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The State of the Market

The Market Reform Debate and Postcommunist Diversity

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This chapter revisits three interrelated claims made in *Problems of Democratic Transition and Consolidation,* the magnum opus of Juan J. Linz and Alfred Stepan. These claims were about the links between market reforms, state making, and democratization in the context of postcommunist economic and political transformations. The first of them involved the relationship between market reforms and state making; the second was about the relationship between democracy and (regulatory) state making; and the third was about the proper sequencing of reforms. The arguments Linz and Stepan made were the following: (1) constructing a functioning market economy presupposed state building; (2) nondemocratic ways of building a capable state in Eastern Europe were not an alternative; and (3) the reforms should start with state building under democratic conditions and later build a functioning market economy on these foundations.

At the time *Problems of Democratic Transition and Consolidation* was written, the dominant view was that market making was about "destatization" and that democracy, at least in the short term, was a liability from the perspective of the necessary reforms that were supposed to lead to a functioning market economy. The right sequencing of reforms followed unambiguously from the previous two propositions of the mainstream view: market reforms should come first; democracy and state building should come later.

Linz and Stepan were not alone in claiming that building markets presupposed state making, and they were not the first to claim that democracy might be an asset for market reforms. They were among the first, however, to make the theoretically based claim that if at the end of reforms the goal was to have both functioning markets and sustainable democracies, then building a *regulatory state* under democratic conditions was the way to start. More precisely, they claimed that to make democracy and market reforms compatible, the goal of reforms should be to create the conditions for the orderly politicizing and regulation of the economy. That was exactly the opposite of what the then-dominant neoliberal paradigm suggested: depoliticizing the economy and making it a private business.

The orderly politicizing of the market meant creating what Linz and Stepan called an economic society: a "set of norms, regulations, policies, and institutions" produced by political society and enforced by the state. Formulating the goals of reforms this way, Linz and Stepan went well beyond the revisionist reform proposals of the 1990s that suggested creating a *market-preserving state* as a condition for free markets but were silent about the regulatory state and, more implicitly than explicitly, rejected the politicizing of the issues of economic transformation.

I present some empirical evidence on the relationship between market reforms, state building, and democracy and show that in *Problems of Democratic Transition and Consolidation* Linz and Stepan were right in their theoretical conclusions. Moreover, early on they provided a key to one of the central factors of postcommunist divergence in developmental pathways.[1] Twenty years after the commencement of economic and political transformations, the former state socialist countries dramatically diverged on key dimensions of economic development. While most of them have introduced all the liberalizing reforms prescribed to them in the early 1990s, less than half have a well-functioning regulatory state. One can find regulatory states comparable to Western standards only in countries where in the 1990s issues of economic transformation and regulation were politicized and decided in a democratic political framework. The development of capable regulatory states in the framework of democratic institutions was the necessary condition for improving global positions in international markets while keeping social inequalities low and domestic social integration relatively high. Lack of progress in building regulatory states meant remaining in or falling to the periphery of the globalizing world economy, drastic increases in social inequalities, and lower levels of domestic social integration (Bruszt and Greskovits 2009).

I begin with a brief synopsis of the arguments of Linz and Stepan, then position the arguments presented in *Problems of Democratic Transition and Consolidation* within the broader debates on what a functioning market economy is and what the politics of economic transformation in the post-Communist countries should be. I will argue that the way Linz and Stepan defined the relationship between market reform, state making, and democratization has a strong family resemblance to the political program of the post–New Deal constitutional political economy and to ordo-liberal views that guided reconstruction in postwar Germany and eastward extension of transnational market building within the European Union.[2] Just a year after the publication of *Problems of Democratic Transition and Consolidation,* in 1997, the European Commission issued its *Agenda 2000* strategy, which insisted on the necessity for the Central European countries that were candidates to join the EU to build regulatory state capacities in order to have a functioning market economy. In the *Agenda 2000,* the introduction of extensive and effective regulatory states was clearly and unambiguously linked to stabilizing democratic institutions and upholding human rights. Departing from the standards of other transnational developmental organizations such as the World Bank or the International Monetary Fund, the EU was the first to connect political with economic conditionality, to insist on the need for the parallel stabilizing of democratic institutions and building regulatory states while going ahead with market reforms.

The third part of the chapter provides some evidence on the evolution of different state capacities and about the relationship between democracy and the evolution of state capacities. The first element of Linz and Stepan's argument was that the creation of markets has to start with state building. Market reforms, according to them, will differ not in degree but in kind, depending on progress in state making: no state capacity, no market economy. The data I present prove that Linz and Stepan were right: the development of functioning market economies in postcommunist Eastern Europe presupposed state building. No market-preserving state and no regulatory state means the absence of a normally functioning market economy. The data also show that the relationship between political regime type and the construction of economic state capacities worked in the way predicted by Linz and Stepan in the post-communist world: No democracy, no regulatory state.

