owned what), modern business accounting rules, development of financial markets, competition policy, regulation of employment conditions and employment rights, and much else came under this heading.

Getting all this right was not easy, and many mistakes were made on the way to building market economies. On the other hand, the basic features of a market economy took shape astonishingly rapidly in several countries, with lots of new businesses being set up, unexpectedly fast transfer of

most trade from Eastern markets (other socialist countries) towards the West (mostly the EU) accompanied by major changes in the structure of exports, and a good deal of foreign direct investment being attracted into the region. Overall, the critical point is whether the new institutional structures would be able to foster savings, innovation and entrepreneurship.

Quite soon it was apparent that these former communist countries not only wanted to shift to the market-type economic system, but also sought to move over from the Eastern system of alliances (Comecon and Warsaw Pact) to the Western system (the EU and NATO). The EU supported these aspirations, initially by means of Association Agreements, though the ensuing accession process was slow and complex. In 2004, eight CEE countries joined the EU (Estonia, Latvia, Lithuania, Poland, Czech Republic, Slovakia, Hungary and Slovenia), in 2007 two more joined (Bulgaria, Romania), and finally in 2013 Croatia joined the EU.

The problem is, signing up to the EU entailed much more than making the core reforms needed to establish a tolerably well-functioning market-type economy. For it meant adopting far more wide-ranging and intrusive economic measures (regulation and the like) than one might have advised these countries to implement had they not been seeking EU membership. Further, it also involved adopting the EU's political model as set out in the Copenhagen criteria and the more political chapters of the *acquis communautaire*. Essentially, therefore, by the time they became EU member states, the CEE countries had adopted the entire *EU model*, both its economic arrangements and its political practices. Even though one can well understand the political imperatives that brought us to this point, the important question that now arises is whether this model is actually viable and sustainable for the countries concerned. Logically, the question breaks down into two parts:

(i) Is the complete EU model needed to underpin a well-functioning market-type economy?

(ii) How far does the EU model conflict with the cultural and historical realities of some of the New Member States, and how important are such conflicts for their economic models?

In what follows we explore some aspects of these questions, especially part (i), by sketching some recent political developments in Hungary and Poland (Section 2), then reviewing some of Kornai's work and drawing out some relevant lessons (Section 3). This leads into an analysis of the 'rule of law', the nature of the state, and Parliament and the Executive (Sections 4 and 5). Section 6 pulls the main findings together, and concludes.

2. Recent Developments in Eastern Europe

In the past few years, both Hungary and Poland have elected right-wing governments which have chosen to implement measures that strengthen the power of the Executive over courts and the judiciary, and which have enhanced government powers in other areas, too. Both countries, along with some other CEE countries, have resisted attempts by the European Commission to persuade them to accept a designated share of recently arrived immigrants to Europe. In Hungary's case, so strong has been the opposition to these new arrivals that new border fences and controls have been erected along the country's southern border. In managing the recent migration crisis, collective action by an EU working together in broad harmony has clearly failed. Indeed, the December 2017

meeting of the European Council came close to acknowledging this failure, when it proposed that some alternative to the present mandatory quotes was needed, though without as yet specifying the likely shape of such an alternative.

2.1. Hungary

Kornai (2015), with an accompanying commentary, Hare (2015), documents what he terms Hungary's U-Turn, also drawing on detailed research by Scheppele (2012). Opinion (2012) also provides some useful insights. Even before the 'official' start of transition in late 1989, Hungary was quite well placed, as the country had already dismantled the more centralised aspects of planning, allowing enterprises substantial freedom to operate independently, and permitting various forms of smaller business to be established. Hence it was not really surprising that during the 1990s, Hungary showed rapid transition progress as measured by the EBRD transition indicators published each year (see *EBRD Transition Report*, various years). This evolution was undoubtedly aided by the large inflows of FDI attracted into Hungary. Similarly, the country was quick to implement most of the EU's *acquis* in preparation for accession. Thus by the time of its entry to the EU in 2004, Hungary had a well-functioning market-type economy based on private markets and the protection of property rights, and it fully complied with all the EU membership conditions¹. This included compliance with those political provisions concerning democracy, protection of minority rights, and the like. Hungary has not yet chosen to adopt the euro and join the Eurozone, though 'eventually' (at some unspecified date) it is treaty-bound to do so.

