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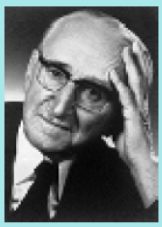



Joachim Ahrens

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Abstract

Central Asia is increasingly the focus of intense international attention because of its geopolitical and economic importance as well as its unsettled transition processes. Central Asian countries, i.e., Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan, faced enormous challenges when the Soviet Union disintegrated. Overall, they have made rudimentary progress in opening up to the international community, creating market institutions, and building more inclusive, democratic political processes. Daunting challenges remain – reflected in the region's relatively low economic and human development indicators. While reforms to stabilize, liberalize and privatize the economy have been conducted in all countries except Turkmenistan, reforms of the institutional environment have been largely neglected. It is evident that the lack of effective institution building as well as rule enforcement in the economic and political realms represents one of the key weaknesses and drawbacks of transition. Hence, crafting adequate market institutions will be of utmost importance in the years ahead. Due to similar political side conditions, high-performing China is taken as a model of orientation for Central Asian countries in this essay; the more so as most governments in the region have recently begun to place a stronger emphasis on improving relations with China. The paper is structured as follows: The next section addresses the need to craft a politico-institutional foundation of economic transition policies from a theoretical perspective. Section 3 elaborates on Chinese economic transition as a reference model for Central Asian countries. Conclusions follow in Section 4.

Keywords:

Transformation, Institutional Building, Central Asia, China

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The politico-institutional foundation of economic transition in Central Asia: Lessons from China[1]

1. Introduction

Central Asia is increasingly the focus of intense international attention because of its geopolitical and economic importance as well as its unsettled transition processes. Central Asian countries, i.e., Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan, faced enormous challenges when the Soviet Union disintegrated. Overall, they have made rudimentary progress in opening up to the international community, creating market institutions, and building more inclusive, democratic political processes. Daunting challenges remain – reflected in the region's relatively low economic and human development indicators (UNDP 2005). While reforms to stabilize, liberalize and privatize the economy have been conducted in all countries except Turkmenistan, reforms of the institutional environment have been largely neglected. It is evident that the lack of effective institution building as well as rule enforcement in the economic and political realms represents one of the key weaknesses and drawbacks of transition. Hence, crafting adequate market institutions will be of utmost importance in the years ahead (Zeitler 2005).

Due to the institutional weaknesses documented in the literature, reported by local and foreign business elites, and analyzed by international organizations such as the World Bank, the Asian Development Bank, or the European Bank for Reconstruction and Development, the objective of this paper is to elaborate the need for a secure politico-institutional foundation of economic transition and to explore a way of how to achieve such a foundation for the Central Asian countries. Since these countries show many differences in terms of initial conditions to transition, resource endowments, financial constraints, and political preferences, no how-to-manual or best-practice approach can be expected. What can be done, however, is to identify broad principles which may be appropriate to guide institution building and policymaking within the given politico-institutional environment. In this context, not

[1] This paper has been written within the project "Emerging Market Economies in Central Asia: The Role of Institutional Complementarities in Reform Processes"; financial support by the VolkswagenFoundation is greatly acknowledged.

only economic efficiency is of importance. Particularly, political feasibility, i.e., measures which are in the interest of the ruling elites, is the key to successful economic reform and development. Due to similar political side conditions, high-performing China is taken as a model of orientation for Central Asian countries in this essay; the more so as most governments in the region have recently begun to place a stronger emphasis on improving relations with China.

The paper is structured as follows: The next section addresses the need to craft a politico-institutional foundation of economic transition policies from a theoretical perspective. Section 3 elaborates on Chinese economic transition as a reference model for Central Asian countries. Conclusions follow in Section 4.

2. The need for a politico-institutional foundation of economic transition

The analysis of institutions has substantially improved our understanding of how economies develop through time.[2] The process of development and transition is regarded as being largely determined by the evolution of institutional arrangements which determine the terms of exchange between different agents. Economic growth occurs if institutions provide relatively low transaction costs in impersonal markets, reduce potential hazards of production and trade, facilitate capital accumulation and capital mobility, allow pricing and sharing of risks, and encourage cooperation. Consequently, differences in economic performance between countries do not ultimately result from countries' natural or technological endowments. Eventually they result from the established economic and political order and the policies pursued by governments. The efficacy of both factors is crucially determined by underlying rules and constraints and particularly by the interplay of economic and political institutions. Institutions are conceived as formal rules and informal constraints (including their enforcement characteristics) which provide the incentive structure for indivudual behvior. Political institutions include those institutional arrangements which directly affect political decision-making processes in the course of economic development and transition. They, e.g., include rules that specify a polity's hierarchical structure, its elementary decision rules, as well as the explicit mechanisms of agenda control. Therefore, these institutions can be considered as devices for the allocation of

[2] This section essentially draws from Ahrens (2002), Section 4.4.

political power and positions and hence affect political leaders' capability of pursuing their preferences and achieving their goals.[3]

The need to consider the importance of political institutions for economic development, transition, and policy reform is clearly revealed by the problems of economic transformation and political transition in less developed and previously socialist countries. Frequently, advisors focusing on economic transition urgently request governments to get the prices right. Although this is a critical issue of economic reforms, this advice is not sufficient to ensure a successful transformation. Many governments face political and social constraints which hinder them in implementing coherent market-oriented reforms. If, e.g., private interest groups have a strong influence on policy making, economic policies may show a significant bias favoring special interests, and do not benefit society as a whole. Even if governments initiate policy reform with a suitable policy mix based on an adequately specified set of economic institutions, economic development may be impeded by political risks resulting from uncertainties about government behavior in the future. As the experiences with failed policy reforms in less developed countries (LDCs) indicate, proper advice regarding the formation of policy reform needs to account for the relationship between the economy and the polity. Emerging markets require not merely well-functioning economic institutions such as private property rights, a rational price system, and a well-defined law of contract. They also require a secure political foundation that allows the formation and implementation of economically and socially necessary reforms.

However, institutions can neither be taken for granted nor is institutional change guided by an invisible hand onto some beneficent path. Eventually, the emergence of adaptively efficient economic institutions crucially depends on the existence of functioning political markets, because the polity specifies, implements, and enforces the formal rules of economic exchange. But political markets are usually neither perfectly competitive nor efficient. The ability of the state to promote institutional change that benefits the economy as a whole crucially depends on the institutional structure of the polity. This is because different politico-institutional arrangements imply different political transaction costs and hence different incentives for policy makers. Political transaction costs affect the interaction between various branches of government and between political authorities, business elites, and other groups of

[3] See North (1989) as well as the works of Dixit (1996), Kiewiet and McCubbins (1991), Krehbiel (1991), McNollgast (1989), and North (1990b).

society. Ultimately they determine political choices. Consequently, economic outcomes are not only responses to market conditions, but also the products of these institutionalized relations (Dixit 1996; Evans 1995).