Market Reforms and *Problems of Democratic Transition and Consolidation*

The propositions of Linz and Stepan on the relationships between market reforms, state making, and democratization, briefly mentioned above, were linked to the way they defined a consolidated democracy and to their conception of the factors of democratic consolidation. In their framework, economic society was one of the five major interrelated arenas that positively interacted with the others to produce what they called consolidated democracy (Linz and Stepan 1996: 13). The five arenas—civil society, political society, rule of law, the state apparatus, and economic society—were all dependent on inputs from each other, getting necessary support for their functioning from the other arenas and producing outcomes essential for the functioning of the others. They defined economic society as a "set of socio-politically crafted and socio-politically accepted norms, institutions and regulations" that mediates between state and markets (11).

In Linz and Stepan's argument for such an economic society, the political crafting of socially acceptable public rules for the private economy was linked to their claims about the economic conditions of a consolidated democracy. The crux of this argument was that there cannot be a consolidated democracy in a command economy and that a completely free market economy cannot coexist with consolidated democracy. The second part of the argument is relevant here. Linz and Stepan gave three reasons why a completely free market economy cannot coexist with consolidated democracy. "No regulatory state—no free market" was their first argument. Market economies "could neither come into being nor be maintained without a degree of state regulation" (12). Their second argument extended the previous one: public rules are necessary for creating the market, and they are also necessary for correcting eventual market failures. The third argument, finally, was linked to the key aspect of a well-functioning democracy, namely, that public rules are contestable and are contested. The very working of a modern democracy leads to the development and changing of norms, regulations, policies, and institutions that constitute economic society.

Note that in this framework the creation of public rules for the private economy was both a precondition of democratic consolidation and a sine qua non of successful economic transformation. The latter part of the argument concerns us more here. As we will see below, at the time of the writing of *Problems of Democratic Transition and Consolidation,* the mainstream literature linked the success of economic transformation exactly to the diametrically opposed condition, namely, the depoliticizing of economic reforms. Picturing functioning markets as a contestable structure of norms, policies, and regulations and defining market making as the institutionalizing of public rules for private economic action was a clear deviation from the conventional definitions of the goals and expected outcomes of mainstream market reforms.

This is where Linz and Stepan bring in the state. "Stateness" was the master explanatory variable of the whole book, coming into focus as part of their analysis of democracy in multinational societies. "Stateness" comes in also when discussing the relationship between market reforms and democratization. Without an effective state that has the capacity to uphold rights, enforce norms and rules, and implement policies, neither economic society nor a functioning economy can come about. To summarize the argument thus far: no effective state à no regulated economy à no sustainable democracy and no functioning market.

With the above formulation of the right sequencing, Linz and Stepan took an unambiguous position in the so-called simultaneity debate. In that debate, linked to the simultaneity of the starting of economic and political change, the mainstream view of the time was that priority should be given to economic change, understood as neoliberal reforms. Political reform and especially state reconstruction, in that view, should wait until the consolidation of liberalizing reforms.

The theoretical argument of Linz and Stepan for putting democratic regulatory state power first was based on the rejection of the neoliberal formulation of the goals and expected outcomes of reforms. "Free markets" cannot be the outcomes of market reforms under democratic conditions, and mere liberation of economic action from the state will not create a functioning economy. Neglecting political reforms and especially state reconstruction might undermine simultaneous transformations. Their argument in brief was that a lack of democratic regulatory state power would negatively affect the chances to create a functioning market economy and a sustainable democracy.

In order to make the argument about the sequencing of the reforms even more unambiguous, Linz and Stepan attacked head-on the key *political* argument of the proponents of the idea that starting with economic reforms would create the foundations for progress in political reforms. The essence of that view was that people cannot make intertemporal trade-offs and that if economic reforms imposed hardships on voters, they would use the political opportunities offered by democracy to halt those reforms.[3] The suggested solution to this dilemma was to use shock therapy and/or insulate the making of economic reforms from democratic political interventions. Based on extensive survey data, Linz and Stepan proved that there is no direct link between the evaluation of changing economic conditions and support for the political system—meaning that "the perceived legitimacy of the political system has given democratic institutions . . . an important degree of insulation from the perceived inefficacy of the economic system" (443). Democratic politics, instead of preventing market reforms, was the mechanism to create room for neoliberal reform.[4]

Finally, Linz and Stepan also rejected the nondemocratic solution to building state capacities in the postcommunist countries by arguing that the reconstruction of state power after the implosion of the one-party state is not feasible without some degree of democratic legitimacy. Trying first to create and legitimate capitalists and then a legitimate market economy as a basis for legitimate democratic political institutions would, they argued, invert the "legitimacy pyramid" (438). The redistribution of wealth and opportunities in the framework of market reforms controlled by the old elite would hardly create a solid foundation for legitimating the new economic order. This is the more practical part of their argument. From a theoretical viewpoint, they called attention to the fact that in the history of Western democracies, democratic political systems always legitimated market economies and never the other way around.

Market Reforms, Economic Development, and State Making

Linz and Stepan were among the first to make theoretically based arguments for starting economic transformation in postcommunist Eastern Europe with building a *regulatory state* under democratic conditions. Below I position these claims in a broader frame of the debates on the relationship between market reforms and development on the one hand and state making on the other.