No one would claim that economic management in Hungary was always of the highest quality (and EU membership still left significant degrees of freedom for domestic policy-making), and many people in Hungary were disappointed at the country's slow catch up to the living standards of more developed member states. However, it was not until 2010 with the election of a new Fidesz government led by Viktor Orbán, and enjoying a two-thirds majority in the Parliament, that Hungarian politics started to change rapidly. Since 1989, it had been understood that proposals for constitutional change should involve wide consultation, including with the main political parties, but the Fidesz government was able to devise and pass a new Constitution for Hungary (termed the Fundamental Law) that came into force at the start of 2012, buttressed by an array of so called Cardinal Laws which themselves require a two-thirds majority in the parliament before they can be changed (Scheppele, 2012). These important changes in Hungary's constitutional order came about with virtually no consultation across the political spectrum.

Moreover, the new constitutional order greatly narrows the normal 'gap' between the executive power and the legislature, weakening or removing many democratic safeguards. The judiciary, too, can no longer be considered fully independent of the executive, one of the major concerns of Opinion (2012). Thus both the separation of powers, and the rule of law, have been undermined, as we discuss further in Sections 4 and 5. Further, important parts of the state apparatus have undergone significant centralisation, with local governments losing powers over schools and parts of the health service, for instance. At the same time, a degree of creeping privatisation, with some recent deals lacking transparency and openness, can be seen as weakening private property rights in Hungary.

¹ For discussion of these conditions, see Hare and Stoneman (2017).

As we shall see below, in thinking about a still evolving political and economic system such as that of Hungary, it is important to have in mind its internal dynamics – thus to draw on ideas of Kornai, does the system possess an internal logic that inherently steers it in certain directions rather than others? And just as important, it is often essential to distinguish between the official ‘rules of the game’ as they are formalised in legislation, regulations and guidelines, and how they function in practice through informal understandings and working conventions. This depends as much on the people holding certain key positions, as on the laws.

The EU, of course, has followed these developments in Hungary with interest and concern. The Commission did challenge the new Hungarian constitution in 2012 and 2013, requesting ‘clarifications’ from the Hungarian authorities. Although both the Commission and the Parliament have favoured adopting active measures to bring Hungary back into line with basic democratic principles, the EU member states have been reluctant to act (see Grabbe and Lehne, 2017). Hence little has been done and Orbán has not found it too difficult to resist EU entreaties. More recently, the Commission has referred Hungary to the European Court of Justice over two matters: (1) Hungary’s failure to cooperate with Brussels in regard to implementing immigration quotas; and (2) New laws about higher education and NGOs receiving foreign funding. The latter are seen as indirectly undermining the legal standing of the Central European University in Hungary, and have provoked widespread international protest.

2.2. Poland

In the early transition years, Poland was lucky in its political leadership and economic management, with the result that its post-communist recession was the shortest and shallowest in the region, and by 1992 the economy was already growing quite rapidly. The economy modernised quickly and incomes rose both absolutely, and relative to the EU average: in other words, there was significant catching up, albeit from a lower base than Hungary. The growth was accompanied by a good deal of restructuring, while unemployment rates remained stubbornly high. Nevertheless, some of the pressure in the job market was undoubtedly eased by the free movement of labour within the EU, in effect from 2004 with the UK, only later with other member states which opted to maintain some labour market restrictions for some years after Poland’s accession. Although receiving almost no foreign direct investment until the mid-1990s, once Poland finally reached a settlement (and significant debt relief) with its external creditors, FDI grew rapidly as the country was able to offer a well-educated workforce, and access to EU markets well ahead of the 2004 EU accession.

Poland has continued to perform well economically, and managed the 2007-9 world financial crisis impressively easily, experiencing at most a minor and short-lived slow-down in growth (see Gradzewicz *et al.*, 2014). This might have been helped by the fact that Poland had not joined the Eurozone (and still has not, even though its sound economic management would enable it to meet the Maastricht conditions), and was thus largely unaffected by the difficulties facing the zone. But effective supply-side policies undoubtedly also had a positive impact².

² It is interesting to contrast the relative transition experiences of Poland and Ukraine. Around 1990, these two countries had roughly the same per capita income, but by 2015 or so, Poland’s per capita income was about three times that of Ukraine, an astonishing divergence. For details, see Hartwell, 2016.

In Autumn 2015, Poland's Law and Justice Party won a majority of seats in the Sejm (lower house of parliament), and formed a new government, led by Beata Szydło until late 2017 (she was replaced by Mateusz Morawiecki, the former Finance Minister, in early December). She is a deputy leader of the Law and Justice Party, whose head is Jaroslaw Kaczynski. Thus he effectively determines the policy orientation of the party and government, and both leaders (as well as the new Prime Minister) share the party's pro-welfare and anti-migrant stance that secured the election success. Their goal is both to appeal to traditional Polish values regarding the family and the church, while helping those perceived to have benefited little from Poland's rapid development. Since the election, the government has delivered on its promises to improve social benefits. It has also taken several steps to enhance executive control over the judiciary leading outside observers like the Venice Commission to raise concerns over the rule of law, and more recently (like Hungary) Poland has not cooperated with the European Commission in accepting its allocated share of recent migrants from the Middle East and Africa.