Hence if initiating and facilitating institutional change by the state is a pivotal component of policy reform and an indispensable condition for its success, we need to recognize that this is only one side of the coin. The flip side is the need to make the state effective in implementing and enforcing institutional and other policies. This requires a thorough analysis of, and a differentiated conceptual approach to, the state apparatus which avoids an oversimplified treatment of the state as a monolithic entity. Max Weber (1972/1921) defined the state as a compulsory association that successfully claims the monopoly of the legitimate use of physical force within a specific community. Contemporary scholars usually view the state in the *Weberian* tradition, but attempt to usefully amend this definition by reducing the complexity of analysing what states do and what roles they perform. Also note that the capability of state actors in achieving objectives such as internal and external security, and effective revenue collection, or in asserting control and autonomy is strongly influenced by the degree of social mobilization, economic conditions, and by the state's internal cohesion and legitimacy. In addition, the pursuit of public interests may conflict with the private interests of individual policy makers and contention along the boundaries of the state often results from, or is closely linked to, disputes between different levels and branches of government, public agencies as well as diverse interests of bureaucrats.

The definition of the state, used in this essay, essentially follows those outlined in Evans et al. (1985) and Grindle (1996). Thus the state is seen as a nexus of institutions for social control, authoritative policy formation and implementation, in which policy makers and social actors interact with each other and influence the path of economic, social, and political development, which in turn shapes the behavior of individuals and groups. In general, state institutions help to mediate conflicting social demands and produce specific policies and rules that govern social interactions within and beyond the political realm. One central purpose of state institutions is to reduce uncertainty about political change. This, first of all, concerns government changes. Institutional arrangements defining mechanisms for government selection significantly shape expectations about who may assume power and what kind of institutional reforms may be expected. Secondly, political change may be associated

with fundamental changes in the structural foundation of a polity. This refers to changes in both the general rules that guide political interaction and the rules that govern the evolution of the polity over time. Institutions governing this type of political change, especially a country's constitution, are essential because they shape the strategies which interest groups and individuals pursue to advance their political objectives in the future.

Since the state itself can be perceived as a complex nexus of institutions, which provide the incentive structure for policy makers and determine the process of policy formulation, implementation, and enforcement, institution building as a key component of policy reform has two dimensions: (1) creating the formal *economic* institutions which guide private sector development and coordination; and (2) crafting *political* institutions which are conducive to the proper and sound implementation and enforcement of economic institutions and policies.

However, the task relating to this second dimension is subject to what Weingast (1993 and 1995) calls "the fundamental political dilemma of an economic system"; namely that a strong government, which is required to protect and enforce property rights, is also able to violate these and other citizens' rights and to confiscate private wealth, thereby creating disincentives for private actors to carry out long-term investment and to provide information. This, in turn, blocks thriving markets, and eventually halts development. As North (1990a: 59) puts it bluntly, "if the state has coercive force, then those who run the state will use that force in their own interest at the expense of the rest of society". This is why a secure politico-institutional foundation limiting the state's ability to transgress the rights of private actors is indispensable for the emergence of a functioning market economy and for its preservation. As Weingast (1993) observes, the absence of a political foundation of policy reform can lead to an equilibrium trap that is characterized by reform failure despite the choice of adequate economic policies. Such a trap may result from government failure to guarantee publicly that it actually will implement the announced reforms and stick to them beyond the short term. McKinnon (1991) argues that an equilibrium trap may be particularly likely if governments face (unexpected) financial difficulties and if the pressure for quick solutions is relatively high. Then governments will be more likely inclined to intervene in economic processes in order to increase net revenues. Since private investors may anticipate government intervention,

uncertainty with respect to economic policies will generate political risk and thus impede long-term economic performance.

More generally, politicians, who reflect multiple interest groups, cannot succeed acting alone, but need to strike bargains about rules and rights with other policy makers, business elites, and social groups with different interests. For example, in order to facilitate private-sector coordination and to foster economic growth, politicians and bureaucrats have to rely on the private sector, which is expected to provide reliable information and to increase private investment. Since future payoffs of alternative political choices, however, are uncertain *ex ante*, policies can be effectively implemented today only if agreements are made that guide future decisions. In order to reduce the costs of political bargaining, legislative exchange, and policy implementation, institutional arrangements must be put in place which facilitate the exchange over both time and space. They need to constitute *ex ante* agreements concerning the cooperation among different policy makers and between them and private business as well as important groups of society (North 1990a). But studies on institutions and transaction costs stress the fact that, while organizations and individuals have numerous incentives to strike bargains, compliance to agreements *ex post* is often a critical problem (North and Weingast 1989). Of course, this kind of problem can be principally overcome by building up a good reputation. Yet it is well known that there are many circumstances in which this mechanism alone is insufficient to prevent non-compliance.

The preceding arguments indicate that economic institutions and policies that can be readily revised by policy makers have significantly different implications for economic performance than the same rules and policies when they are not subject to revision or when a revision is associated with high transaction costs. Therefore, for sustained economic development to occur, political institutions must be established that effectively bind political authorities to adhere to prior agreements and to use their powers in the public interest. This problem essentially comes down to the question of how *credible commitments* on the part of policy makers can be realized in order to help to overcome time inconsistent behavior and hence the potentially harmful effects of political discretion, opportunism, and arbitrariness. The argument to be elaborated here is that political institutions may provide the means which are suitable to make commitments credible.

As Shepsle (1991: 247; italics original) defines it, “a *commitment* is a promise, pledge, vow, covenant, guarantee, or bond to perform in a specified fashion. A commitment is *credible* in either of two senses – the motivational and the imperative, respectively.” A commitment is said to be motivationally credible if it is self-enforcing in the sense that the respective party still wants to honor its commitment at the point in time when it is to be performed. More important in the realm of policy making, however, is commitment in the imperative sense. This means that the respective party “is unable to act otherwise [at the time of performance; J.A.], whether he or she wants to or not; in this sense a commitment is credible, not because it is compatible with contemporaneous preferences but rather because performance is coerced or discretion to do otherwise is disabled” (ibid.). Since policy makers usually possess varying degrees of discretionary authority and are often not believed to be motivationally credible, they cannot credibly deny that they will behave opportunistically *ex post* even if such a denial would be truthful. They are credible only if they are willing and able to tie their own hands. Hence the necessity for policy makers credibly to commit themselves to policy reforms in the imperative sense underlines the importance of political institutions.