The Developmental State

It has always been a contested issue what capacities states were supposed to have to promote economic and political development. In the scholarly literature, what was usually meant by state capacity was the variable and changeable probability that specific states will provide diverse types of public goods related to the maintenance and development of (social, economic, political) order. In addition to such "demand-side" specifications, definitions usually included the probability that states will be able to get the necessary resources (e.g., in the form of taxes, political support) needed to supply these public goods. What these public goods were, or what they were supposed to be, was contested and varied in time and space. Students of the political and economic transformations in the East and the South have listed and studied several relevant state capacities, ranging from the capacity to maintain the rule of law and enforce citizenship rights (O'Donnell 1994; Linz and Stepan

1996), uphold economic freedoms and create a predictable policy environment (North and Weingast 1989), collect taxes and impose enforceable rules in the economy (Woodruff 1999; Bruszt 2002), and resist corruption or state capture (Hellman 1998) to such capacities as implementing unpopular restructuring policies (Haggard and Kaufman 1995) or formulating and implementing coherent policies that reflect wider developmental considerations (Evans 1995; Stark and Bruszt 1998).

The role states were expected to play in socioeconomic development, and the list of capacities they were supposed to have, has changed several times during the past three decades, and it still differs dramatically across the world's regions. Until the early eighties, in most of the developing countries in the South and the East, states were seen to be the prime movers of development (Gereffi 1995; Evans 1995; Stepan 1978). Based on the work of scholars like Shonfield (1968), the mainstream academic view was that the capitalism of the North (and West) also moved toward a "mixed economy" characterized by significant state management of markets and development. Later, in the late seventies and early eighties, the reviving interest in the study of the developmental state capacities coincided with the rediscovery of the state by neo-Weberian scholars (Stepan 1978; Skocpol, Evans, and Rueschemeyer 1985). The resulting revival of research interest in states has provoked an ongoing fruitful debate on the sources of the autonomous role states can play in development and the bases of their capacity to design and implement coherent developmental programs (Evans 1995; Doner, Ritchie, and Slater 2007).

The Market-Preserving State

During the eighties, partly as a result of the failure of the state-based developmental models in several Latin American countries and, later on, the collapse of the state socialist model in Eastern and Central Europe, states began to be perceived more as part of the problem itself than as part of the solution. For some time the capacity to "introduce and sustain the right policies" of liberalization, privatization, and stabilization—the mantra of the international financial institutions (IFIs)—was the sole cited challenge on the pathway of economic transformation and development. The yearly progress reports of the IFIs ranked transforming countries according to the capacity of their states to make progress in the introduction of the policies of "de-statization." In that context, state capacity to further market reforms was pictured as being the function of success in depoliticizing economic reform (Haggard and Kaufman 1995).

At the beginning of economic transformation in Eastern and Central Europe, these were the dominant views in both scholarly and policy circles. The policy suggestions of IFIs were shaped by an amalgam of the "capture theory of regulation" and by libertarian pre–New Deal ideas of constitutionalism stressing the importance of preserving the prepolitical status of "private ordering."

According to the capture theory of regulation, first proposed by George Stigler (1971) and later the basis for broader public choice models of the state, markets have to be saved from regulations. Regulations are closer to conspiracies by rent-seeking groups than to expressions of something that could be called public good. In the popularized version of this thesis, interest groups and other political participants will use the regulatory and coercive powers of government to shape laws and regulations in a way that is beneficial to them. Attempts at politicizing economic issues and giving the state regulatory powers are the surest way to the corruption of states and markets. Liberating the markets from social and political regulations was in this framework pictured as liberating the state from the hold of rent-seeking groups.[5]

Behind the policy advice given by IFIs in the initial period of economic transformation one can also detect the revival of laissez-faire ideas from pre–New Deal era constitutionalism.[6] Until the mid-1930s, U.S. Supreme Court decisions tried to restrain the legislature and the executive from politicizing market ordering and rejected a large part of regulatory interventions with arguments referring to the superiority of private ordering (Sunstein 1987). For the Spencerian proponents of laissez-faire, market order was the outcome of millions of private contracts. The most important goal of the state was to uphold the maximum freedom of contracting and maintain the "prepolitical" status of economic transactions. Public interventions in free contracting were pictured as unjust redistributions of wealth and opportunities, as arbitrary "taking" (Sunstein 1987). State neutrality meant staying away from private ordering, leaving it to courts and the judiciary branch to deal with conflict. It also meant minimizing the possibility of politicizing economic transaction by way of interventions of the executive or the legislature (Sunstein 1987). In this perspective, the key task of states was to preserve markets by upholding the key economic freedoms: freedom of property and freedom of contracting.[7]

At around the time *Problems of Democratic Transition and Consolidation* was published, reports on the progress in market making prepared by the IFIs started to rank countries based on elementary state capacities to uphold market freedoms. Typical was the study commissioned by the World Bank that made the first interregional comparative study on the capacity of states to uphold property rights, enforce contracts, maintain a stable and predictable policy environment for businesses, and combat corruption (Brunetti, Kisunko, and Weder 1998). While the reports were still silent about regulations, they were the first to depart from the public choice assumption of a uniform state and thus were the first to represent postcommunist states as variable and changeable entities.