Just as for Hungary, this has led to the EU starting an enforcement process against Poland. In fact in December 2017, the European Council invoked Article 7 of the Treaty on Economic Union³ for the very first time, an action that some have described as the 'nuclear option'. The first 'stage' of an Article 7 intervention involves the Commission submitting to the 'offending' member state's government a 'reasoned proposal' explaining how the principles of the rule of law are being violated, and specifying what actions are needed for the government concerned to comply once more with the EU treaties. Commission (2017) did this for Poland, giving the government three months (i.e. until late March 2018) to respond. Failing a satisfactory response, Article 7 provides for further measures, including the possible suspension of Poland's voting rights in the Council. However, this step requires a unanimous vote by all member states other than Poland, but Hungary has already stated that it would not permit such a vote to go through.

3. Kornai's Work and Lessons to be Drawn

For space reasons, it is clearly impossible to refer to all of the works of Kornai that would be relevant for this paper, and I shall therefore be extremely selective. On the workings and failings of central planning, I refer very briefly to Kornai (1959) and Kornai (1980); on the functioning of capitalism, Kornai (2013); and on the recent developments in Hungary in particular, Kornai (2015). Many other significant works by Kornai could just as well have been cited.

3.1. Central Planning

The really essential point here, brought out remarkably early by Kornai (notably in Kornai, 1959; but elaborated in much greater depth conceptually in Kornai, 1980), is that central planning was not a bad system due to avoidable administrative deficiencies or poor economic leadership. Quite simply, it was *inherently* a bad system for running an economy⁴. Informational and incentive issues identified by Hayek among others partly explained this, as did Kornai's understanding of the feedback mechanisms that operated within a centrally planned economy to ensure its inefficient

³ See Lisbon Treaty (2007), which consolidates the two main treaties under which the EU operates: the Treaty on Economic Union, and the Treaty on the Functioning of the Economic Union.

⁴ See Hayek, 1944, 1945; also Hare, 1991; and specifically on the soft budget constraint, Robinson and Torvik, 2006; Maskin, 1996; and Maskin, Kornai and Roland, 2003.

functioning. Thus partial reforms (such as reducing the number of compulsory plan indicators) always failed, as the internal workings of the system generated pressures to restore something like the *status quo ante*. Planned economies tended to generate shortage conditions (often associated with queues and rationing), were inimical to innovation, and state-owned enterprises enjoyed 'soft budget constraints' (SBCs). In the early postwar decades, the centrally planned economies did manage to generate quite respectable growth rates of GDP, though slower growth rates of consumption/living standards due to the over-emphasis on heavy industry. But the centrally planned model for the economy ran out of steam, and the political leadership in the various countries was too rigid to allow any experimentation with alternative models⁵.

3.2. Functioning of capitalism

In sharp contrast to the poor functioning of socialist economic systems, Kornai (2013), building on much of his earlier work, highlights some of the key institutional features that have enabled capitalism at its best to be economically successful, and to generate high and growing incomes. As Xu (2017) explains in his very interesting review of Kornai's book, Kornai sees capitalism as being underpinned by private-property rights, market coordination, and entrepreneurship. Taken together these tend to generate conditions of surplus (in contrast to socialism's shortage), support hard budget constraints (HBCs) (in contrast to socialism's SBCs), and foster innovation and the constant renewal of production. Departing from the equilibrium theories of mainstream neoclassical economics, Kornai sees capitalism as fundamentally dynamic, undergoing processes of creative destruction as was first discussed by Schumpeter (1942). In this model, innovation not only brings down production costs for existing and well established products and services, but far more importantly it results in new products that can rapidly displace the old ones – this is the creative destruction. Generally, private businesses are not protected by SBCs (e.g. subsidies, directed credits and other forms of state intervention) that might allow failing firms to survive, hence their survival depends on maintaining their competitiveness in an ever changing market.

In practice, neither socialist nor capitalist systems exist in completely pure forms. Thus even the most centralised socialist economies, as in the former Soviet Union, allowed limited operation of private production and markets, as in the widespread private-plot production and sale of foodstuffs, for instance. However, the scope of such private endeavours was always heavily circumscribed, subject to periodic crackdowns, and with no one enjoying private property rights that were assured and protected. Consequently, such activity was never permitted to develop sufficiently to threaten the basic internal logic and dynamics of the socialist system.