Disabling political discretion requires institutionalizing an asymmetry, that is, making it relatively easy to initiate new policies or to make agreements and making non-compliance relatively difficult. This can be achieved by the division of political labor. Various institutional arrangements can enhance the credibility of reform policies. These include, e.g., constitutional provisions and imperatives that prohibit the expropriation of private property; an independent judiciary; independent regulatory agencies; as well as the empowerment of veto groups that may force unanimity between different political bodies such as the executive and the legislative branch of government. Similarly, institutional procedures may reinforce political structures and enhance the credibility and durability of decisions and policies. For example, procedural arrangements such as mandatory delays, which prescribe several deliberations before a status quo can be changed, raise the transaction costs of policy making and help to disable political discretion.

So far the question of how to make political commitments credible has been discussed with particular respect to the durability and sustainability of public policies. But there is more to it as Lupia and McCubbins (1998a and 1998b) observe. Starting from the premise that a credible government commitment is not necessarily based on

reputation, ideologies, partisanships, individual backgrounds, or repeated play, they find that political credibility results from three conditions, the satisfaction of which is significantly facilitated by specific institutional foundations. These determinants include the sincerity (or truthful revelation) condition, the capability condition, and the sustainability condition. All three components are necessary conditions for credible political commitments. First, recall that actions speak louder than words. Even if a government is able to implement reform policies, a lack of sincerity or truthfulness of political decision makers who support reforms by words, but not by deeds, is sufficient to ensure reform failure. Secondly, even if policy makers truthfully reveal what they actually mean, reforms will be doomed to fail and promises will be regarded as non-credible, if the government lacks the capability of technical implementation and of forming appropriate legislative and enforcement coalitions. Third, even if pivotal political actors are sincere and capable, policy reforms will fail if they cannot be sustained over time in the course of government changes or exogenous shocks. This implies that the three conditions are individually necessary and collectively sufficient to make political commitments believable.

Specific institutional arrangements, within which a pivotal political actor makes promises to the citizenry or a policy statement in negotiations with international organizations, can serve as substitutes for his personal attributes with respect to sincerity. An appropriate institutional context needs to increase opportunity and transaction costs for breaking, revising, or reneging on promises (for example, through bonding or signaling mechanisms). Furthermore, in order to satisfy the capability condition, specific institutions are required to ensure technical capability of implementing reforms (e.g., a competent and meritocratic public administration and bureaucratic procedures and administrative law setting the terms of delegation) and to ensure the effectiveness of a legislative and enforcement coalition (e.g., appropriate agenda control mechanisms and institutional arrangements for the creation of ministerial positions and committees). Finally, in order to ensure the sustainability of reforms, institutions need to be in place which can protect policy reform beyond the enacting government’s or political leader’s stint of power (e.g., veto gates in the governmental process and deliberation councils).

There is a broad consensus in the New Institutional Economics literature that a credible government commitment is a necessary condition for successful policy reform. In addition, it is widely agreed that suitably designed institutional features

(which complement reputation-building) can impose effective restrictions on the *ex-post* behavior of policy makers and are primary devices to enhance the ability of governments to stick to their bargains and to deliver their promises to citizens.[4] Political institutions, in particular a country's constitution, play a critical role because they primarily determine the incentives of political actors and hence political outcomes in the form of economic rules and regulations and policies.

Two qualifiers to the credibility-enhancing effects of political institutions, however, are to be taken into consideration. First of all, whether a society is driven by the rule-of-law depends not only on its political institutions. Since constitutions, laws, and regulations can be politically ignored, altered, or removed, mechanisms must be put in place which allow for the policing of deviations by governments. Weingast's (1993 and 1995) analyses suggest that the effectiveness and maintenance of political institutions defining the legitimate boundaries of the state crucially depend on a consensus among citizens about the limits of government. This consensus, in turn, depends on the interaction of informal (opinions and attitudes of citizens) and formal institutions. In order to create a societal consensus during the development or transformation process, promoting the emergence of a civil society is of utmost importance. Formal institutions may become a focal point to help coordinate and align citizens' informal attitudes, so that (new) formal institutions of policy making and representation can be sustained. Thereafter, the constituency is better prepared to control government behavior and to react in concert against the government if it is perceived to transgress its legitimate boundaries.

Secondly, enhanced credibility through asymmetric institutionalization may come with a cost in that it implies a loss of policy flexibility. If political institutions are in place that effectively bind policy makers' hands today and in the future, it will become increasingly difficult to revise the course of policy reform, if external circumstances or the preferences of the constituencies change over time. Cox and McCubbins (1997) persuasively argue that too many veto points, which are controlled by political actors with diverse interests, may imply state indecisiveness and political stalemate.

These caveats imply that single institutional features alone, which help overcome credibility and incentive-compatibility problems, will be insufficient to ensure successful policy reform. Only a coherent and consistent set of political, economic,

[4] See, e.g., North and Weingast (1989), North (1990a), Borner *et al.* (1995), Weingast (1995), World Bank (1995), and Lupia and McCubbins (1998a). With respect to the role of institutions for achieving credible commitment in the realm of macroeconomic policies see,e.g., Persson and Tabellini (1990).

and social institutions including both formal rules and informal constraints will lay the structural and procedural basis that is appropriate to secure thriving markets, to ensure policy adaptability, and to implement policy reforms effectively. This finding indicates the need for an overall *governance structure* as a politico-institutional foundation of economic and social development. Hence, in important respects the logic behind political organization shows significant parallels to that underlying economic organization. Regarding the latter, Williamson (1985: 48–9) recognizes that

"Transactions that are subject to *ex post* opportunism will benefit if appropriate safeguards can be devised *ex ante*. Rather than reply to opportunism in kind, therefore, the wise (…) [bargaining party; J.A.] is one who seeks both to give and to receive 'credible commitments.' Incentives may be realigned, and/or superior governance structures within which to organize transactions may be devised."

When institutions and economic policy are seen as the focal points of the development problem, attention needs to focus on questions such as (1) what are the integral components of a politico-institutional foundation of policy reform; and (2) which conditions will be conducive to the emergence of an *effective governance structure*. The ramifications of the preceding arguments for Central Asian countries are discussed in the subsequent section against the background of Chinese transition experiences.