The Regulatory State

The state had been brought back in by the second half of the 1990s, and the list of (missing or weak) state capacities grew in the meantime. Until the second half of the 1990s the talk about state capacity to regulate the economy was not politically correct in serious economic developmental circles. However, the European Bank for Reconstruction and Development (EBRD) in 1997 had already introduced measures in its progress report showing the highly uneven capacity of the transition countries to introduce extensive and effective regulation of their financial and capital markets.

While the World Bank and the EBRD were very active in the second half of the 1990s in propagating the need to build regulatory capacities, theoretical reflections on regulations and the need for regulatory state were in short supply throughout the decade. Until the collapse of the Russian financial markets in 1998 and the publication of the first studies on the uneven development of capital markets in the leading postcommunist reform countries, there were very few theoretically oriented reflections on the role of regulatory institutions in postcommunist market building (Stiglitz 1999; Coffee 1999). That markets are neither self-constituting nor self-regulating was perhaps not news to many economists. Still, arguments for developing regulatory institutions as the precondition for making functioning markets were largely invisible until the late nineties in the discussions among economists dealing with economic transformations.

Students of comparative capitalism, on the other hand, took the existence of robust regulatory states for granted, as they were concerned primarily with understanding persistent divergences among well-functioning regulatory regimes that have differed only in the content of regulations (Hall and Soskice 2001). The issue of the politics of making regulatory institutions and developing regulatory states in formerly communist countries was thus mainly absent in the theoretical literature on economic transformation. In a footnote, Linz and Stepan approvingly cite a leading North American economist to claim that "neglect of the role of the state in the transformation by economists borders on the criminal" (Linz and Stepan 1996: 253 n. 42). The ideas represented in *Problems of Democratic Transition and Consolidation* on the need for regulatory states could thus be weakly linked to ongoing debates among economists or students of political economy. When making their theoretical arguments, Linz and Stepan cited only one economist participating in the debate on the goals and means of economic transformation. On the issues of regulations and the regulatory state, they cite classics from political economy and political science such as Adam Smith and Robert Dahl (12–13).

Besides these classics, Linz and Stepan's concept of economic society and their arguments in favor of regulations can be linked to the political program of the post–New Deal constitutional political economy and to the ordo-liberal views of the founders of the German social market economy.[8] Common among these thinkers was the rejection of the libertarian ideas that (a) social and economic order could be the outcome of free private contracts and (b) that freedom of contracting and property are natural rights that have to be protected from political interference. Both of these approaches saw markets as based on politically constructed and socially accepted norms that can be politicized and contested. While post–New Deal constitutionalism was primarily about extending regulatory state interventions after a period of laissez-faire, the "soziale Marktwirtschaft" of the post–World War II ordo-liberals was based on the idea that democracy cannot coexist with a command economy or with laissez-faire capitalism.

Both of these approaches saw freedom of contracting and property as politically crafted and socially legitimated rights that were created and upheld with reference to a public good that therefore did not enjoy a prepolitical status. Both approaches saw public interventions in free contracting as necessary measures to constitute the market order, correct market failures, and maintain competition. They have rejected the views of the libertarians who saw public regulations as unjust redistribution of wealth and opportunities. For the representatives of post–New Deal constitutionalism and ordo-liberalism, nonintervention would have meant toleration of the misuse of asymmetries in economic power, which would have resulted in the public sanctioning of unfair redistributions. State neutrality for both of these approaches meant *not* staying away from unjust or unfair private ordering. According to both approaches, political society cannot be prevented from politicizing and contesting the public rules of the private economy.

During the first period of economic transformation in the postcommunist countries the above ideas seemed to have been forgotten, at least in the world of IFIs advising these countries how to go about creating markets.[9] The originality of Linz and Stepan was to bring these ideas back based on democratic theory and linked to the idea of democratic consolidation.

While among the Washington-based IFIs each and every little step of moving away from neoliberal orthodoxy was celebrated as a paradigmatic change, the EU, the other key external player in the Eastern European transformations, did not make a big fuss about regulation and regulatory state capacities. Brussels and the Eurocrats never participated in the ongoing global debates about the relationship between success in market reforms and building state capacities. Without much ado in the mid-1990s, the Commission posted tens of thousands pages of regulations to the aspiring applicant countries. These regulations were supposed to be introduced in the national legal systems and implemented as a condition for being considered a functioning market economy ready for EU membership. The EU demanded not the mere transposition of thousands of pages of EU laws to the domestic law books, but also insisted on building state capacities to implement and adjust these norms on the ground.

