Good Governance, Welfare, and Transformation

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Abstract

Market conforming institutions are a precondition for a thriving and stable economy. This is the upshot of the Washington consensus or, of somewhat earlier origin, the "Eucken hypothesis". Another hypothesis of Eucken has it that market conforming institutions are the product of a strong state. However, more general and more important than the strong state is good governance. In this paper I refer to it as the "Lorenzetti hypothesis". The paper tries to figure out the mechanisms by which good governance and economic order influence economic outcome. Then the two hypotheses are tested for two aspects of economic outcome: productivity as measured by GNP per capita over a wide range of countries and transformation success as measured by GNP growth over the European transformation countries. The tests confirm the theoretical expectation that good governance is more important than good order.

JEL codes: O1, P2

Keywords: Governance, Economic order, Development.

1 Introduction

In 1338-9 Ambrogio Lorenzetti painted frescos in a room of Palazzo Pubblico at Siena that have become famous under the name *Buon governo – mal governo* (Frugoni 1988). What we see, is a confrontation of good and bad governance and their consequences for town and countryside. Good governance is represented by personified virtues: *sapientia, iustitia,* and this in both forms: *commutativa* and *distributiva, concordia, fides, spes, caritas, pax, fortitudo, prudentia, magnanimitas, temperantia,* and likewise personified vices for bad governance: *tyrannia, avaritia, superbia, vana gloria, crudelitas, proditio, fraus, furor, divisio.* The consequences for town and countryside are displayed in many details: in the case of good governance flourishing fields outside the walls and thriving commerce within under the heading *securitas*, in the case of bad governance violence, war, destruction under the heading *timor.*

The iconographic program is a clear political economic theory which – freedom of the arts – produces simultaneously its empirical confirmation (Rubinstein 1958). The basic hypothesis reads: good governance creates security and trust and, hence, economic welfare; bad governance creates mistrust, anxiety, and uncertainty and, hence, is destructive. We will call it in the following the "Lorenzetti hypothesis". It should be distinguished from the Hobbes hypothesis according to which any government is better than the unregulated state of nature. The "Lorenzetti hypothesis" is as old as political theory and can be traced back to Aristotle, as the concepts of *iustitia commutativa* and *iustitia distributiva* do already show. In his *Politics* Aristotle (1977) saw the ultimate

objective of good governance in happiness (*eudaimonia*) by which he, however, understood virtue and wisdom rather than economic welfare.

Later, the so-called cameralists, 17th and 18th century German economists, have treated good governance under the name of good politics (gute Polizey) as one of their major research topics. The Aristotelian roots remained recognisable in the objective of economic policy – common happiness (Dithmar 1745: 134, see also Rieter 1993: 68), by which they understood welfare rather than Aristotle's eudaimonia. It is quite astonishing that this topic has been lost in economic theorising and only recently made its reappearance under the heading of good governance. Bad experiences with neoclassical growth theory in the context of developing countries and the inability to explain by traditional factors of growth the puzzle "why growth rates differ" (Denison 1967) in a satisfactory way brought back to front stage the state and its political achievements in the process of development. Institutions matter and different equilibria can result, depending on whether they function well.

Transformation of a totalitarian, basically administratively coordinated, system into a democratic one that is coordinated predominantly by markets and competition has been triggered by, among others, the perception of a serious deficit in welfare and happiness. It is a complex process: individuals' states of mind, entrepreneurial behaviour, and public policy will have to cooperate to get this process under way with a non-negligible chance of success. Public policy has a special task transforming the economic order by liberalisation, privatisation, stabilisation, and the installation of institutions that are essential for competition. It looks an impossible mission, since at the same time the political system has to be reconstructed from scratch. How the problem has been solved need not concern us here. What we see, 13 years after transformation began, are sufficiently differentiated success stories which make it possible to test our hypothesis: it was good governance that is responsible for success and bad governance for failure.

The next section will pay more attention to the concept of governance. A theoretical support of the hypothesis follows in section 3. Section 4 discusses the data that will be used in the empirical testing. The test is an ordinary regression model whose results will be discussed in section 5. In the conclusion we finally try to speculate about the causes of good or bad governance.

2   Good governance

The Greeks understood by the word πολιτεία, from which are derived terms like politics, policy, and police, such rules of a state on which its welfare is based. "So policy consists in a good order and constitution of persons and things of a community; political science teaches how the internal and external nature of a community can be preserved in good state for the happiness of the individual and all together. The internal nature of a state consists of the number of inhabitants, their Christian and virtuous life and conduct, health, civilisation, nourishment and wealth; the external, on the other side, consists of good order of persons and things as well as gracefulness of the country." (Dithmar 1745: 133-4; the baroque flavour of the quote is unfortunately lost in translation). What he means by good governance, the author explains in detail enumerating the institutions that are indispensable for general welfare: fear of god, peace, justice, education, health, economic activity, communal rules and institutions, free trade, a monetary system, and a legal system. What he does not touch in detail, is

government itself. In a rather absolutist tradition he merely states: "Policy is based on civil society according to which the prince is entitled to govern the actions and things of his subjects to preserve the commonwealth" (ibid.)