3. The unorthodox institutional foundation of economic transition in China

The notion of an institutional shock therapy has not played any role in the transition and development processes in East Asia, where economic transition has taken place in an authoritarian setting. In the 1960s and 1970, South Korea, Taiwan, Singapore, Indonesia, and Malaysia showed remarkable and sustained economic growth rates in non-democratic settings. In China, Vietnam, and Laos, the communist party has enjoyed a monopoly of power and has not been willing to give up or share the political leadership with other political forces. Nevertheless, most governments started genuine market-oriented reforms making East Asia the economically fastest growing region over the past forty years. Recognizing that political power can be only maintained in the course of time if sustained economic growth is achieved which

benefits not only the political elite and big business but all strata of society, marketization and economic growth have become key policy objectives to gain political legitimacy. Authorities in all of these countries managed to credibly commit to market reforms, to establish incentives for productivity enhancing activties, and to enhance the incentive compatility of policy makers's interests and the needs for sustained economic performance.[5]

Today, a common understanding holds that no blueprint exists regarding the design, the evolution, or the components of a market-enhancing governance structure (MEGS), which implies a secure and sustainable politico-institutional foundation for economic transition and development. A governance structure to be effective and societally accepted needs to account for country-specific characteristics (Rodrik 2007). And yet, many studies indicate that broad principles exist, which may guide policymakers, advisors, and academics though the complicated terrain of institution building: Besides the need for a strong but limited state and building market-oriented capacity in the public administration, key economic institutions should be crafted and enforced which ensure a proper functioning of market processes and private foster sector coordination.[6]

According to Rodrik (2007), key economic institutions relate to rules for macroeconomic stabilization and structural adjustment, rules of the legal, regulatory, educational, financial, and social infrastructure as well as institutions for conflict management. These institutions leave room for considerable interpretation and adaptation. In Rodrik's (2007: 6) words:

> "first-order economic principles (…) do not map into unique policy packages. Reformers have substantial room for creatively packaging these principles into institutional designs that are sensitive to local opportunities and constraints."

In particular, the high-performing countries in East Asia have convincingly demonstrated that pragmatic (not first-best) institutions can foster sustained economic growth in a non-democratic setting. Examples include the East Asian tigers, South Korea, Taiwan, Singapore, Malaysia, and Indonisia, and more recently Vietnam and China. These cases indicate that unorthodox *transitional institutions* may turn out to be more effective than presumably best-practice institutional

[5] See Root (1996), Campos and Root (1996), and Ahrens and Mengeringhaus (2006).

[6] For an overview of these studies as well as an in-depth introduction into the concept of market-enhancing governance structures, see Ahrens (2002).

arrangements in a period of economic transition. Especially for an authoritarian regime, they could make market-oriented reforms a viable policy choice, because they help political authorities to maintain power and control and, in addition, open up ways to make political elites winners of reform. Finally, specific transitional institutions tailored to the needs, capacities, and capabilities in the respective countries could be much faster developed than best-practice institutions – the latter usually need a long period of time to be crafted and enforced, and in many underdeveloped autocratic transition economies (e.g., in Uzbekistan, Tajikistan or Turkmenistan), there would be a lack of human capital to operate them (e.g., law drafting and enforcement). Evidence shows that transitional institutions can serve as functional equivalents to first-best institutions, e.g., with respect to creating incentives for doing business, to introduce competition, or to establish control rights over the means of production (Qian 2003).

For example, Chinese special economic zones (SEZs) represent a transitional institution regarding a gradual external opening-up strategy in the sense that a free-trade area or a customs union with third countries would be more efficient from a theoretical viewpoint, but at a given point in time this is not a feasible option. Therefore, SEZs serve as a second-best way to open up the economy and, in addition, signal a government's commitment to market-oriented reform. This would be reinforced, e.g., through public infrastructure investment, low tax rates, and liberal institutions and market rules governing the SEZs (Khan 2002).

With respect to internal economic reforms, transitional institutions may, incrementally but visibly, enhance a government's credibility. The starting point would be to create a strong state, i.e. to enable authorities to credibly pre-commit to market-oriented reforms and to enforce new rules of the game. A key challenge is to shield policymaking entities such as the economic bureaucracy and key government agencies from the influence of reform opponents. Thus, public administration reform and capacity building are essential to strengthen the state apparatus. This requires (i) strengthening economic policy formulation, coordination, and implementation, e.g., through a central economic planning board – possibly staffed with foreign experts; (ii) public financial management reform; and (iii) civil service reform. In addition,

meritocratic recruitment and promotion standards could provide bureaucrats with long-term career rewards thereby reducing incentives for corrupt behavior.[7]

Since measures such as performance-based employment policies, downsizing surplus staff, and organizational restructuring are central to improving the implementation capacities of weak executing agencies, it is necessary to complement sector-level capacity building with measures that concern the public administration in its entirety.[8] Such an approach to public administration reform would not threaten the political regime per se. To be effective, however, institutional and organizational reforms usually have to be complemented by human resource development, the more so as knowledge of market economics and modern management techniques is often absent in (less developed) transition economies.

In advanced democratic market economies, state strength is usually limited and political credibility enhanced through a subtle system of checks and balances. This option, however, is not available in autocratic transition countries. In such a case, one (far from perfect but) feasible option is to limit the government through an external flanking of the respective country's reform and international integration process. Gradually opening up the economy and increasing its exposure to foreign competition as well as membership in international organizations such as the World Trade Organization (WTO) helped Chinese authorities to incrementally and credibly enhance reform commitment. In the longer run, the authoritarian, though possibly reform-minded government can seek to bind its own hands at least regarding specific policy realms (e.g., through establishing an independent central bank).

Regarding economic reforms, macroeconomic stability is an unalterable precondition. This presupposes a market-oriented price system and a (possibly) independent central bank as well as prudent fiscal management and at least a rudimentary market-oriented tax system. However, as the Chinese example shows, a complete price liberalization could contradict the interests of the political leadership in distinct country-specific contexts. The same holds for large-scale privatization. Chinese and other East Asian experiences support the view that it may be more promising to legalize and foster already existing small-scale private transactions, e.g. on farmers markets, in the retail sector as well as in industry and in an emerging

[7] See Root (1996), Campos and Root (1996), Ahrens (2002), and Ahrens and Mengeringhaus (2006) for in-depth analyses how specific institutions contributed to enhance governments' capacities and capabilities in the high-performing Asian economies including China.