Just a year after the publication of *Problems of Democratic Transition and Consolidation,* in 1996, the Commission issued its *Agenda 2000. Agenda 2000* insisted on the need for the candidate countries to build regulatory state capacities, including the judicial and administrative capacities to enforce and monitor the European public rules of the regional market economy. The way the EU translated the dominant neoliberal paradigm to non-negotiable conditionality is unique and still unmatched by other transnational integration regimes, such as NAFTA or Mercosur. *Agenda 2000* implied the need to combine the building up of the institutional conditions for meeting EU demands with the adoption of 80,000 pages of EU institutional standards and regulations detailed in thirty-one chapters or policy domains ranging from consumer protection to corporate governance, from banking regulation to state aid policies, and from environmental protection to public procurement. EU conditionality documents made it clear that market building, besides liberalization, means building up *institutional capacity*—remaking administrative and regulatory state capacities and creating developmental state capacities (Bruszt 2002).

At least as important, and similar to the ideas advanced in *Problems of Democratic Transition and Consolidation,* the EU also used extensive assistance programs to build what Stepan and Linz called "economic society." Various assistance programs throughout the 1990s and early 2000s empowered diverse public and private actors, not simply via resources, but particularly by enhancing their political and functional participation in institution-building efforts. By the late 1990s, the EU had built up a diversified and complex assistance program (Bruszt and McDermott 2009). With an overall budget of around 28 billion Euros, these programs targeted building capacity both within and outside the state and involved the direct participation of thousands of experts and policy makers from the EU member states.

Finally, one can detect a third similarity between the ideas in *Problems of Democratic Transition and Consolidation* and the developmental interventions of the EU in the Central and East European (CEE) countries. By connecting political with economic conditionality and closely monitoring the upholding of political rights and the rules of fair political competition, the EU helped to keep constant domestic democratic rights to contest policies and rules while at the same time giving a clear and unambiguous directionality to domestic bottom-up pressure in the form of accession conditionality. The embedding of CEE domestic markets in a broad transnationally monitored regulatory frame has strengthened the bargaining position of domestic states vis-à-vis rent-seeking domestic firms and transnational corporations (TNCs). It has also improved the political opportunities of diverse weaker economic actors and has contributed both directly, through assistance programs, and indirectly, through increased political opportunities, to the building of economic societies in these countries.

The State of the Market in the CEE Countries: Some Evidence

In this section I present some evidence on the relationship of market reforms, state building, and democratization. I start with the link between market reforms and state building. As noted above, at the time of the writing of *Problems of Democratic Transition and Consolidation,* IFIs still measured progress in market reforms with different indicators of economic liberalization. In that framework the outcomes of market reform were expected to differ from each other in degree: some of the countries made more while other countries made less progress in introducing the prescribed policies. The first element of Linz and Stepan's argument discussed above was that creating markets has to start with state building. To put their prediction in simple terms, the outcomes of market reforms will differ not in degree but in kind, depending on progress in state making: no state capacity, no market economy.

To present some evidence on this prediction, we need to operationalize two concepts: progress in market reforms and progress in state building. To measure progress in market reforms we use the indexes constructed by Campos and Horvath (2006) that are based on the most encompassing data set put together on progress in market reforms in the twenty-eight postcommunist countries. The data set of Campos and Horvath measures actual introduction of liberalizing reforms constructed from thirty variables for external liberalization and three for internal liberalization. Regarding internal liberalization, they collected data on the number of goods subject to price regulation, the share of administered prices in the consumer price index (CPI), and wage regulation. Regarding external liberalization, they used thirty measures of capital controls and trade barriers.[10] The higher the scores countries have on these measures, the fewer the number of state controls and the freer the economic transactions are from different kinds of state interventions.

We use two measures for progress in building state capacities. First we measure state capacity to maintain rule of law using data from the World Bank governance survey (Kaufmann, Kray, and Mastruzzi 2005). The Rule of Law index in this survey combines several indicators to measure the subjective perceptions of the presence of an effective state: the extent to which agents have confidence in and abide by the laws of society. These include perceptions of the incidence of crime, the effectiveness and predictability of the judiciary, and the enforceability of contracts. Together, these indicators measure the success of states in developing an environment in which fair and predictable rules form the basis for economic and social interactions and the extent to which property rights are protected. Higher scores on this index mean the presence of states with higher capacity to create stable expectations about rule of law.

Figure 4.1 presents some preliminary evidence on the relationship between progress in neoliberal reforms and state capacity to maintain rule of law. According to the measures of Campos and Horvath, by the early 2000s most of the postcommunist countries had liberalized their economies. Twenty-one of twenty-eight countries were close to the extreme right on the horizontal axis, meaning that they had implemented all the liberalizing policy measures that were prescribed by the IFIs in the 1990s. According to the measures of Campos and Horvath, Central European countries such as Slovenia and Estonia have at least as liberalized economies as post–Soviet Republics such as Moldova or Georgia.

These countries, however, differ dramatically on the vertical axis, which measures rule of law using the 2004 data of the World Bank.

