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Regulation and Public Sector Development: A Post-Transition Perspective

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For nearly two decades now the historic attempt to overcome the constraints of the Soviet-type economy and its modified or reformed variants has been gathering momentum. Rather than improving the regime through piecemeal changes, an attempt to change the entire construct has been undertaken. The more we know about the outgoing regime, even with the benefit of hindsight, the less we are surprised to see the high transition costs. The ossified economic structure, dominated by heavy industrial output, primarily for military purposes and intermediate consumption, the low efficiency in the use of natural resources, misallocation of finance and a generally innovation hostile bureaucratic environment have made the modernisation of the second half of the twentieth century much more of an appearance than a reality.[1] Therefore introducing market incentives, stabilisation, liberalisation, privatisation and other components of sound macroeconomic policy, even the building of new up-to-date institutions, at first triggered sizable costs. At this point we should quantify how big these costs were in terms of overall output. However, this has remained a subject of controversy in the international literature (A slud, 2002, chapter 4; Winiecki, 2002; and more critically Havrylyshin, 2004) for a number of reasons. The latter include the improper accounting of the socialist period with its numerous value-subtracting activities and conceptually flawed statistical reporting practices. It was also exacerbated in the first half of the 1990s by the lack of proper recording of much of the output and quality improvement that was due to the new private sector.[2] Also, the very fact that structural changes were momentous does not allow the customary reliance on long-term time series of statistics.

All in all, the received wisdom, both contemporary and more recent, has seen privatisation to be the major thrust of the transformation exercise. This is legitimate, even with the benefit of hindsight and despite critical voices, as long as we do not know of a single instance where a market-based economy could function without the predominance of private property. A more recent survey by the World Bank (Kikeri & Nellis, 2004) has summarised empirical evidence in advanced and developing countries. The authors conclude, in a self-reflective tone, that while the idea of privatisation tended to be oversold, especially in terms of policy, private corporations

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have proved by and large more efficient than public, semi-private, cooperative and other non-privately owned firms. This finding has been shown to be contingent upon meeting a number of criteria, in terms of regulation and institution building. However the 'bottom line' has remained unchanged, that is, the hypothesis can be taken as empirically proved, and qualifications must be interpreted as additional though important caveats.

From this angle it might well have been by and large inevitable that the role and function of the—remaining and newly created—public sector has remained ambiguous and often not very well specified. In part owing to ideological fervour, in part to the dominance of crisis management in actual policy making, the role of the public sector has rarely been discussed, in either normative or descriptive terms. In the transition-specific literature public firms tended to be seen as residual, and the public regulatory frame falling outside the scope of economic analysis proper. In his influential book on the strategy of change Kornai (1990) formulated the suggestion, long dominating mainstream thinking, that private firms should be deregulated, while public firms should be kept under control.

This suggestion is in line with the approach we find in most public finance treatises. However, in the reformed Hungarian economy, and later also in other transforming economies,[3] regulators have been faced with an insurmountable task in this respect. Very few of the actual units falling under their control could be seen as exclusively private or exclusively public. For instance, most large Hungarian firms were not only corporatised but also managed by enterprise councils, with elected managers exercising *de facto* control rights. Some of these firms were owned by financial institutions, typically banks. The latter, by contrast, have often been owned partly by other industrial firms, and increasingly also by foreigners. It is hardly by chance that the first democratically elected Hungarian government, when it tried to enforce public ownership, basically failed. Most corporations were either already spontaneously privatised or were emptied in a series of reorganisations, leaving only debts with the former enterprise centre (Mihályi, 1998; Voszka, 2003).

In other transition countries different trajectories have led to similar outcomes. For instance, in countries that opted for mass privatisation vouchers were collected by investment funds. The latter, in theory, exercised property rights, but remained, as financial investors usually do, quite passive. Meanwhile the stock exchange had not yet developed the qualities needed for evaluating corporate performance. Accounting remained dubious and arbitrary, disclosure and external, independent auditing requirements were not enforced (in some cases, like in Latvia and Albania, not even elaborated). Absence of regulatory constraints allowed giant pyramid schemes to emerge in a number of countries, from Romania to the Czech Republic in the 1990s, and not only in the financial sector. Realistic assessment of the net asset value of private-sector corporations has remained unsettled for many years, as testified by the recurring politicisation of privatisation.[4]