[8] See Ahrens (2002) for further elaboration regarding the following aspects.

service sector. Promoting newly emerging small and medium sized enterprises and gradually creating a labor-intensive private sector in a bottom-up manner could reinforce a partial price liberalization, support supply-side reactions of the economy, and foster job creation.

Chinese reform experiences show that agricultural reform by abolishing agricultural collectives and establishing a household responsibility system can yield substantial and quick productivity gains. This might increase confidence in market forces and strengthen the support of further reforms at later stages (Lee 1997). Regarding industrial restucturing, China adopted a dual-track approach which allowed to maintain parts of the planned economy for a transition period, until a possibly emerging private sector will have gained sufficient economic strength so that it can absorb surplus labor from heavy industry (Qian 2003). This approach helped to enhance economic efficiency of state-owned enterprises (SOEs), to minimize opposition to economic reforms *ex ante* (due to temporarily protected status-quo rents) and to increase the opposition to reform reversal *ex post* (due to an increasing number of people benefiting from reforms) (Lau et al. 2001). In other countries, such an approach could make industrial reforms compatible with a prevailing, potentially market-skeptical political ideology. Furthermore, it would be consistent with a gradual strategy of opening up vis-à-vis the rest of the world.

Last but not least, as long as no dominant private sector exists in the economy, growth-enhancing reforms need to be in the interest of regime officials at the central and local level. Only if these actors can preserve their power and privileges and become reform winners, economic transition will be politically feasible. Again China offers an example of how to deal with such a challenge: Decentralized public commercialization through the devolution of economic competencies and the creation of township-and-village enterprises (TVEs) with hard budget constraints helped to re-align incentives of local policymakers and bureaucrats and made them residual claimants of market processes. Moreover, the experience of TVEs suggests that control rights may be established and can foster entrepreneurial activities even if property rights are not clearly defined (Qian and Weingast 1997). Thus formal legislation is neither a necessary nor a sufficient condition for ensuring effective control. In practice, Rodrik (1999) concludes, the efficacy of control rights is contingent not only on legislation but also on enforcement as well as informal norms such as customs and tradition. In order to avoid a capture of local governments by

possibly emerging local groups owning immobile factors of production such as land, the introduction of a household responsibility system should be complemented by a possibly more egalitarian distribution of land rights at the beginning of an economic reform process.

In sum, China gradually improved the quality of its market-oriented governance structure.[9] This clearly strengthened the politico-institutional foundation of gradual economic transition fostering competition in the domestic markets and gradually exposing domestic companies to the competitive pressures of the world market, providing incentives for productive business transactions, and rewarding economic risk taking. Market-enhancing governance, Chinese-style, has neither followed a straightforward theoretical imperative nor has it yielded clear-cut lessons for other countries at the same stage of economic development (see Figure 1). But the Chinese case reinforces the view that institutions and governance matter. Basic principles such as accountability, participation, predictability, and transparency play a key role in China, too. Of course, these principles are not realized as they are in advanced democratic Western economies. Accountability of the political leadership, e.g., can hardly be observed with respect to citizens. But relatively effective monitoring devices help to hold the public administration accountable vis-à-vis the central government, and the institution of market-preserving federalism (MPF) in combination with a comparatively autonomous economic bureaucracy contribute to enhance accountability and incentive-compatibility within the public sector as well as the participation of lower-level governments in economic policymaking. Moreover, policy choices faced by Chinese policymakers at the national as well as the regional level appear to be comparatively transparent and predictable. Since it is in the interest of most, if not all, political actors concerned with economic policymaking to foster overall growth and development, due to the competitive character of the MPF system and due to the openness of the overall Chinese economy, private economic actors tend to have relatively stable expectations regarding the course of economic policymaking in the short as well as the long run, although authorities still tend to intervene selectively particularly into processes of distinct branches of the economy such as the financial sector (Ahrens and Mengeringhaus 2006).

Furthermore, the political leadership managed to enhance its legitimacy and its credibility from the viewpoint of citizens through its distinct approach to economic

[9] The following arguments are drawn from Ahrens (2007).

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

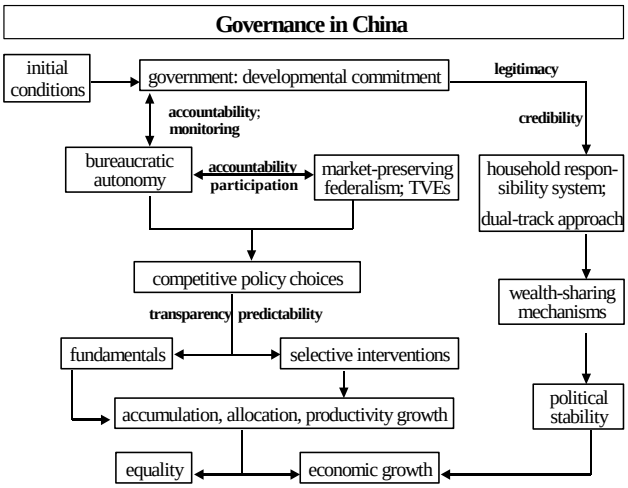


Figure 1: Governance in China

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

While the Chinese governance structure has performed comparatively well

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

4. Implications for Central Asian countries

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

Even in successful transformation countries, governance structures are not perfect. But in each case, they exhibit key characteristics which help to enhance government commitment to economic growth and development. In all those countries, numerous institutions underlying the governance structure score comparatively high according to four governance dimensions: accountability, participation, predictability, and transparency; either because countries such as the

new member states of the European Union have sought to implement Western best-practice institutions (which in their cases materialized) or, as in the case of China and other East Asian countries, because effective transitional institutions could be crafted which represented functional equivalents to orthodox market institutions.

Building and impartially enforcing institutions are key tasks for governments. This holds equally for introducing and enhancing market development as well as for preserving functioning markets through time. Therefore, state apparatuses need to be made effective in implementing market-oriented policies, enforcing market-order institutions, and promoting private sector coordination.

However, Weingast's (1993) "fundamental political dilemma of an economic system" has not yet been overcome in any of the Central Asia countries. Especially, Kazakhstan, Uzbekistan, and Turkmenistan possess strong governments, which could basically protect property rights and enforce other market rules. Since none of these governments, however, is sufficiently limited in its powers, they would be also able to violate rights of private business and citizens. Even if political authorities do not intend to transgresss against these rights, policymakers cannot credibly precommit to comply with the rules. This fact creates disincentives for domestic and foreign private actors to carry out long-term investment and to provide information. Eventually, this may block thriving markets and impede development.