Modern discourse summarises the objects of good governance under the heading of social infrastructure which – in a good state – lowers transaction costs and allows for an undistorted formation of prices, with the result that economic subjects receive the greater part of the social benefits of their activities in the form of private income (Hall and Jones 1999: 84). Under bad governance substantial parts of the benefits are diverted against the will of the producers and distributed among people who did not contribute to their production and, hence, the producers will reduce their efforts after a certain period of time. A major element of social infrastructure is the economic system whose constitutive properties, as far as a competitive market order is concerned, have been known since Eucken (1952/1990: 254-89):

> a well-functioning price system
> a stable monetary system
> free entry and exit
> private property
> freedom of contract
> liability rules
> a stable economic policy.

Beyond the economic system, and closely related to it, the legal system, health and education, as well as culture play a role, of which the latter Dithmar had enumerated under religion, civilisation, and gracefulness of the country.

Social infrastructure is generally seen as a task of government. And this raises the question, to stay with Eucken (ibid.: 332), of: "How can the state become a power organizing a well functioning and free order of the industrialised economy?" (It should be noted that in German the abstract state is at issue, whereas in English one would rather ask about government.) This is again the same question about good governance, which Eucken too does not answer. The following definition of government in the sense of governance, and not in the legal sense, may be a point of departure: "the traditions and institutions by which authority in a country is exercised. This includes (1) the process by which governments are selected, monitored and replaced, (2) the capacity of the government to effectively formulate and implement sound policies, and (3) the respect of citizens and the state for the institutions that govern economic and social interactions among them" (Kaufmann, Kraay and Zoido-Lobatón, 1999a: 1). The three quoted authors, a World Bank team researching social infrastructure, try to operationalise the definition by confronting indicators of good and bad governance following, probably unwittingly, the model of Lorenzetti. They identify indicators for democratic selection and control of government, for its political competence, and for the relation between state and citizens aggregating them in six antithetic clusters:

Good governance	**Bad governance**
Voice and accountability	**Political instability and violence**
participation	unconstitutional conduct
democratic rights	interference of the military

freedom of press	political terrorism
government effectiveness	**regulatory burden**
transparent administration	incompetent personnel
credibility	market unfriendly policies
ability to compromise	ineffective judicial control
rule of law	**graft**
enforceability of contracts	corruption
predictability of courts	state capture
respect of the institutions	rent seeking

These are examples of indicators that can be pigeon-holed in the six clusters. Briefly summarised good policy is democratically legitimated, effective and credible, whereas bad policy is unpredictable, costly, and corrupt. Such properties are created not only by the formal institutions and their implementation, but to a considerable extent also by informal institutions, attitudes, and culture – the social capital.

3 Theoretical background

The "Lorenzetti hypothesis" looks intuitively self-evident: good governance creates welfare. Yet how it works in detail requires a theoretical explanation. One can conceive of a system production function as a grand relationship (Koopmans, Montias 1971, Kornai, 1971, Wagener 1979):

(1) $\quad Y^t \quad = \quad h(E^t; S^t; P^t)$
(2) $\quad S^t \quad = \quad \{R^t; O^t\}$
(3) $\quad P^t \quad = \quad \{P_O^{\prime t}; P_I^{\prime t}\}$
(4) $\quad W(Y^t) \quad = \quad W(y_1 \ldots y_j \ldots y_m), \quad j = 1 \ldots m \quad$ elements of the Y-vector.

The time superscript, t, is omitted whenever it is not needed.

Y is an m-dimensional vector of system outcomes over which performance is evaluated.

W is the Bergson-Samuelson social welfare function over the dimensions of Y. The preferences that are embodied in W, of whomsoever they may be, are culturally and historically determined.

E denotes the system's environment: external factors; which may include previous states of the system $\{Y^{T-1}, Y^{T-2}, \ldots, S^{T-1}, S^{T-2}, \ldots, P^{T-1}, P^{T-2} \ldots\}$ – the problem of initial conditions of transformation, for instance, and the phenomenon of path dependency.

P denotes the strategies or policies of the agents that can be directed onto different fields:

P_O are changes in the rules of the game or the economic and political order (constitutional policy).

P_I denotes direct interference and influence upon the outcome (interventionist policy).

The set P is not restricted to political or administrative agents, but encompasses also the strategies of private economic subjects – labour market decisions, investment, etc.

S is the system, i.e. the set of institutions which determine the playing field of the agents as well as their decisions; in the terminology we have used above it may be seen as the social infrastructure consisting of

O comprises formal institutions, the constitutional order, that can be influenced and constructed by political decisions; by definition this is the object of transformation policies aiming at a concrete reconstruction of the political and economic order

R are informal institutions or rules of conduct, traditions, attitudes, mental models, knowledge, all of which are not immediately accessible by political influence; this complex can be summarised as culture or as social capital; for the moment it is a very inhomogeneous conglomerate.