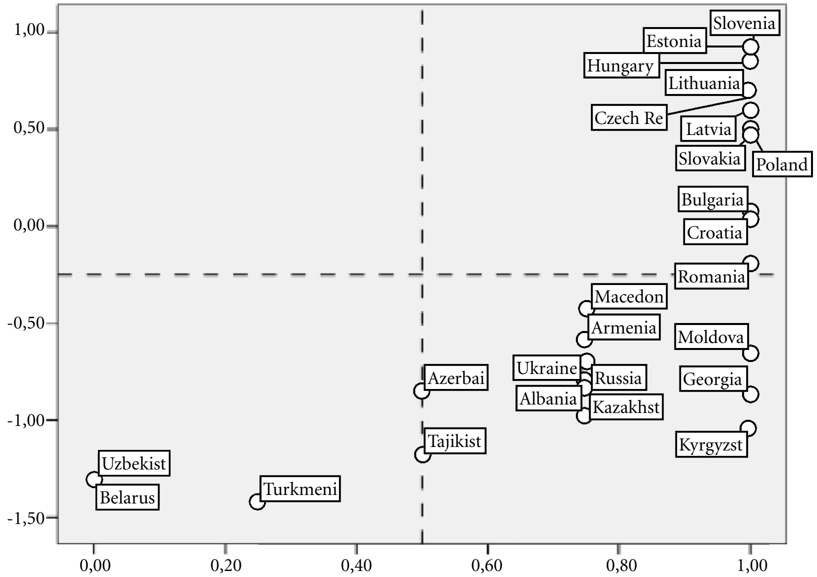

Figure 4.1 Level of Economic Liberalization and Rule of Law

According to these measures, postcommunist countries can be clustered in three groups. In the first group are countries in which a high level of market liberalization combines with a high level of rule of law. In these countries, economic actors can have stable expectations that they can profit from rational calculative enterprise in the presence of a state that enforces their rights. The Central European countries belong to this group. At the other extreme we find three countries, Uzbekistan, Turkmenistan, and Belarus, where in the early 2000s low levels of economic liberalization were combined with low levels of rule of law. These countries could hardly be described as market economies.

Most of the former Soviet Republics belong to the third group, where a high level of economic liberalization combines with a low level of rule of law. In the early 2000s, a decade after the beginning of economic reforms, the factor that differentiated postcommunist countries from each other most was not the level of freedoms from the state but the presence or absence of a state with the capacity to uphold these freedoms.

We find the same differentiation when we link market liberalization to the evolution of regulatory state capacities. To put the related

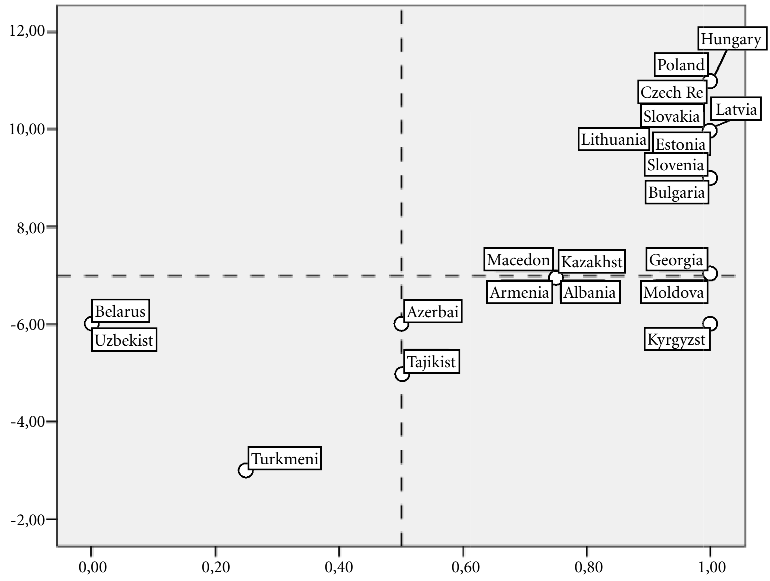

Figure 4.2 Economic Freedoms and Regulations

argument of Linz and Stepan in a simple form: no regulatory state, no progress in market building. We measure progress in regulatory state building using the data compiled by the EBRD (2005). The EBRD data measure the capacity of a regulatory state in three dimensions: regulation of competition, the financial sector, and capital markets. In each of these three dimensions, countries can get scores ranging from 1 to 4, with 4 equaling the presence of extensive and effective regulations. Going down from 4 to 1 means having regulatory norms on the books that are weakly enforced, that are not enforced at all, and, finally, not having regulations even on the books. For this chapter I aggregated the three indicators to construct an index that ranges from 1 to 12. The higher countries score on this measure, the stronger the presence of a market-regulating state. Countries with scores below 8 might have regulations on the law books, but they do not have state capacities to enforce them. (See fig. 4.2.)

Among the countries that we could include in this measurement we found the same differences as in the case of rule of law. The Central European countries combined high levels of economic liberalization with high levels of regulatory state capacities. In these countries, as a rule, economic actors can profit only from rational calculative enterprise and cannot use either asymmetries in economic power or information asymmetries to make rents in the markets of production or in the financial and capital markets. In the absence of such a regulatory state, the liberalized economies of the former Soviet Republics had different versions of crony capitalism. Again, the factor that differentiated postcommunist countries from each other most was not the level of freedoms from the state but the presence or absence of a state with the capacity to enforce public rules for economic transactions.