This situation has obviously threatened all financial institutions—banks, insurance companies and investment funds alike. Lack of transparency coupled with unhealthy intertwining has put the newly emerging financial sector on a frail footing. On the one hand, banks often have found their industrial clients to be too big to fail. On the other hand, industries have found their banks to be vulnerable and unable to extend the financial services they needed (especially though not exclusively in the New Independent States). The Czech, Russian and Romanian currency crises and the Latvian and Albanian banking crises have shaken confidence in the domestic financial system, especially in the new private pillars. The intertwining between bad banks and bad corporations, both located in the private sector, both able and willing to accumulate big losses in the (justified) hope of mutual cover-up has been shown to be a big surprise to most financial analysts, in a striking similarity to what later became known as stylised facts in the East Asian crisis of 1997–99 (Meyerdorff & Thakor, 2002).

The Public Sector in the First Transition Phase, 1989–1995

What has been said above may explain why the private sector has remained much less of a source of enhanced efficiency and improved allocation than originally expected. In other words, the transformational recession (Kornai, 1994), a specific and transitory but significant drop in output and employment, lasted longer and was also much deeper than contemporary observers would have had it, inside and outside the region. While social expectations were built on the insights from mainstream economics, namely that abolition of distortions would automatically improve welfare, especially if non-Keynesian effects of stabilisation prevailed, this has not been the case. The drop in output was due to several contractionary policies or processes that were acting in a self-reinforcing manner. The collapse of the Eastern trading bloc, CMEA, deprived most of large-scale socialist industry and much of agriculture of its traditional markets. Imposing fiscal discipline, hardening the budget constraints of firms by introducing bankruptcy procedures in 1986–93 also induced costs in terms of lay-offs. Finally, the employment and growth-generating ability of the private sector has remained much weaker than assumed. For instance—and most importantly—the traditionally underdeveloped services sector proved unable to make up for the losses of non-competitive and macroeconomically value-subtracting activities. One of the reasons for this mediocre performance has been growing uncertainty, due to the major rearrangements in politics and economy alike, and also the weak state of financial intermediation described above.

This state of affairs implied that conditions for rapid and sustained growth have been coming into being only at a gradual, slow pace. Financial institutions accumulated sizable risks, primarily in the new private sector (and not, as often claimed, due to inherited bad debts). Risk assessment and credit screening were non-existent, as was the case with track records and credit history. The tacit knowledge needed for banking, know-how and also technology, such as computers and data-processing networks, were missing. Furthermore, given the survival of old or hardly improved accounting procedures, corporate-level information was unreliable and unfit for providing forward-looking insights into the future profit-generating ability of any activity or organisation. Had the situation not been exacerbated by high or moderate levels of inflation, this circumstance alone would have been bad enough. And indeed, in countries like the Czech Republic or Slovenia, where hyperinflation never occurred, banks have been struggling just as much with their bad portfolio as has been the case in countries which underwent high inflation. Under these circumstances there was no reason why allocation of financial resources should have qualitatively and quickly improved under post-communism, which used to be the conventional assumption among policy makers and the majority of their advisers.

Once the new private sector had failed to deliver its promise, attention inevitably turned back to the public sector, often treated as something ephemeral, transitory and a remnant of the past. There are two ways in which this turn has become palpable. First, state-owned firms needed attention in terms of policy, for they continued to account for a major share of employment. Moreover, regional differences have emerged, even in small countries like Hungary, reaching a dimension of 1:3 in a space where half a day of driving is enough to get from one corner of the country to the other. These differences have become much bigger in other countries. In the largest European country, Russia, for instance, the region on region difference in terms of per capita income widened to 1:13 by the middle of the 1990s.

Second but no less important, it had to be acknowledged that a number of activities could not be privatised, at least not within the short horizons dominating contemporary agendas. Even in the traditional tradable sector the poor state of the economy, the uncovering of hidden weaknesses—such as environmental costs in eastern Germany—and the generally pessimistic outlook for economic improvement made strategic investors wary. For instance, the Hungarian conservative government wished to privatise the Hungarian national airline, but could not find a better partner than state-run Alitalia, a symbol for poor business management in Europe. Unsurprisingly, the deal had to be reversed in the late 1990s and no tangible improvement of efficiency could be observed,[5] either at the macro or at the microeconomic level. Lack of interested strategic investors has been anything but an exceptional phenomenon.

For these and other reasons disenchantment with privatisation and practical exigencies such as strikes in Poland or intensive lobbying by MPs in Russia have put the public sector back on the agenda relatively early on. Money and attention needed to be devoted to what was then still a major share of the economy.