In order to get a broad, though comparative impression of the politico-institutional situation in Central Asia, it may be telling to take the analyses of the Bertelsmann Foundation and the World Bank into consideration.[10] The Bertelsmann Transformation Index (BTI) examines 125 countries and ranks them according to two composite indicators: the status index measuring a country's state of transition towards a market economy and a democracy; the management index reflecting the governance quality of decision makers. Figures 2 – 6 provide a comparative perspective on the politico-economic situation in Central Asia. While Figure 2 compares Kazakhstan (blue line), economically the most advanced country in the region, with China (red line), Figures 3 – 6 compare Kazakhstan (blue line) with each other Central Asian country (red line).

[10] The Bertelsmann Foundation provides information on the development of political and economic transition in a great variety of countries. For more information, see http://www.bertelsmann-transformation-index.de/11.0html?&L=1; the World Bank provides its Governance Indicators at http://www.govindicators.org

Figure 2:
Transformation in Kazakhstan and China

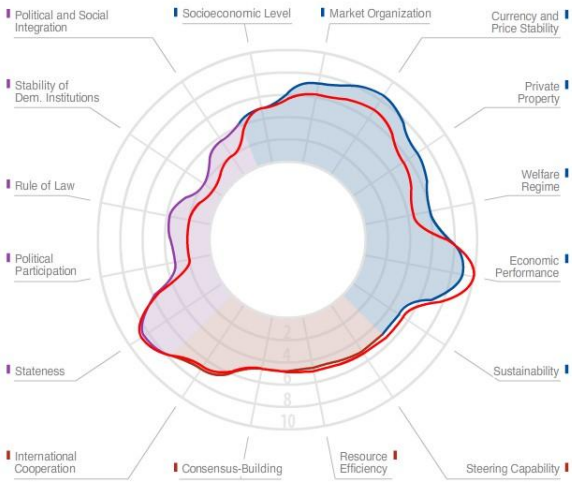


Figure 3:
Transformation in Kazakhstan and Uzbekistan

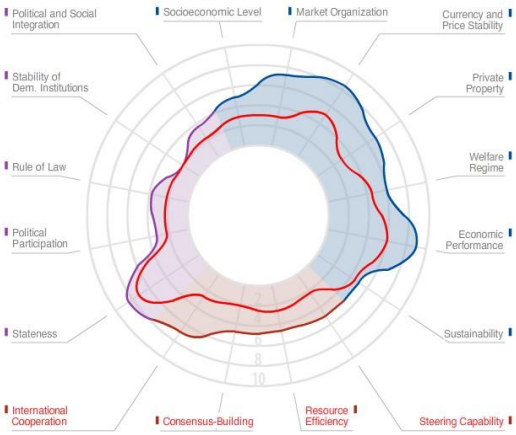


Figure 4:
Transformation in Kazakhstan and Kyrgyzstan

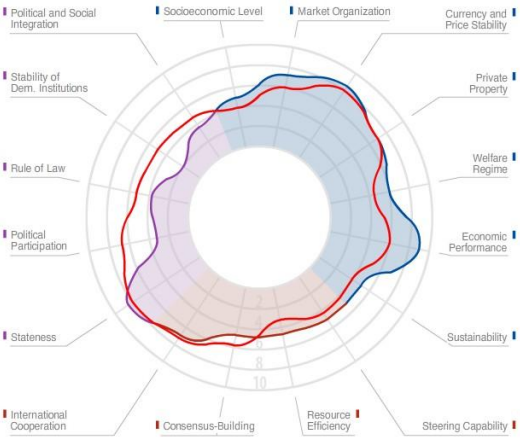


Figure 5:
Transformation in Kazakhstan and Tajikistan

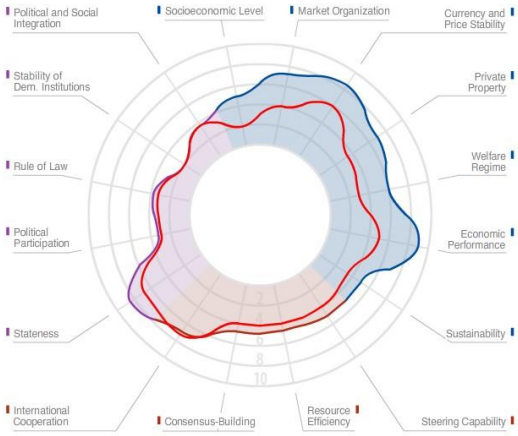
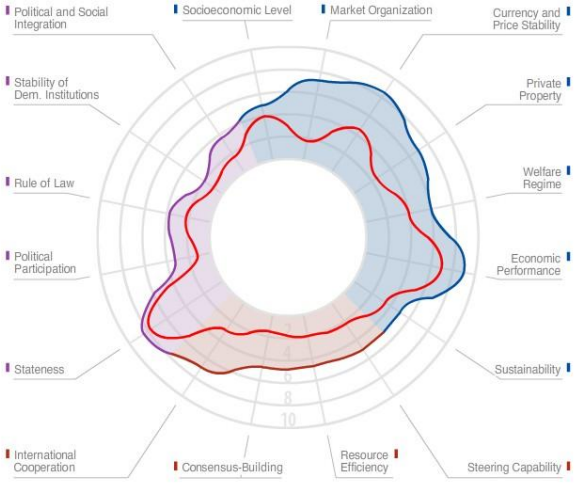


Figure 6:
Transformation in Kazakhstan and Turkmenistan



Source: Bertelsmann Foundation (2009)

The similarity of the portrays of Kazakhstan and China is striking. While both countries perform relatively poorly in terms of democratic transition[11], which does not come as a surprise given the political history and power constellations in both countries, performance is much better as regards the achieved state of economic transition attributing Kazakhstan the second rank in the Commonwealth of Independent States.[12] The management index shows intermediate scores for both countries suggesting that a lot of efficiency-enhancing potential exists concerning the

[11] See the indicators stateness, political participation, rule of law, stability of democratic institutions, and political and social integration. On a scale from 0 to 10, Kazakhstan scores 4.2; for explanation of how indicators are calculated, see Bertelsmann Foundation (2009).