It looks, at first glance, as if governance could not be spotted in this taxonomy. The inhomogeneous conglomerate *R* does, however, contain variables that determine good or bad governance and thus influence directly the outcome *Y*. In the second instance, we may hypothesize indirect influences via *P* and *O* about whose generation nothing has been said as yet.

In order to generate a model we have to discern exogenous and endogenous variables. Y is evidently endogenous, and *E* seems to be exogenous by definition. However, if *E* contains previous states of the system, $\{Y^{T-1}, Y^{T-2}, ..., S^{T-1}, S^{T-2}, ..., P^{T-1}, P^{T-2}, ...\}$, it will be partly endogenised in a fully dynamic model: this is the phenomenon of path dependency. In simple words, the level of development is determined by policy, social infrastructure and social capital, but policy, social infrastructure and social capital will be influenced by the level of development. These variables show a kind of co-evolution. The same may be said of W. Transformation is clearly a case of changing preferences which cannot be assumed given and constant. It is possible, however, to assume that the preferences of the agents or elites are given and constant, but different agents or elites replace one another in the course of transformation. The policy makers at time *t* after the turnaround are others than those before, at $(t - \tau)$, $\tau = 1,2, ...$ This change has not so-far been sufficiently researched. We consider the turnaround an external shock and treat the new preferences as given. It should be clear that they are among the most tenacious elements of the social capital *R* with a strong impact upon governance. The attitude towards the law or Dithmar's fear of God comes to mind.

The strategies P are endogenous. They are influenced by the external factors E, the constitutional order O and the social capital R which, as seen, contains the preferences W. All that happens in the minds of the agents, whom we may assume to know E, S and the model *h*. They tune P in such a way that expected outcome $\hat{Y}$ will be optimised.

$$(5) \qquad P^* = \arg\max W^t (h (E^t; S^t; P^t)), \text{ and } \hat{Y} = h (E^t; S^t; P^*)$$

Other assumptions about the formation of *P* are also conceivable. By transformation we understand the conscious reconstruction of the economic and political order of a country, i.e. ΔO is at the centre of the exercise. Since *O* has been defined as those elements of the set of institutions that are accessible for political change, it is the result of constitutional policy

$$(6) \qquad O = k(P_O)$$

The aim is an improvement in the system's outcome, $\hat{Y}$, howsoever it may be specified. Formation of P is influenced by O and R: constitutionally excluded or culturally tabooed policies, for instance, are outside the choice set. There are similar approaches to a political economy of policy reform, such as the theory of actor centred institutionalism (cf. Mayntz and Scharpf 1995; Müller 1999). It explains policy choice by the actual situation E of the agents and by their modes of interaction determined by the structure of institutions S that constrain the agents. The policy maker need not be an optimiser, but can apply a rule of thumb, g,:

(7) $P = g[E; S; W(\hat{Y})]$

Good governance therefore has three major channels of influence:

through the preferences or the system of values of the agents,

through its impact upon the choice of strategies and policies by which the constitutional order as well as economic policy proper are determined, by which, above all, the individual economic subjects shape their decisions concerning production and investment,

through its direct influence upon performance which modifies the impact of order and policy, i.e. their effectiveness, in the same manner as good management in a company enhances the commitment and productivity of the employees.

Good governance implies good order and good policies. It could be sufficient, therefore, to concentrate upon these variables to explain differences in general welfare and in transformation success. This would imply that we should rely entirely upon the "Eucken hypothesis". Eucken identified the crucial variables of P_O: liberalisation (a well functioning price system and open markets), stabilisation (a stable monetary system and monetary policy), privatisation, the introduction of legal institutions that determine the rules of the game of competition (freedom of contract and liability rules) and a predictable government. And he assumed that a good order in these terms will produce welfare and growth. A similar program has become notorious under the name of the "Washington consensus" (Rodrik 1997). It has been criticised for neglecting the initial conditions, path dependency, institutions, the embeddedness of economic policy in politics and culture (e.g., Stiglitz 1999). In the context of our descriptive model it is quite plausible, however, that transformation policy should concentrate only upon those variables that are accessible to political influence, i.e., on the variables of O and P, at least in the short run. But regardless of how important these variables may be, transformation success will hardly be explained satisfactorily by O and P, even if there is good chance that a good policy choice is highly correlated with good governance, i.e. R.