The first ideas were obviously the revival of old concepts, such as industrial policy and crisis management. In a way, quite unsurprisingly for this revolutionary period, decisions tended to be improvised and followed no abstract strategy (despite the fact that the latter were produced diligently as well). The two concepts did not necessarily overlap, as crisis management tended to be ad hoc and followed immediate presures from the political process.

This implies that recourse has often been had to old-fashioned concepts, either in terms of continued ad hoc subsidisation of existing plants, covering whatever losses they made, or via indirect methods, granting soft credit to large organisations.

Early analyses (Winiecki, 1993) already indicated this to have been the case also in countries like Poland, where contemporary official economic policy was full of radicalism. But likewise in Russia the 1992–94 period was marked by the duality of radical projects and soft policies, bailing out basically the politically powerful sectors such as the military, heavy industry and farming. Given the regional diversity of the country, this practice must be seen, with the benefit of hindsight, to a degree as justified, at least in terms of sustaining the political and social feasibility of the transformation project.

Over and above traditional measures of crisis management, however, new concepts of industrial policy also emerged. In the case of Hungary, for instance (Török, 1995), analysts called for the application of Western concepts and practices, which implied a number of changes. First, state-owned firms, mostly corporatised, were no longer seen exclusively as objects of future privatisations. Second, and related to the first insight, incentive schemes for managers to act in line with market signals were gradually introduced. In Hungary, the reorganisation programme for the so-called 'dirty thirteen'—the largest industrial corporations in difficulty—and reorganisation plans, implying lay-offs, debt write-off and the like were introduced. In some other obvious problem areas, such as mining (of low calorific value coal in environmentally damaging attempts to sustain self-sufficiency in energy supply), arrangements well known from Western public policy practices were adopted. These included the integration of coal mines with profitable electricity generating plants, thereby allowing employment to be gradually phased out over a period of a decade, rather than in months. Such decisions—together with protecting the domestic market and sustaining monopoly positions during and after privatisation in 1995—did indeed incur heavy costs for consumers. On the other hand, these measures allowed an orderly divestment of activities, and thereby contributed to the success of the overall process, even if in an indirect manner.

Other Western-like propositions suggested in the study quoted above, such as support for research and development, provision of better financial services, helping the pooling of assets of local firms, supporting their activities with collective marketing and export promotion activities have hardly been heeded. The political dynamics of change favoured radical approaches, that is, quick privatisation. This was the case even in Hungary, where the case by case method was never questioned. British-style privatisation thus prevailed. It was a common assumption that new owners would be entitled and obliged to restructure the firms they obtained. While this approach did prove successful in terms of luring in FDI and speeding up micro-structural adjustment, the neglect of the public sector has contributed to the low efficiency of overall macroeconomic change.

Perhaps the most important, unintended, consequence of the rapid spread of the private sector has been the bleeding of public administration and the continued under-funding of all activities that one way or another remained in the hands of the state, from health care to education.[6] Interestingly, and despite intensive theoretical debates, nobody had a clear idea of the size and future of the public sector. While in many areas—from waste management to medical services—spontaneous privatisation proceeded, without much fanfare, and actually mostly untouched by contemporary projects aimed at fostering various fashionable forms and areas of accelerated privatisation, the bulky and extended public sector remained basically without a strategic development concept, a vision or a strategy.

This has triggered a number of unfavourable developments. First, good-quality people and good-quality assets tended to be moved out of the public sector, thereby exacerbating its low efficiency. Since public administration was, to a considerable degree, used as a buffer against unemployment, the area remained oversize, and adverse selection remained the name of the game. While persons with several degrees and in good command of foreign languages tended to migrate to the private sector, those remaining were selected often according to political loyalty as well as a generally subservient behaviour and lack of initiative. Ideas of reforming the welfare state, which should have triggered changes in these areas, have not even been put on the agenda, despite the pressures of the IMF and the resultant promises made to it and to the World Bank.

The Public Sector in the Phase of Big Privatisations, 1995–2001

The misconceived attempt to generate growth irrespective of actual progress in structural and institutional reforms from 1993 created a situation where radical adjustment became inevitable. In Hungary, the Bokros package of 1995 had two major features (for more on that see Kornai, 1997 and Antal, 1998).[7] First it was a conventional heterodox stabilisation programme, well known from many Latin American economies. Second, it also contained a series of structural reforms that were, at the end of the day, unrelated to short-term macro-management. The latter included the introduction of tuition fees in universities, the partial privatisation of medical care (e.g. dentists), and launching the reform of public pensions. While these measures were gradually slowed down, not least because of opposition from within the then ruling parties, they could not be entirely undone. These triggered small but steady changes in the entire public administration.