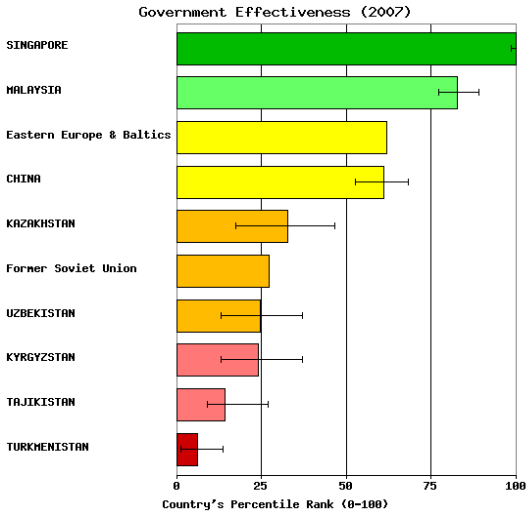
[12] The so-called market-economy status comprises indicators such as socioeconomic level, market organization, currency and price stability, private property, welfare regime, economic performance, and sustainablity. In a scale from 0 to 10, Kazakhstan scores 6.8.

reform determination and management and steering capabilities of the public sector.[13] A comparison of Kazakhstan with the other Central Asia countries reveals that the former outperforms the others in virtually every respect; except for Kyrgyzstan with respect to the democracy status. Key backlogs appear to exist in Uzbekistan and Turkmenistan regarding these countries' cooperation with the outside world. This holds in terms of regional cooperation, but also concerning the effective use of external support and acting as a reliable partner to third countries and international organizations. Similary, these countries lag behind in terms of institutions for conflict management, political consensus finding and participation, as well as in terms of using public assets efficiently, fighting corruption, and coordinating reform policies (Bertelsmann Foundation 2009). Furthermore, Kazakhstan takes the regional lead in virtually all dimensions of economic transition and performance. This clearly reflects the country's progress in building key economic institutions which constitute a market economy and provide incentives for market exchange.

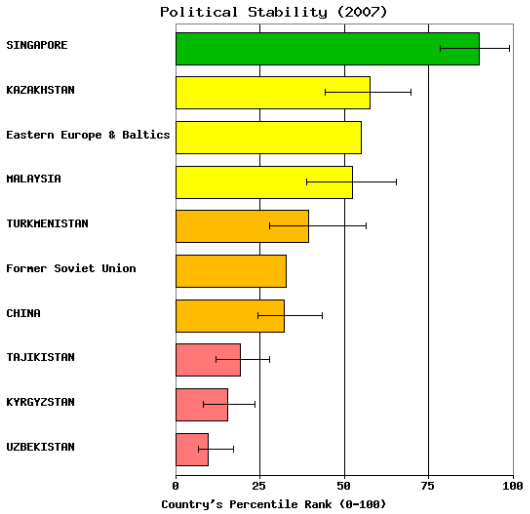
The World Bank Governance Indicators (WBGI) support this assessment (Figures 7 – 12). The World Bank (2009) defines governance as "the traditions and institutions by which authority (…) is exercised. This includes the process by which governments are selected, monitored and replaced, the capacity of the government to effectively formulate and implement sound policies; and the respect of citizens and the state for the institutions that govern economic and social interactions among them". Governance is measured through expert surveys according to six dimensions: voice and accountability, political stability, government effectiveness, regulatory quality, the rule the law, and control of corruption. Figures 7 – 12 depict the scores of all Central Asian countries plus China, Malaysia, and Singapore as comparator countries plus two regional averages with respect to all governance dimensions.

[13] The management index comprises indicators such as the steering capability, the resource efficiency, consensus building, and international cooperation as regards the public sector. Kazkhstan scores 4.7 on a scale from 0 to 10.

Figures 7 – 12



Source: Kaufmann D., A. Kraay, and M. Mastruzzi 2008: Governance Matters VII: Governance Indicators for 1996-2007
Note: The governance indicators presented here aggregate the views on the quality of governance provided by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. These data are gathered from a number of survey institutes, think tanks, non-governmental organizations, and international organizations. The aggregate indicators do not reflect the official views of the World Bank, its Executive Directors, or the countries they represent. The WGI are not used by the World Bank Group to allocate resources or for any other official purpose.



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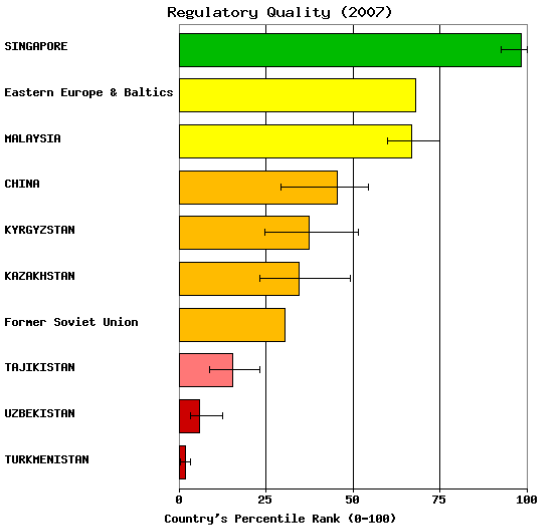

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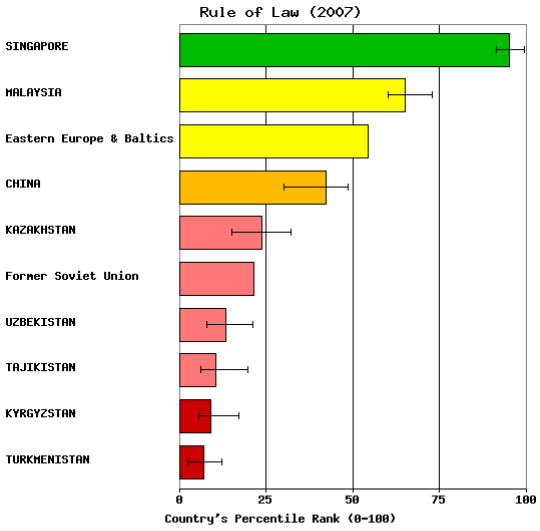

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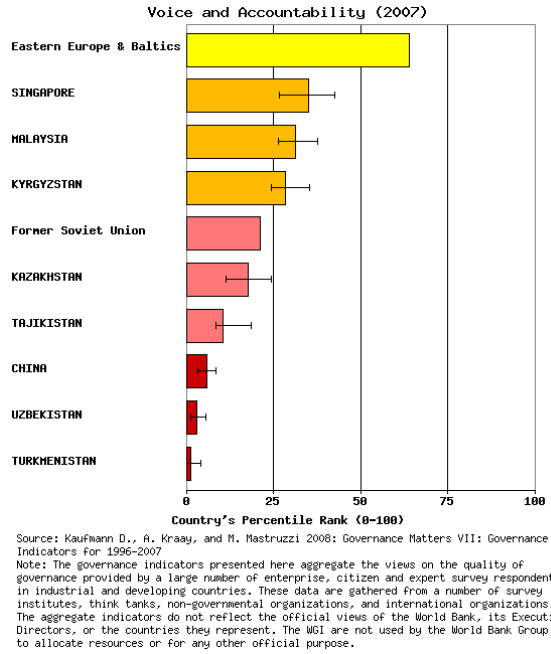