The proposition that "economic welfare depends on good governance" does not invalidate the conventional theory of growth that explains welfare or productivity of a system by the accumulation of physical and human capital. The "Lorenzetti hypothesis" takes only one step further back, asking under which conditions such accumulation will proceed continuously. And it holds that the economic subjects will exert sufficient efforts if they find themselves in an environment with as little uncertainty as possible and if they are to benefit as much as possible from the fruits of their efforts. If we test the hypothesis, we need not control for the traditional factors of growth. For they are

exactly the major material channel by which good governance becomes effective. Another factor of growth, on a similar level as good governance, for which one should therefore control, is natural endowment with resources. One may presume that richer countries will produce higher welfare than countries less favoured by nature.[2]

Numerous empirical studies of transformation get to the result which Havrylyshyn and van Rooden (2000) have formulated succinctly: institutions matter in transition, but so do policies. Yet this is almost trivial, taking into account that transformation or the transition from a planned economy to market competition implies almost by definition a fundamental change of institutions and policies. In this context everything is important: politics, constitution and order, culture, social infrastructure, initial conditions, expectations (for instance, regarding integration in the European Union), actual policies, etc. The hypothesis to be tested here has it that good governance constitutes a primary factor of influence for successful transformation that works through formal and informal institutions and policies.

In the case of transformation the problem of causality can perhaps be solved in favour of good governance. If Weder (2001: 7) holds that "richer countries have a higher quality of institutions for a variety of reasons", she is implying a reverse causality. The question how these countries have become richer remains, however, unanswered. There is the co-evolution hypothesis: welfare and good governance develop over long periods of time, each individual sub-period of which recurrently linking up with the previous. In this context the proposition of Weder makes sense: rich countries are able to improve their social and institutional infrastructure more easily than poor ones and thus get richer. In transition we deal not only with richer and poorer countries, but also with those that overcome more or less rapidly the transformation crisis. And this may be ascribed, such is the hypothesis, not only to the initial conditions of welfare, but rather to social infrastructure or good governance.

Good and bad governance did exist mutatis mutandis also under the communist regime. What did not exist by definition was the productivity enhancing economic order of market competition. So we may be able to discern the two influences, or the "Lorenzetti hypothesis" and the "Eucken hypothesis", in this case. What does good or bad governance under the communist regime really mean? It was stated above that good governance implies a productive economic order, which certainly did not exist under communism. The reasons, however, were that communists had the conviction, a kind of a mental model regarding the function h in equation (1), that socialist planning creates a productive economic order, given the lack of contradictory experience. One may have qualms about speaking of good governance in the context of the dictatorship of the proletariat and of totalitarian practices in socialist states. Only few of the indicators of governance which were formulated above seem to be relevant here: participation, democratic rights, freedom of the press versus unconstitutional behaviour, intervention by the military, political terrorism; transparent administration, credibility, ability to compromise versus incompetent personnel, system-incongruent regulations, deficient legal control; finally observation of the constitution by citizens and government, enforceability of contracts, independence of the judiciary, predictability of policy versus exercise of public power for private gains, corruption, state capture, and rent seeking.

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[2] Although this is by no means self-evident, and phenomena such as the Dutch disease and corruption, i.e. a deterioration of governance, in the presence of natural riches (Leite and Weidmann 1999) show that this is not always the case.

Even if the level of governance on the whole was rather low by these standards, we can nevertheless discern – mutatis mutandis, of course – socialist countries with not so poor governance from those with very poor governance.

A second meaning of good governance in the context of communist political and economic systems and their transformation is based on the fact that this is a phenomenon of *longue durée*. Putnam (1993) is speaking of centuries necessary to build up an efficient social infrastructure, even though a liberal competitive market order can be installed within a short period of time, as the actual transition has proved. Transition countries with high quality of governance, then, are such where corresponding traditions existed. During the communist period these qualities were dormant, they may even have worn down, since the communist system had a general tendency towards bad governance. The differences in governance which are to be found in the transition countries can, for a large part, be ascribed to the pre-communist period. In this context one should remember the fact that the Soviet system has been introduced in most countries of Central and Eastern Europe on the tip of the bayonets of the Red Army, and it collapsed as soon as these bayonets were withdrawn.

Testing alternatively the "Lorenzetti hypothesis" vs. the "Eucken hypothesis", or the "Washington consensus", implies to document the different impact of a free market order and good governance. The basic hypothesis assumes that a competitive order is a precondition for success of transformation which finally comes with good governance. Since both, the constitutional order O and social infrastructure R, show strong collinearity – for we hold that a good order is the result of good governance, we cannot use them as control variables for each other (see Section 5). It is to be demonstrated that differences in transformation success cannot satisfactorily be explained by the institutionalisation of a market order: liberalisation, stabilisation, and privatisation. This would back the critics of the "Washington consensus" who underlined the importance of other institutions and social infrastructure. It does not imply, however, that the *policy* of the "Washington consensus" was wrong.