In capitalist economies, too, there are often some state-owned firms, commonly in key infrastructure sectors; public bodies delivering essential services (such as the UK's National Health Service, or NHS), along with diverse public services delivered by private firms. The latter firms are often selected by competitive tender, usually operate with fixed term contracts, and are expected to achieve a range of performance indicators. Despite the best efforts of the public authorities responsible for overseeing these diverse activities, however, the reality is that it proves politically and economically difficult to enforce HBCs on these activities and firms. Knowing this provides

⁵ Perhaps China, and more recently Vietnam, have learned from this bad experience in Eastern Europe, since they have allowed a great deal of market-oriented reform, even moves towards (quasi-)private ownership, while retaining overall Communist Party political control, along with a great deal of state ownership.

opportunities for gaming the authorities in ways that limit competition, raise costs, and probably also constrain innovation. This gives rise to a common dilemma in capitalist economies, namely how to ensure that public services are delivered to a good standard without interruption, while also keeping costs down, as well as fostering innovation and competition among service providers. Different countries find different, and quite diverse solutions to such dilemmas.

That said, as noted above it remains the case that the core institutional features of a capitalist economy concern the protection of private property rights (often discussed under the heading, 'rule of law'), market coordination (implying the absence of coordination by command or through an administrative hierarchy), and entrepreneurship (with no one needing official permission to set up a new business, or to pursue a new idea or business model). These are powerful conditions, and for all their undoubted and sometimes huge shortcomings, they have mostly served us well.

3.3. Recent developments in Hungary

Kornai (2015) carefully describes Hungary's U-Turn which, as we outlined above, appears to reduce the separation of powers, strengthen executive control over the judiciary, strengthen direct government control over parts of the economy (including to some extent the National Bank), and weaken many democratic safeguards. In short, the substantial recent changes in Hungary's constitutional order and related legislation serve to undermine the 'rule of law'. This gives rise to three inter-related questions important for the present paper:

Q1. Are the changes recently experienced in Hungary – political and economic – sufficient to undermine the functioning of the market-type economy in the country?

Q2. Additionally, do these changes, and other recent policy developments in Hungary, significantly conflict with Hungary's compliance with the EU's *acquis communautaire*? This question refers both to democratic values, and to the 'rule of law'.

Q3. Last, can we point to any internal dynamics within the Hungarian economy and political system that might lead to a reversal of recent changes?

Briefly, the answers to Q1 and Q2 appear to be 'yes', though it is too early and in any case unclear whether these answers yet imply notable economic harm to Hungary. Such harm could take the form of reduced inflows of foreign investment, lower GDP growth rates, perhaps more emigration of highly skilled people. To date there is little firm evidence for these kinds of impact.

Regarding Q3, I am inclined to be a little less pessimistic than Kornai. For Kornai sees many of the recent changes in Hungary as entrenched by the ruling party's use of its former two-thirds majority in the Parliament to make future constitutional changes and changes to Cardinal Laws and other new regulations and practices exceptionally difficult. This is an important point, and while the Fidesz Party remains strong (even though a bit less so than before), and while former governing parties still suffer from a serious lack of trust and credibility, nothing is likely to change very soon. But this situation can change, with Fidesz by no means guaranteed to remain in power more or less indefinitely. True, it would be surprising if another party secured a two-thirds majority, but constitutional amendments and other changes can still come about by consensus across party lines, and nothing that has so far occurred in Hungary prevents this – eventually. This doesn't quite amount to a dynamic that guarantees to restore the *status quo ante*, but it does show that the possibility is not (yet) ruled out. Clearly the Fidesz government led by Orbán has undermined

democratic values (Lendvai, 2017), and this is already a great concern to the EU as we saw above. But the changes already made could still be rolled back.

Against this perhaps naïve notion of mine is the observation that not only in Hungary, but elsewhere in Eastern Europe (e.g. Poland as we saw above), there is limited historical experience of democratic government, and a good deal of popular sympathy for relatively autocratic, nationalistic rule. In the process of EU accession, of course, those parts of the *acquis* that concerned democracy, the judiciary, protection of minorities, protection of the media, etc., had to be adopted and taken on board along with everything else. However, it is worthwhile to question how firmly ‘embedded’ the provisions in these areas became in the region’s nascent democracies.