A related feature was the launching of large-scale privatisation, especially of banking and the energy sector, often considered to be too 'strategic' in West European countries like France and Spain to be fit for privatisation. Since these policy-induced measures coincided with ongoing smaller-scale privatisation, the intensity of competition in the Hungarian economy increased. It is worth noting that, with a degree of delay, similar waves emerged in Poland, the Czech Republic and after 1998 also in Slovakia (to a lesser extent since 2000 also in Slovenia).

- Privatisation of strategic firms (utilities, banks, insurance) also triggered some restructuring of the public sector as new regulatory bodies with clearly specified agendas had to be created.[8] While critical analyses (Sajó, 2004) have shown these often falling prey to political pressure, resulting in conflict of interest situations, it would be hard to imagine how else complex matters requiring expertise and relatively stable regulation can be saved from the pressure of populist policies, or even simply of cyclical waves that would undermine their credibility and ability to enforce any rules.
- New bureaucracies, capable of communicating and keeping abreast with the new foreign owners, on the one hand, and their EU counterparts on the other, had to be established in the public sector. This helped to cement the relatively independent standing of some of these regulatory bodies.

Moreover, not least owing to the process of acceding to the European Union, attempts to reverse trade and financial liberalisation were thwarted (Csaba, 1995). On the contrary, the policy of accelerated EU accession and the competition among the candidate countries allowed further liberalisation in trade and finance. These changes have translated into an intensive foreign penetration of most economic and social sectors, exerting competitive pressure on the state-run activities irrespective of their size. This feature has resulted, as early evidence indicated (Belka, Pinto & Krajewski, 1993; Major, 1993), in improved performance in the public sector as well. It also brought about additional adjustment measures, irrespective of whether the government followed a hands-off strategy (in theory at least) as in the Czech Republic and Hungary, or was involved in a variety of activist projects, as in Poland under the left-wing government (1993–97).

How did these changes affect the public sector at large? First, competition produced efficiency incentives. Second, competition policy gathered momentum. The latter has been shaped, to a large extend by the competition policies of the European Union as well as by the process of accession. In the course of the latter the narrow interpretation of competition policy, as stipulated by the legislation in Central Europe, has become subordinated to the broad interpretation of the EU (Török, 1999; Voszka, 2003). While local legislation aimed at ensuring the independence of competition agencies from day to day politics, thus following a narrow definition of fighting disproportionate market power and some merger control at best (with not many players suffering in any of the countries for related trespassing), the EU has sustained a more powerful interpretation. The latter includes a ban on state aid, subsidies and entitlements unless an explicit waiver is granted by Brussels. In short, much of what is often discussed in terms of 'industrial policy' fell under the EU legislation.

This change was slow but important. The closer the eventual date of accession came, the less it proved possible for the transition countries to dodge the rules on state aid, while publicity was focused on the abolition of customs free areas, which had acted as offshore centres for exporting firms, and on the tax rebates granted to foreign direct investors. The latter were transformed into individual and limited regional subsidies in the last minute before the conclusion of the accession agreement in Copenhagen in December 2002. What indeed caused more trouble for these countries was that all state aid and guarantees needed to be reported in a consolidated fashion (which was not in line with traditional fiscal accounting practices). Furthermore and even more importantly, 'everlasting' subsidies granted on political grounds or just traditionally were to be discontinued, and time limits and quantitative constraints/caps were imposed on them. These implied of course an approximation to sound practices in public finance, which however made life quite difficult for many state-owned firms and many players in the overextended state administration. Gradual improvements, spread over several years, were started, though a major conceptual overhaul has not taken place.

Last but by no means least, mention should be made of the influence of 'Europeanisation' on the evolution of the territorial structure. It has been a widely shared belief and hope that joining the European Union will provide a healthy dose of financial injection in modernising public administration as well as regional management. The ideology of Europe of regions, the ever growing significance of structural funds and/or regional spending as a share of common expenditure of the Union, as well as the experience of the southern members, were all indicative of this eventuality.