Seen over a longer period of time, governance is a highly tenacious variable. If we encounter good governance in year t, there is a high probability that we would have encountered good governance in year t - τ, τ = 1, 2, …, too. It follows that time lags are not needed when estimating the influence of governance – this is what the co-evolution hypothesis is about. Things are slightly different in the case of the economic order. It can be changed at rather short notice and then it needs a certain period of time until this change will show its effect. If we encounter a competitive and free order at time t, the probability of having encountered a similar order at time $t - \tau$ will be smaller than in the first case, even if the probability in conjunction with good governance, is positive. Here time lags do matter.

4   The data

The elements of good governance enumerated by Lorenzetti or Dithmar can be ascertained only subjectively. Nothing has changed in this respect with recent data about governance. We have subjective estimates of governance quality of a country which are produced by "experts" (e.g., international organisations, so-called think tanks, NGOs), by business people or by ordinary citizens. Comparable estimates presuppose comparable knowledge of individual countries. Business people who trade with different countries may be able to make such comparisons. However, they will rarely trade with

all countries with similar intensity. That leads to a differentiation in their perception. Data on governance, which are based only upon such individual observations, will therefore exhibit extreme variations. Somewhat more reliable should be data that aggregate subjective evaluations. The aggregated data are averages, most probably with wide deviations. In short, data on governance should be treated very carefully, since they are liable to show even greater errors than economic data in general.

The data on governance which are used here have been compiled by a research team of the World Bank and have been updated once (Kaufmann, Kraay, Zoito-Lobatón 1999b, 2002). They aggregate pre-aggregated observations of governance indicators, which have been published by 15 different institutions. This procedure estimates the unobserved governance components, namely the six clusters mentioned in section 2, from data on observed indicators. The reader is referred to the original source[3] for the model's assumptions and the exact method used. The result are point estimates and standard deviations for the governance components:

> voice and accountability
> political stability
> government effectiveness
> regulatory quality
> rule of law
> control of corruption.

For our purposes we have aggregated the six point estimates again by calculating their arithmetic mean. Standard deviations were lost by this procedure. But the general warning of the authors, not to over-interpret minor differences in governance quality, remains fully valid. The original observations are for the years 1997/8 and 2000/01 and the data are available for 175 countries among which are all transition countries in Eastern Europe and the former Soviet Union. We selected a sample of 103 countries from all continents which by their size are of some importance and where the number of original observations was large enough to make the estimate of governance quality more or less reliable.

To test the "Eucken hypothesis" we need data on the institutionalisation of a competitive market order. The components which have been mentioned as relevant can be observed more objectively even if it may not be so in every individual case. This may warrant reliance on a single source of data. We use the so-called "Economic Freedom Index" (EFI; whose description and critical evaluation can be found in Voigt 2002: 147-66, and whose most recent data are in Gwartney et al. 2002). It is an aggregated index whose individual indicators comprise seven components:

> size of government activity
> state or market coordination
> monetary policy and price stability
> currency convertibility
> rule of law and security of property rights
> openness and free trade
> financial markets

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[3] (Kaufmann, Kraay, Zoito-Lobatón 1999b).

The seven components are not fully congruent with Eucken's elements of a competitive market order, but the correspondence is sufficient for our purposes. The EFI is available for the years 1999 and 2000/01 and for 123 countries, including the accession candidates for the European Union in Eastern Central Europe as well as Croatia, Albania, Russia and Ukraine.

The progress of reform of the transition countries has regularly been evaluated since 1994 by the EBRD. The progress of transformation is measured for nine components (an exact description is to be found in EBRD 2002: 20-1):

> large-scale privatisation
> small-scale privatisation
> corporate governance and restructuring
> price liberalisation
> trade and foreign exchange system
> competition policy
> banking reform and interest rate liberalisation
> financial markets
> infrastructure

The elements of *O* that are covered can be compared to the elements of *O* contained in EFI even if individual indicators differ and will certainly be differently operationalised. We calculated the unweighted arithmetic mean to obtain a general transformation indicator. It is available, evidently, only for the transition countries in Central and Eastern Europe and the former Soviet Union. We use the data for the year 2002.

As to the outcome variables Y, it has become customary to measure transformation success by real GDP compared to the starting year 1989 (= 100). Transformation aims at improving the economic conditions of the people. This target could be reached only by the detour through a deep and extended transformation crisis, whose severity differed among the transition countries. The chosen indicator of success therefore shows how rapidly the crisis has been overcome and to what extent the original target has been reached. There are many problems linked to the indicator, however, among which are the comparison of national income data of planned and market economies, the size of the shadow economy, and inflation. The most recent set of data is published for the year 2001 by EBRD (2002: 58).

Since the "Lorenzetti hypothesis" relates to the effect of governance upon system outcomes, i.e. economic welfare, the chosen indicator is GDP per capita measured in purchasing power parities. Comparisons of national data are not problem free. Eurostat (2003), for instance, calculates such data for the 15 EU member states and the accession candidates plus Croatia, Macedonia, Russia and Ukraine. A much wider coverage is to be found in Maddison (2001) whose data we use for the 103 countries of the large sample. Comparisons of Eurostat and Maddison shows that they do not always correspond, even not for statistically solid countries like the EU member states. Deviations should be considered normal and can be ascribed to differences in methods, above all in the calculation of purchasing power parities.