4. The ‘Rule of Law’

The ‘rule of law’ is a complex and quite subtle idea, commonly misunderstood (Bingham, 2010). As regards the economy, it requires that private property rights (ownership, business contracts, etc.) are legally protected against infringement either by other private agents or by agents of the state itself. Such protection is not merely desirable *per se*, but is important for its role in creating the conditions to stimulate investment and innovation. For a predominantly private-sector economy to function well, it is also important for the state itself to enjoy similar protection against malfeasance by private agents, or indeed by other parts of the state. This last point implies that public ownership includes not just a state-owned firm at the national level, but can include ownership by, say, a local authority or regional government. These different levels of ownership also need due protection under the law⁶.

As regards the civil society, the ‘rule of law’ requires a similar duality: legal protection for citizens to ensure that both civil wrongs and criminal offences are treated with due process, in an open and transparent manner; and that citizens may also seek legal remedies against improper (and possibly illegal) actions by the state and its agents. Citizens also need mechanisms to challenge actions and decisions undertaken by the state (e.g. in the UK we have a process called judicial review, as well as provision for occasional public enquiries).

Taken together, all this quite correctly conveys the impression that a democratic state operating in accordance with the ‘rule of law’ is likely to seem quite messy, with lots of procedures and arrangements to block or delay significant change at the higher levels, along with much protection for individual citizens and private firms. Democratically elected political leaders might well find this frustrating, and seek remedies that enable them to speed up change and act more decisively; this is precisely why the constitutions of democratic states tend to embody numerous ‘checks and balances’, deliberately making change more difficult, and providing alternative ‘channels’ to protect private agents, both individual and firms. Usually this includes an active and free media.

⁶ It is worth remarking that at the start of transition from socialism to the market-type economy, when privatisation was under active consideration, the nature and ‘location’ of state ownership suddenly came to matter. In several countries, consequently, the first stage of privatisation was a scramble by different parts/levels of the state to establish who owned what. Previously, this had not mattered in the least. For under central planning, who cared whether a particular enterprise ‘belonged’ to Moscow City, the surrounding *oblast*, or a national ministry?

Can much be said about the institutional framework⁷ required to support the ‘rule of law’ in the sense outlined here? For space reasons, I limit myself to a short list that could readily be elaborated in great detail:

- Sound laws guaranteeing private property, protecting business transactions and contracts
- Laws to protect private individuals in their dealings with the police, the courts, etc.
- Laws to guarantee such fundamental rights as freedom of assembly, freedom of speech, etc. Also laws to protect minorities whether defined in terms of ethnicity, religion, sexual preferences, etc.
- Independence of the police service, the legal profession and the courts from the legislature (Parliament), with very limited and carefully constrained oversight from the executive.
- Independent media, not under the control of the executive, and with extensive freedoms to report. Laws on media ownership and regulation.
- Requirements for government to operate openly, with significant reports normally published promptly; ministries and government agencies accountable to parliamentary committees which also publish their evidence and findings openly and promptly.
- All public bodies to be subject to audit or other appropriate form of review by agencies set up for the purpose, free to produce and publish reports on topics of their choosing (though within the broad remit defined in law), substantially independent though possibly accountable to the Parliament.
- Published codes of conduct in place for ministers, members of parliament, civil servants and the like, with significant penalties for breaches.
- Legal framework to deter corruption by politicians and state officials at all levels, preferably overseen by an independent body vested with strong powers.

As soon as a list like that above is written down it is apparent that in many countries, several of the proposed provisions would prove to be seriously problematic. Most evident in this connection is the last provision on my list, concerning corruption, which several countries in Eastern Europe reportedly experience on a large scale. Not only does corruption serve to enrich an undeserving few, more importantly it can deter investment, slow down economic growth, and hence damage everyone’s living standards (except those most engaged in corrupt activities and deals). But politically, corruption can be an extremely challenging issue to tackle effectively, because of the powerful interest groups likely to be benefiting from it (Rothstein and Varraich, 2017).

The second most problematic issue is the third in my list, to do with fundamental rights and minorities. Provisions on these matters were essential for EU accession, and good practice is clearly regarded as a core element of the EU’s notion of a ‘democratic Europe’. But to some degree the area cuts across the historical and cultural traditions in the new member states, such as support for the Catholic Church in Poland. Hence in some countries, enforcing these rights as understood by Brussels is not seen as a great priority, nor is it considered to have much impact on economic functioning.

⁷ In a development context, this is discussed very nicely in Dam (2006).

None of the other issues on my list is straightforward in the sense of being easy to legislate for and implement, not least because effective implementation requires firm political commitment. This is far from always assured, partly because much of the above institutional framework was put in place very quickly, and countries are still learning what works (for them), what doesn't, and how to make changes that fit local conditions without losing sight of the core principles⁸.