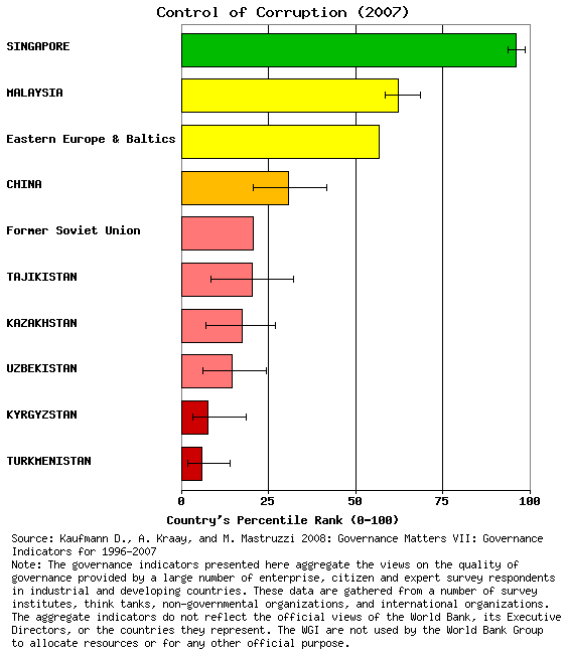

Source: World Bank (2009)

The three East Asian comparator countries had been selected because they have (so far) successfully managed economic transition in a non-democratic setting with active and often effective government intervention and guidance of economic reform processes. All countries have pursued non-orthodox, largely independent development strategies, established a very competent economic bureaucracy and relatively effective government-business interfaces (Campos and Root 1996; Ahrens and Mengeringhaus 2006). In addition, these three countries represent economies at three different stages of economic development (see Table 1).

Table 1: Central Asia and comparator countries: economic indicators; 2008

Country	**GDP/capita (PPP)*, 2008**	**EBRD liberalization index****
Kazakhstan	11.563	3.04
Kyrgyzstan	2.174	3.08
Tajikistan	1984	2.50
Turkmenistan	5.765	1.50
Uzbekistan	2.606	2.21
Comparator countries		
China	5.943	n.a.
Malaysia	14.225	n.a.
Singapore	51.649	n.a.

Sources: IMF (2008), EBRD (2008), own calculations, * PPP : purchasing power parities ; IMF estimates, ** EBRD Transition Indicators are based on experts' judgments and range from '1' (unreformed centrally planned economy) to 4.33 (institutional quality of a representative developed market economy).

While Central Asian countries are clearly lagging behind in all dimensions, particular observations appear to be noteworthy. The comparatively bad performance in terms of *voice and accountability* is no surprise given the authoritarian regime or limited democratic standards in all countries. While Central and Eastern European (CEE) countries follow the democratic model of the EU, it should be borne in mind that accountability mechanisms and participatory involvements in policymaking are basically conceivable (at least to some extent) in non-democratic settings as well. This has been documented in the Chinese case, and it is supported by the data on Malaysia and Singapore. Therefore, all Central Asian countries need to seek for ways especially in the public management domain to find more inclusive and accountable ways of formulating and implementing policies. Experiences in China and other high-performing Asian economies show feasible ways: deliberation councils which constitute a closer government-business interface, fostering business intermediaries, and promoting competition can help to make progress in this area (Root 1996, Ahrens 2002).

Similarly, measures improving the *rule of law* and *fighting corruption* appear to be largely independent of the political regime. Even Singapore and Malaysia score relatively high in these domains. In terms of public sector management and the quality of policymaking Kazakhstan performs relatively well given its stage of economic development. Huge backlogs appear for long-time closed Turkmenistan and poor Tajikistan.

While Kazakhstan has already taken important steps towards improving its governance structure, huge tasks remain especially for Uzbekistan, Turkmenistan, and Tajikistan. The key challenge is to enhance the credibility of political authorities, to improve public sector management and to create market incentives. China and other East Asian countries provide useful lessons of how to find mechanisms to tie politicians' hands and to raise their credibility. Creating strong and capable public administrations will not undermine the power of ruling elites but enhance the capabilities of implementing market-oriented policies. Fostering international cooperation and competition may serve as disciplining devices for strong governments. Central Asian countries cannot rely on a strong external anchor such as the EU or NATO, but as in the case of China, they may seek WTO membership, or may assume a leading role in OSCE like Kazakhstan and, last but not least, expose domestic companies to competitive world market pressures.

Furthermore, through an economic empowerment of local governments, local (public) enterprises can be developed and become crucial for an economic take-off process even before large-scale privatization is undertaken. In addition, it would be conceivable to create competition under a dual-track approach; e.g., by fostering the emergence of private businesses in sectors such as agriculture, retail trade, and light manufacturing, and strengthening the corporate-control structures of, and introducing hard budget constraints for, TVEs and SOEs following the Chinese model. At a later stage, industrial liberalization and privatization can further proceed.

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

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

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

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

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

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

Finally, these propositions would be reinforced through a *shared-growth strategy*, which provides people with public goods as well as *real* assets. Such wealth-sharing

mechanisms can provide market-oriented incentives and reinforce people's loyalty vis-à-vis political authorities. Real assets may include granting private property rights to the population regarding the houses and apartments, in which they live, pieces of land, which they could cultivate, as well as free education and health care. In addition, fostering labor-intensive manufacturing, public investment in infrastructure, and land reform may help people to exploit their assets more effectively. Eventually, a shared-growth strategy can help to credibly signal the political leadership's commitment to economic development. In combination with a dual-track approach, it may help to create win-win situations, i.e. a reform without losers. This would enhance the legitimacy of the political leadership, reduce potential resistance to reform as well as incentives to migrate.

These considerations illustrate again that a universal market-enhancing governance structure does not exist. But the ultimate objective of crafting flexible governance structures is the same in all countries, namely to establish strong but limited governments which are embedded in institutional structures that provide a secure politico-institutional foundation for market reform and economic development.

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