Finally, we present some evidence for the relationship between progress in regulatory state building and democratization. Linz and Stepan had two interrelated arguments on these issues. First, they argued for linking democratization with the development of regulatory states. Second, according to them, nondemocratic roads to regulatory state building were not available in the postcommunist countries.

We assess level of democratization with the help of Freedom House indexes for Political Rights and Civil Liberties using the data for the initial period of economic reforms. In most of these countries this was the period of the early to mid-1990s. For the war-torn countries of the former Yugoslavia we have used the data for the postwar period starting with 1999. We count Romania as a liberal democracy at the time of reforms because after a few years of initial wavering, from 1996 it got the adequate Freedom House scores continuously. Also, we count Slovakia as a liberal democracy at the time of economic reforms because it was a liberal democracy in the 1990–96 period, the key phase of economic change, and except for the short 1996–98 period of the Meciar government, it has continued to be a liberal democracy until the present.

We measure regulatory state capacities as above, with the aggregated EBRD indexes from the year 2005 (table 4.1). The findings are unambiguous: liberal democracy and regulatory state capacities go hand in hand. There is a strong association between the two variables. Countries that were liberal democracies in the period of economic transformation in the 1990s are the ones that have states that can enforce public rules in the private economy in the early 2000s. Countries that could not guarantee political rights and could not uphold civil liberties in the period

Table 4.1 Democratization and Regulatory State Capacity

Political rights and civil liberties in the initial period of economic reforms Progress in regulatory state building in 2005	1–2.5 Liberal Democracies	3–5 Hybrid Regimes	5.5–7 Authoritarian regimes
12–9 Strong to medium regulatory state capacities	Bulgaria (2) Croatia (2.5) Czech Republic (1.5); Estonia (2.5); Hungary (2); Latvia (2.5); Lithuania (2); Poland (2); Romania (2.5)* Slovakia (2.5)** Slovenia (1.5)		
5–8 Weak regulatory state		Albania (4); Armenia, (4.5); Azerbaijan (6) Belarus (5) Bosnia-Herzegovina (4); Georgia (4.5); Kazakhstan (5); Kirgizstan (4); Macedonia (3.5); Moldova (4); Russia (3.5); Ukraine (3.5) Uzbekistan (6.5)	
Below 5 No regulatory state			Tajikistan (7); Turkmenistan (7)

Notes:
In parentheses, Freedom House scores.
*From 1996 on continuously.
**Except for the 1996–98 period.

of economic reforms all score below 8 in the EBRD index, that is, below the minimum threshold of a functioning regulatory state. The aggregated low scores on this index might mean two things. First, scores below 8 might mean that while these countries have some of the rules necessary to run a functioning market economy "on the books," they do not have the needed state capacities to monitor and enforce these rules on the ground. Low scores in regulatory state capacity might also mean that some of the laws enforced in these countries reflect the interests of the strongest private actors only. Finally, even minimal regulatory state capacities are absent in the authoritarian countries. In the postcommunist setting the dictum of Linz and Stepan proved to be right: no democracy, no regulatory state.

We could, finally, see Linz and Stepan's argument on the relationship of democracy and the evolution of regulatory state capacities as a forceful critique of attempts at depoliticizing issues of market reforms. *Problems of Democratic Transition and Consolidation* can be read as a strong rejection of the idea that successful reforms must be based on strong power centralization that gives concentrated power to reformers who are assumed to know which reforms best serve public interests. Although they are not explicit on this issue, based on their arguments, one would expect an inverse relationship between power concentration and progress in regulatory state capacities.

We also analyzed the relationship between power concentration and regulatory state capacities using the presidential power index (PPI) as a proxy (results not shown).[11]

We have found a strong correlation between distribution of authority within the state and regulatory state capacities. In countries where executive power is more constrained and checks and balances are present, regulatory state capacities are stronger. A high level of power concentration within the state goes hand in hand with low probability of having a state with regulatory capacities.

It should be noted that this relationship between democracy and state capacity to regulate holds only for the postcommunist setting, where the remaking of political institutions started in the framework of a noncapitalist economy, and we do not find this relationship in other parts of the world where democratization started in the framework of more or less consolidated capitalist economies. The mainstream view at the time Linz and Stepan's book was published was that the exceptional starting position of the postcommunist countries is a liability from the perspective of the simultaneous transitions. Accordingly, the politicization of economic transition might prevent both the liberalization of markets and the coming about of the right institutions. Because of their flat and inarticulate social structure, runs the argument, the economic transformation would create too many losers and too rapid an increase in inequalities. The losers would not tolerate these changes and would use their newly acquired political rights to stop the process (for a critique of this approach, see Hellman 1998).