Nevertheless, a properly implemented set of provisions to assure the 'rule of law' is very likely to be significantly self-reinforcing in Kornai's sense, at least as regards its impact on the functioning of the economy. This is because contract violations and other economically harmful behaviour can be challenged in the courts, and successful judgements against either harmful private behaviour or against unlawful actions by the state should be enforced. That said, for such a mechanism to work credibly and effectively, what matters is not merely the formal rules of the game, but the incumbents occupying various key positions. What happens, for instance, if a state agent simply ignores an unfavourable judgement, or even worse arranges for new legislation to cover the case, perhaps even taking effect retrospectively (well known to be a very bad legal principle)? Likewise, what happens if a wealthy and politically well-connected private agent ignores a judgement? If such things can happen with impunity, then the 'rule of law' is already a lost cause.

5. The Nature and Role of the State: Parliament, the Executive, Law and Order

We tend to think of a well-functioning state as one where there is a clear separation between the legislature, the executive and the judiciary. So important is this notion that it is often simply referred to as the 'Separation of Powers'. The idea was touched on in the previous section, now we elaborate a little more. The US Constitution was explicitly and deliberately written to embody a clear 'separation of powers' between the legislature (i.e. Congress, comprising a lower house, the House of Representatives; and an upper house, the Senate), the executive (led by the elected President, with senior Cabinet appointees being appointed by the President, subject to confirmation by the Senate) and the judiciary (system of Federal courts led by the Supreme Court, whose judges are appointed on the recommendation of the President, subject to confirmation by the Senate, but otherwise wholly independent of both the legislature and the executive branch).

In many other democratic countries, the executive (often simply termed, the government) is drawn from the legislature, though the government's activities and decisions have to conform to the laws currently in effect. Moreover, it is common practice that government cannot function without a budget in place that has been presented to and approved by the legislature⁹. The legislature is

⁸ After all, most countries where the 'rule of law' works tolerably well have evolved their current arrangements over centuries of experimentation and reform. In the British case, for instance, the process included a civil war, the execution of a King (Charles I), a short period as a republic under Cromwell (the Lord Protector), then the restoration of the monarchy (initially under Charles II). Since these 17th century 'events', our domestic politics has been far more stable, with many reforms, but no major wars, coups, or anything of the sort (though the boundaries of the British state have changed over time, with the union of parliaments in 1707 making Scotland part of the Union, and Irish independence being granted in 1922).

⁹ The brief shutdown of the US Federal Government in January 2018 is a graphic illustration of this point. In fact the US fiscal year runs from October 1st, and the US currently has no approved budget in place for fiscal 2017-18. Hence the US government is operating with a series of Continuing Resolutions (CRs) which extend forward the approved spending of the previous fiscal year in a strictly time-limited manner. The shutdown

generally independent of government and the judiciary, including the highest court, a supreme court or in some countries a constitutional court; at most there will be limited opportunities for the government and/or the legislature (e.g. through some form of judicial appointments committee) to have a say over the most senior judicial appointments. But such an influence is normally very constrained, and properly so.

The UK stands out in all this as departing from this 'standard' model. First of all, we have never had a written constitution¹⁰, despite a long history of writing constitutions for the countries of our former Empire, as part of their progress towards independence from Britain. Second, for centuries the top level of our court system was, essentially, a committee of the House of Lords¹¹ (the upper chamber of our Parliament), comprising the Law Lords. It was therefore formally part of the legislature, rather than being properly separate as the 'separation of powers' doctrine would entail. Since 2009, we have had a Supreme Court, created as part of the Constitutional Reform Act 2005, and the 12 Justices who sit on the court are barred from sitting in the House of Lords. Belatedly, therefore, we have taken some steps towards achieving the separation of powers (see Benwell and Gay, 2006).

What the UK's recent experience illustrates, though, is surely the importance of distinguishing between form and substance in constitutional matters. On the surface the UK looked like a country with very limited separation of powers, but there were conventions and practices in place that enabled what looked like a poorly designed system to function rather well. This is often the case. But it can cause problems for the EU institutions seeking to verify whether one or other constitutional norm is fulfilled in a given country being examined. For it is all too tempting to make a judgement based on the formal arrangements (i.e. very much a box-ticking approach), without digging down more deeply to learn how a system really functions. This depends on a whole range of informal understandings and practices, in addition to the formal arrangements themselves.

For Hungary and Poland, recent events have changed important aspects of their formal arrangements to do with judicial appointments, the functioning of the judiciary, and other constitutional and policy matters, and these changes have attracted criticism both from domestic opposition groups in each country, and from the EU. The separation of powers has clearly been undermined, and for the time being there cannot be any reliance on goodwill, informal practices or 'suitable personnel' to ensure outcomes better than one might otherwise expect. In both countries, the ruling political party has too much power to allow that. At least for the time being.