Finally the control variables. The most important control variable for the relation between governance and welfare is, as we have argued above (see Section 3), the countries' endowment with natural resources. We have taken fuel as most important single resource and introduced a dummy for countries with important oil and gas reserves. A dummy for transformation countries should test whether or not they have returned to the fold of "normal" countries. This may be interpreted as a disguised time lag if their welfare does not fully correspond to their governance quality or their economic order. Three regional dummies, for the EU, for Africa and for Latin America, are also added. The latter seem to be relevant only in connection with EFI which appears to be systematically overestimated for Latin America. The one for the EU is derived from the observation that some EU member states, mainly in the South and the West, exhibit a comparatively low governance quality without recognisable effect upon welfare. It can be hypothesized that EU membership constitutes a governance quality of its own. Africa is an almost hopeless case of development policy where other forces seem to be at work which are not covered by the governance indicators. A usual control variable of success of transformation is the initial conditions, represented here by GDP per capita at purchasing power parities in 1990 (Maddison 2001).

5   Results

In the first instance, the "Lorenzetti hypothesis" should be tested for a broad sample of countries: does good governance bring about higher welfare? GDP per capita for 1998 (GDP) is regressed on governance for the year 1997/8 (GOV). The scatter diagram indicates that the relation is not linear. Therefore a quadratic function is estimated. Five dummies serve as control variables: three regional ones (Latin America, Africa and EU-15), one for countries with sizeable fuel reserves and one for transition countries. Alternatively the "Eucken hypothesis" is tested: does a competitive and free economic order bring about higher welfare? Here, the independent variable is the Economic Freedom Index for the year 1999 (EFI). The same control variables are used. We expect "Lorenzetti" to have a higher explanatory value than "Eucken". The results follow in Table 1.

The expectation is validated: "Lorenzetti" (column 1) does explain more than "Eucken" (columns 2 and 3), but both exhibit an unexpectedly good fit. A coefficient of determination of .86 for the correlation between welfare and governance in a sample of 103 countries raises some sceptical doubts. Could it not be the case that individual observations of governance quality are biased toward the much more obvious levels of welfare? Such a bias cannot be excluded. However, it is highly improbable. The governance indicator is composed of many individual observations of sub-indicators which are not collinear. Furthermore, the relationship is quadratic, which would overstrain the individual observers. We may accept the result: good governance explains a great deal of welfare differences in the world. The competitive and free economic order is evidently an important instrument by which good governance influences the productivity of an economy. But the good order has to be filled with life and thus constitution conforming behaviour and a culture of trust become a second channel along which governance exerts its influence. Under conditions of good order, stability and trust the necessary accumulation of physical and human capital enabling welfare takes place. As expected the indicator of good order, EFI, and the governance indicator exhibit a high correlation (column 4).

Table 1: **OLS estimates of regressions for the level of welfare**

	GDP	GDP	GDP	EFI
	(1)	(2)	(3)	(4)
Constant	23.43***	39.08	-7.18	6.27***
	(9.05)	(1.39)	(-1.07)	(39.53)
GOV	21.59***			1.52***
	(13.34)			(11.07)
GOV^2	7.05***			
	(5.00)			
EFI		-14.43*		
		(-1.69)		
EFI^2		1.99***	0.9***	
		(3.04)	(8.36)	
Africa	-12.10***	-18.32***	-17.38***	-0.13
	(-3.23)	(-3.42)	(-3.23)	(-0.47)
Latin America	-5.87*	-18.39***	-19.13***	0.76***
	(-1.83)	(-4.35)	(-4.50)	(3.34)
EU-15	2.34	13.65***	14.09***	-0.21
	(0.63)	(2.85)	(2.91)	(-0.78)
Transformation	-6.09**	-3.16	-2.84	-0.78***
	(-2.01)	(-0.62)	(-0.56)	(-3.17)
Natural resources	7.23***	8.77**	10.98***	
	(2.72)	(2.05)	(2.66)	
R^2	0.86	0.75	0.74	0.73
N	103	87	87	87

See text for definition of variables. Asterisks denote significance levels: * at 10%, ** at 5%, and *** at 1%.
(t-ratios in parentheses).

As far as the control variables are concerned, they show the expected signs although the parameters are not always significant. Fuel reserves improve welfare, other things equal. The status of a transition country has a significant negative impact only in the context of governance quality (column 1). The difference with order as the independent variable, where this influence is not significant, is reflected also in the relation between EFI and GOV (column 4): quality of economic order is lower than expected by governance quality. This result supports the hypothesis of a hidden time lag: the economic order of transition countries is not in full correspondence with their governance traditions and therefore they show a certain welfare gap in this respect. The statement of Weder (2001), that transition economies are again "normal" cases, has to be slightly modified.