As it turned out, fears of the losers of market reforms proved to be exaggerated while the dangers represented by the early winners of liberalizations were underestimated. The abolition of state control over prices and trade and the rapid privatization of public firms resulted in a dramatic redistribution of wealth and economic power within these societies and between the state and the most powerful economic actors. The latter had strong incentives to set the rules of the private economy for themselves, and, as a result of the fast privatization, they had concentrated economic power. In countries where states did not have institutionalized defenses in the form of checks and balances and political pluralism was weak, early winners could capture the state, use it to set the rules of the private economy, undermine the fledgling democratic institutions, and redistribute wealth and opportunities to themselves. Political competition and the presence of mechanisms extending the accountability of incumbents, on the other hand, have helped to strengthen state capacity to resist capture and introduce public rules for the private economy representing complex exchanges and accommodating diverse interests (Hellman 1998; Bruszt 2002).

Conclusion

This chapter revisits three interrelated arguments of *Problems of Democratic Transition and Consolidation* on the links between market reforms, state building, and democratization in the context of postcommunist economic and political transformations. Linz and Stepan argued that (1) the development of a functioning market economy presupposed state building; (2) nondemocratic ways of building a capable state in Eastern Europe were not an alternative; and (3) the right sequencing of reforms started with state making under democratic conditions and then building a functioning market economy on these foundations. Their most important claim was that to make democracy and market reforms compatible, the goal of reforms should be to create the conditions for the orderly politicizing and regulating of economic action. That was exactly the opposite of what the than dominant neoliberal paradigm suggested: depoliticizing the economy and making it a private business.

As the evidence presented here shows, Linz and Stepan were right both in their predictions and in their prescriptions. Moreover, they early on provided a key to one of the central factors of postcommunist divergence in developmental pathways. Twenty years after starting economic and political transformations, only those countries in which in the 1990s issues of economic transformation and regulation were politicized and decided in a democratic political framework have regulatory states comparable to Western standards. Moreover, the construction of capable regulatory states in the framework of democratic institutions was the necessary condition for improving global positions in international markets while keeping social inequalities low and domestic social integration relatively high. Lack of progress in building regulatory states meant staying in or moving toward the periphery in the globalizing world economy, drastic increases in social inequalities, and lower levels of domestic social integration.

Notes

1. On the diverse developmental pathways in postcommunist settings, see Stark and Bruszt 1998; Bruszt and Greskovits 2009.

2. Ordo-liberals rejected laissez-faire capitalism; they were distrustful of the "invisible hand" and have argued for public rules for the private economy primarily to prevent misuse of power asymmetries among economic players. The dictum of the ordo-liberals was simple: no public regulation, no free market. On the ordo-liberal views, see Böhm, Eucken, and Grossmann-

Doerth [1936] 1989; Eucken [1948] 1989; Reiter and Schmolz 1993; and Vanberg 1988.

3. For a detailed presentation and critique of this approach, see Hellman 1998. Some of the representatives of this approach were Fischer and Stanley 1991; Boycko, Shleifer, and Vishny 1995; and Lipton and Sachs 1990.

4. Remmer (1993) provided robust evidence to substantiate this claim based on survey data in Latin America. See also Bruszt 1996.

5. For critical discussions of the public choice perspectives on the state, see Evans 1995; Stark and Bruszt 1998.

6. For an insightful discussion of pre–New Deal era constitutionalism, see Sunstein 1987, 1990.

7. On the market-preserving state, see North and Weingast 1989; and Weingast 1995.

8. On post–New Deal constitutionalism, see Sunstein 1987. On the ordo-liberals, see Streeck and Yamamura 2005; and Borchardt 1991.

9. Actually, the IFIs have stayed with their close to libertarian views until the most recent, still ongoing financial crisis supporting the deregulation of global financial markets.

10. The indicators for capital controls include controls on commercial credit, controls on foreign direct investment, controls on the liquidation of foreign direct investment, documentation requirements for the release of foreign exchange for imports, exchange rate taxes, interest rate liberalization, investment liberalization, multiple exchange rates, permission requirements for foreign exchange accounts held abroad by residents, permission requirements for foreign exchange accounts held domestically by residents, permission requirements for foreign exchange accounts for nonresidents, repatriation requirements, repatriation requirements for invisible transactions, surrender requirements, and surrender requirements for invisible transactions. Data on trade barriers include the following: compatibility with Article VIII (current account convertibility), export duties as percentage of tax revenues, export licenses, export taxes, import duties as percentage of tax revenue, import licenses and quotas, import tariff rates, OECD and WTO membership, trade openness, share of trade with nontransition countries, tariff code lines, tariff revenues as a percentage of imports, and tax revenues on international trade (as a percentage of revenue).

11. The PPI is a standard measure for power concentration within the state, which lists all the powers that presidents have either exclusively or shared with the legislative (Frye 1999). We recoded the PPI index giving the value of 1 to all powers that presidents can use exclusively and 0 to all that they can exercise only together with the legislative. The index is a good proxy for the distribution of decision-making authority within the state: in countries where the PPI value is high, the concentration of power in the executive is high. Low values indicate authority that is more dispersed within the state.

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Part III
Democratic Transitions and Democratic Regimes