What this means is that as far as democracy is concerned, notably those features of democratic polities that form part of the EU's *acquis*, both Poland and Hungary now fall short of complying fully with the 'EU Model'. As noted, the EU is already taking enforcement action, but the treaty provisions for such action are quite weak and may not secure sufficient support from all the other member

occurred because one such CR was running out of time, and the Congress failed to agree a new CR in good time. Interestingly, when advising developing countries on public financial management matters, the IMF and other international bodies place great importance on the process of agreeing and approving a budget in a timely manner; for example, see <https://pefa.org/>. The US is not a good exemplar!

¹⁰ Among democratic countries, we share this distinction only with Israel and New Zealand.

¹¹ The House of Lords comprises the Lords Temporal and the Lords Spiritual, the latter consisting of 26 bishops of the established Church of England. In most countries nowadays, this would be considered an extremely anomalous composition, but it seems to have worked tolerably well for some centuries already.

states. Hence the EU is facing an interesting test of its determination and capacity to require member states to comply with the *acquis*.

Interestingly, in the economic sphere the EU's ability to insist on full compliance has already been tested, though most significantly in an area not formally covered by the basic treaties. Thus in the Eurozone it was understood quite early on that some coordination of fiscal policy might be needed, with limits on deficits, public debt and the like. This wholly reasonable idea gave rise to the Stability and Growth Pact, and since 2012 a European Fiscal Compact embodied in treaty form; 22 member states have signed up to this, namely the Eurozone countries and three others. While very laudable in its intent, several violations of these fiscal principles, including by some of the larger member states, have gone unpunished. In practice, enforcement occurs, if at all, through openness and transparency, in that published fiscal indicators show who is complying with the rules, who is not. What we have, therefore, is a form of what we call in the UK 'naming and shaming', where we like to think that public embarrassment can induce better behaviour. Sometimes this approach even works, though whether it can do so in an area as politically sensitive as fiscal policy¹² is uncertain.

On the other hand, this broad approach does seem reasonably efficacious in relation to EU member states' implementation of the Single Market rules, which are wide ranging and quite complex. The EU publishes each year a Single Market Scoreboard in which it gives detailed data on compliance for each member state (http://ec.europa.eu/internal_market/scoreboard/index_en.htm). This tracks new regulations and their transposition into domestic legislation, outstanding ECJ cases and compliance with judgements, and shows the progress by each member state over several years, including in comparison to the relevant EU average and targets specified in the Single Market Legislation. All this ensures that enforcement actions are kept fairly low key and routine, while it is clear the Commission pressure on any given member state will not cease while there remain issues to be addressed. Perhaps surprisingly, this fairly 'soft' approach to enforcement seems quite effective. Moreover, where these economic rules are concerned, both Hungary and Poland have a good record of compliance.

6. Conclusions

Kornai's writings, as we have seen, give us a very good understanding of the failures of central planning in Central and Eastern Europe, and provide a clear picture of the key economic institutions that had to be put in place across the region to enable a successful transition to a well-functioning market-type economy. Most importantly, and quite correctly, Kornai places great emphasis on: private-property rights, market coordination, and entrepreneurship. Sections 4 and 5 above sketched out how these basic ideas need to be elaborated to ensure the 'rule of law' and the 'separation of powers'.

In recent years, both Hungary and Poland have departed in various ways from the democratic/political aspects of the 'EU Model' while still largely complying with the EU's economic 'rules of the game'. EU enforcement of the 'democratic *acquis*' has so far proved both unwelcome

¹² Moreover, the economic analysis underlying the EU's fiscal rules is itself more than questionable, which gives member states an opportunity to depart from the rules using soundly based arguments.

(threatening sovereignty of a member state, undermining local cultural values, etc.) and ineffective (very limited sanctions). There is a significant risk that undermining the 'rule of law' in these countries could inflict damage on the economy, but there is not yet strong evidence for that. In the meantime, it is important to distinguish between those 'rules of the game' vital for sound economic functioning (thoroughly examined by Kornai in various works), and those that fulfil our preferences for an open and democratic polity. The notion of 'European values' is an important idea, very much forming part of the *acquis*, but perhaps not so critical for the operation of a market-type economy. This interface between the economics and politics is an area calling for much more research, both conceptual and empirical.