Membership of EU has a positive influence upon welfare. However, it is significant only with respect to the indicator of order EFI (columns 2 and 3). Two different reasons may be surmised. The "Economic Freedom Index" is based upon a rigidly liberal theory. The more *social*-liberal economic systems of the European continent come off rather badly compared to the more orthodox Anglo-American systems. If there are qualities in a social-liberal system, EFI will underestimate them, as our results seem to indicate. A second reason for a positive EU effect could be found in

the fact that part of government competency within the EU moves to Brussels, i.e. that local governance qualities are superimposed by EU governance qualities. Gillingham (2003: 45), for instance, ascribes the extra-ordinary Italian EU support to the conviction "that government from any European capital had to be better than that from Rome". This may be good news for accession countries in Eastern Central Europe which have lower governance qualities than incumbent EU members. For they can expect to benefit from the governance lead of the EU. There are even indications that they already did so in the pre-accession period. The group of candidates differs significantly in governance from the group of non-candidates or not-yet-candidates. Implementing the *acquis communautaire* as pre-condition of accession may have such beneficial effects. However, it is difficult to discern the effect of governance traditions and EU candidate status: according to its Copenhagen conditions the EU accepts as new members only countries that have a certain governance quality and a competitive and free market order.

Finally the two remaining regional dummies. No further comments are necessary with regard to Africa. The Latin America dummy shows a strong negative impact in connection with the indicator of economic order (columns 2 and 3). The relation between EFI and GOV (column 4) makes clear that compared to its governance quality the economic order in Latin American countries seems to be significantly more developed. Two effects may be at work. The first would be an observation bias on the side of the makers of the Economic Freedom Index. Alternatively it is conceivable that the economic order in Latin America has been reconstructed during the last years in accordance with the "Washington consensus" which had been formulated in the 1980s exactly for that region and which was imposed by Washington. The improved order did not yet result in a corresponding improvement in welfare – another instance of a disguised time lag. In addition, the change of order does not yet correspond to the existing long run governance quality – the latter should adapt in an upward direction to make the former really effective, which may be taken as another proof of "Lorenzetti" dominating "Eucken".

Constitutional policy is at the centre of transformation. We will have to test our two hypotheses now for the case of transformation. Economic success will be measured by the growth of real GDP for the period 1989 - 2001 (ΔGDP). The independent variable for "Lorenzetti" is the governance indicator for 2000/01 (GOV). The alternative "Eucken hypothesis" explains growth by a competitive market order. In this case the transformation index of EBRD for 2002 (TR) is preferable to EFI, since the number of observations is greater (27 instead of 14). The initial conditions are represented by GDP per capita at purchasing power parities for the year 1990 (GDP). Our sample consists of 25 transition countries, excluding Bosnia and Yugoslavia. The results are given in Table 2:

Both equations have been estimated twice, first for the total sample and then excluding Belarus, Uzbekistan and Turkmenistan. The second estimate is considerably better. The reason is quite simple: Belarus, Uzbekistan and Turkmenistan have not really started their transition and have therefore not yet suffered a real transformation crisis. At the same time their governance quality is estimated rather low. Therefore they should be dropped from the sample.

Table 2: **OLS estimates of regressions for transformation success**

	ΔGDP	ΔGDP	ΔGDP	ΔGDP	TR
	(1)	(2)	(3)	(4)	(5)
Constant	119.55***	121.53***	53.29**	-55.79*	2.98***
	(7.51)	(9.35)	(2.16)	(-1.77)	(51.25)
GOV	30.89***	41.93***			0.82***
	(3.81)	(5.97)			(9.60)
TR			12.68	55.33***	
			(1.25)	(4.36)	
GDP_{90}	-0.005**	-0.006***	-0.009	-0.004*	
	(-2.10)	(-2.97)	(-0.37)	(2.00)	
R^2	0.40	0.66	0.07	0.51	0.79
N	25	22	25	22	27

See text for definition of variables. Asterisks denote significance levels: * at 10%, ** at 5%, and *** at 1%.
(t-ratios in parentheses).

Again we find that "Eucken" (columns 3 and 4) is weaker than "Lorenzetti" (columns 1 and 2): good governance is more than installing market-conforming economic order. But again we find that good governance is predominantly effective through the channel of a good order. Regressing TR on GOV (column 5) we can add Bosnia and Yugoslavia, for which the relevant data are available, to the sample. And we need not exclude the three unrepentant autocracies, since their low governance quality should be reflected in their constitutional policy. This is not self-evident. For Hellman, Jones and Kaufmann (2000) hold that state capture, a clear case of bad governance, is found mainly in intermediate situations and not where either transformation has not yet started or where it is almost accomplished. Our data do not support this hypothesis for governance in general. The impact of the control variable GDP is significant in three of the four estimates. The negative sign, however, is somewhat unexpected: the higher is productivity in 1990 the lower is economic growth for the period 1989-2001. Theoretically it could be explained as a catching up effect. It should, as well, not be overlooked that the source of data for the initial conditions (Maddison 2001) gives rather high estimates of per capita GDP at purchasing power parities for the Soviet republics or their successor states. The Baltic states, for instance, come off higher than Poland or Hungary. Although this does not fit with corresponding estimates of EBRD and Eurostat, it is not entirely implausible. For it is in line with our information about pre-transformation Soviet regional development. Since all Soviet successor states experienced a deep and, for most, also an extended transformation crisis, this may explain the negative sign.