References

- Benwell, Richard and Gay, Oonagh (2006), 'The Separation of Powers', *Standard Note SN/PC/06053*, London: House of Commons Library
- Bingham, Tom (2010), *The Rule of Law*, London: Penguin Books
- Commission (2017), 'Reasoned Proposal in Accordance with Article 7(1) of The Treaty On European Union Regarding The Rule Of Law In Poland: Proposal for a Council Decision on the determination of a clear risk of a serious breach by the Republic of Poland of the rule of law', COM(2017) 835 final, Brussels: European Commission
- Dam, Kenneth W. (2006), *The Law-Growth Nexus: The rule of law and economic development*, Washington, DC: The Brookings Institution
- Dewatripont, Mathias and Roland, Gérard (1995), 'The Design of Reform Packages under Uncertainty', *American Economic Review*, vol.85(5), pp.1207-1223
- Grabbe, Heather and Lehne, Stefan, 'Defending EU Values in Poland and Hungary', Brussels: Carnegie Europe. <http://carnegieeurope.eu/2017/09/04/defending-eu-values-in-poland-and-hungary-pub-72988>
- Gradzewicz, Michał; Growiec, Jakub; Kolasa, Marcin; Postek, Łukasz; and Strzelecki, Paweł (2014), 'Poland's exceptional performance during the world economic crisis: New growth accounting evidence', *NBP Working Paper 186*, Warsaw: Narodowy Bank Polski
- Gros, Daniel and Steinherr, Alfred (2004), *Economic Transition in Central and Eastern Europe: Planting the seeds*, Cambridge: CUP
- Hare, Paul (2015), 'Comment on "Hungary's U-Turn" by János Kornai', *Capitalism and Society*, vol.10.
- Hare, Paul (1991), *Central Planning*, Chur: Harwood Academic Publishers
- Hare, Paul and Stoneman, Richard (2017), 'The Evolving Architecture of Europe: Functioning or Dysfunctional for the Twenty-First Century?' , *Comparative Economic Studies*, vol.59 (4).
- Hartwell, Christopher A. (2016), *Two Roads Diverge: The Transition Experience of Poland and Ukraine*, Cambridge: CUP
- Hayek, F.A. (1945), 'The Use of Knowledge in Society', *American Economic Review*, vol.34(4), pp.519-530
- Hayek, F.A. (1944), *The Road to Serfdom*, London: Routledge
- Kornai, János (2015), 'Hungary's U-Turn', expanded version of paper published in *Capitalism and Society*, vol.10 (2015), Budapest: Corvinus University of Budapest

- Kornai, János (2013), *Dynamism, Rivalry and the Surplus Economy: Two Essays on the Nature of Capitalism*, Oxford: OUP
- Kornai, János (1980), *The Economics of Shortage*, 2 volumes, Amsterdam: North Holland
- Kornai, János (1959), *Overcentralization in Economic Administration*, Oxford: OUP
- Lendvai, Paul (2017), *Orbán: Europe's New Strongman*, London: C. Hurst and Co.
- Lisbon Treaty (2007), See the website: <http://www.lisbon-treaty.org>
- Maskin, Eric (1996), 'Theories of the soft budget-constraint', *Japan and the World Economy*, vol.8, pp.125-133
- Maskin, Eric; Kornai, János; and Roland, Gérard (2003), 'Understanding the Soft Budget Constraint', *Journal of Economic Literature*, vol.41(4), pp.1095-1136
- Opinion (2012), 'Opinion on Hungary's New Constitutional Order', Amicus Brief for the Venice Commission on the Transitional Provisions of the Fundamental Law and the Key Cardinal Laws, various authors, edited by Gábor Halmai and Kim Lane Scheppele, Council of Europe
- Portes, Richard (1991), 'Introduction' (pp.1-15) to 'The path of reform in Central and Eastern Europe', *European Economy*, Special edition No.2, Brussels: Commission of the European Communities
- Robinson, James A. and Torvik, Ragnar (2009), 'A political economy theory of the soft budget constraint', *European Economic Review*, vol.53(7), pp.786-798
- Rothstein, Bo and Varraich, Aiysha (2017), *Making Sense of Corruption*, Cambridge: CUP
- Scheppele, Kim Lane (2012), 'The Unconstitutional Constitution', *New York Times Opinion Pages*, January 2nd (linked to Paul Krugman's blog, <https://krugman.blogs.nytimes.com/>)
- Schumpeter, J. (1942), *Capitalism, Socialism, and Democracy*, New York: Harper & Bros.
- Turley, Gerard and Luke, Peter J. (2011), *Transition Economics: Two decades on*, London: Routledge
- Xu, Chenggang (2017), 'Capitalism and Socialism: A Review of Kornai's *Dynamism, Rivalry, and the Surplus Economy*', *Journal of Economic Literature*, vol.55(1), pp.191-208

PGH/January 2018