6 Conclusion

Even in a competitive economic order the market and the state are inseparably intertwined (Wagener 2002). This statement is quite trivial, since a well functioning market system does not emerge from spontaneous self-organisation, and an organised self-organisation implies precisely the democratic state. A precondition for a productive and stable economy is a constitution and order in conformity with the market. This is exactly the "Eucken hypothesis" or the "Washington consensus". The precondition of a well functioning competitive order is a strong state. This additional hypothesis of

Eucken needs clarification. For what is a strong state? The socialist state, subject to the principle of democratic centralism, was certainly a strong state. The strong state that can institutionalise and keep up a market economy must be different and must obey the principle of subsidiarity. The "Lorenzetti hypothesis" goes one step further back: it is not so much a strong state than good governance which brings about economic welfare. And good governance is a social phenomenon which is not restricted to the state, but includes attitudes and behaviour of economic subjects or the citizens, in particular their attitudes towards the state and the law. It is the collaboration of formal and informal institutions, the social infrastructure, which determine the way how the market and the state complement each other and bring about economic welfare.

To test such a hypothesis is not an easy task. For the conglomerate "social infrastructure" is composed of most different components that in addition are difficult to perceive in a comparative manner. One has to make do with rather fuzzy data sets. Such data have been collected in recent years, making possible an attempt at testing. The results support the "Lorenzetti hypothesis": where freedom, security and trust prevail the economy flourishes, where they are lacking the costs of long-term investments are too high (see also Kaufmann, Kraay, Zoido-Lobatón 1999a, Raiser et al. 2001). Causality is a problem. If a high level of development correlates with good governance, it may be interpreted as support for the so-called "Lipset hypothesis" stating that democracy follows economic welfare. Barro (1997: 86), among others, has confirmed the latter.

The most important instrument of good governance is a competitive market order which produces sustainable welfare and growth. This proposition is not disproved by our data. However, what has been called the "Eucken hypothesis" is weaker than the "Lorenzetti hypothesis", in conformity with our theoretical considerations. For good governance influences the economic process through other channels too, above all through attitudes and informal institutions, i.e. through the social infrastructure that enhances the effectiveness of formal institutions. Such has also been the critique of the "Washington consensus" (see Stiglitz 1999, e.g.). However, one should not throw away the baby with the bathwater. Liberalisation, stabilisation, privatisation are important preconditions of transformation success and they refer to the elements O of the economic system S that are amenable to political formation. It is only logical that economic policy should concentrate upon these elements. The social infrastructure R, the informal institutions and attitudes, may be as important or even more so, but they cannot be influenced in the short run.

A solid social infrastructure, like Rome, has not been built in one day. Putnam (1993) considers it the result of cultural development over centuries. This makes the question of causality a problem of the chicken and the egg: welfare and good governance have developed concomitantly. In the context of transformation we have to do with much shorter periods of time. It may therefore help to discern more clearly cause and effect: good governance – consolidation and growth, bad governance – crisis and stagnation. The initial conditions of the transition countries seem to be quite similar: a socialist society with one party rule and a planned economy on the basis of Marxist-Leninist ideology. Nevertheless, even there one can discern good and bad governance. The extent of socialist lawfulness, planning security, cronyism and corruption differed widely between East Berlin and Tashkent. And a good deal of the cause of such variations can be found in the pre-socialist history of these countries. The rule of law, for instance, is a rather familiar concept for Poles, Czechs, Hungarians, and Slovaks, much less so for Kirgisians, Tadzhiks, and Uzbeks.

If short run transformation success can be explained by good governance, the major impact comes from a distant past when social infrastructure, political culture and economic welfare co-evolved. Leninist legacies, if they could be detected, would be of rather recent origin. A very short run influence upon the governance structure of transition countries stems from their geographical and political distance from Brussels (cf. Fischer, Sahay, Vegh 1998;, Wagener 2000). Joining 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.

Integral 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 raises the question how some countries, mainly in Eastern Central Europe, more or less succeeded in accomplishing the transformation task while others, mainly in Eastern Europe, are lagging considerably behind. In this historical situation a strong state was not at hand. It 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. Within a functioning social infrastructure the almost impossible task of a total reconstruction of formal social institutions was achieved in a short period of time so that these countries are able to accede to the EU in 2004. Explaining the differences in social infrastructure in the region remains a desideratum for future research.

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