One important avenue of thought has been the conviction (Ágh, 2004) that the challenge of the European Union will allow large-scale modernisation of territorial administration. These authors believe that regional development would require this streamlining anyway, so that accession to the EU should be seen as a window of opportunity. They call for a degree of 'federalisation' of the state, with directly elected regional bodies acquiring financial elbow room and responsibility, much in line with the German *Länder*. The alternative approach, less well represented in the literature but much more strongly present in the political process, would stick to the existing arrangements. In some countries, notably Poland and Romania, the majority of the political class has been wary of the ramifications of territorial decentralisation and fears for the cohesion of the unitary state, just as much as has been the case in France (Hrbek, 2001; Dieringer, 2004). For this reason they oppose such reorganisation. Their arguments include the lack of palpable efficiency gains in the practical functioning of territorial administration, over and above the self-managing ideology.

Finally, no clear strategy emerged on what is or is not to be done with those assets that remain in the hands of the state for a long time. In the case of Hungary a special organ, the Treasury Asset Management Directorate (Kincstári Vagyonkezelö Igazgatóság) was established. This organisation, however, has proved unable to come up with any initiative that could have improved the conduct of affairs in public firms. Likewise the State Property Holding and Privatisation Co tended to see public firms only as potential objects for privatisation—a plus under left/liberal and a threat under centre-right governments.

This state of affairs was only made more complex by the fact that the Constitution in Hungary (and several other countries) endowed local municipalities with proprietory functions. They are in charge of hospitals, schools, roads, waste management and most public services. This choice is hard to dispute on grounds of democratic theory. However, real life has been burdened with a number of challenges.

First, in a drive to counter traditional centralisation, in Hungary, a country of a mere 10 million people, 3,200 (!) local municipalities have been formed. Legislation, however, does not differentiate between municipalities such as Budapest (1.8 mn) and a village of 300 inhabitants. For this reason public administration is overextended (though, as indicated above, this is hardly the only reason). Second, owing to persistent fiscal imbalances, a tendency to centralise funds while leaving functions and tasks to local authorities emerged under governments of different political shades. Third, the process of adverse selection has not left local organs untouched. For this reason—exacerbating historical handicaps—very few young and talented people remained to manage the formidable challenges posed by mass unemployment, restructuring and inadequate physical infrastructure, to name just a few.

From this angle it is understandable that local organs have rarely been acting as agents of change. Their relationship to the business community tended to vary, in some cases being quite cooperative, in others much less so. In matters of territorial decentralisation the European perspective did create incentives. However, lack of financial and administrative resources and the threat of creation of an additional layer of power between them and the centre, or worse, replacing them as basic units of policy making (e.g as units of political competition at national and local levels alike) has made regional and local authorities cautious at best.

The Public Sector During European Accession, 2002–2013[9]

Joining the European Union has implied not only the completion of the first and second phases of systemic change but also entry into a third, open-ended stage of transformation. On the one hand, the EU has evolved into an ever broader and deeper set of trans-national regulations. On the other hand, the diversity of intra-European economic and social systems has remained a lasting one, with Britain and its free market system at one and, and Finland and Austria with their neo-corporatist welfare systems at the other end of the continuum. On the basis of what we know about the European Constitution it can be safely forecast that this diversity will remain a lasting feature of European development.

This is not the place to reiterate the arguments elaborating the paradoxes ensuing for the new member from the fact that they must adjust to an international arrangement that will not necessarily lead to their improved global competitiveness, as reflected in the soul-searching Lisbon Strategy of the EU (Csaba, 2004). In a way, the new stage is burdened with the greatest challenges. For one thing, some structural reform measures have yet to be taken in the process of living up to their commitment to adopt the euro (Szapáry & von Hagen, 2004). Further measures are needed to live up to their commitments to the environmental and social chapters of the *acquis*.

The more demanding and innovative task, however, is to elaborate globally competitive arrangements and find the appropriate place for the public sector as a lasting component of their system. Furthermore, this public sector should no longer be treated as a residual, but an integral part of the globally competitive society.[10]

One of the fundamental challenges ensues from the circumstance that the traditional dividing lines between public and private, tradable and non-tradable, intra-firm and inter-firm, national and trans-national have become blurred. The boundaries are permeable and changing, especially in view of the spread of information technology and the emergence of virtual communities and societies, posing insurmountable difficulties to traditional concepts of taxation and regulation based on nineteenth century concepts of state sovereignty (Salzberger, 2002).

A related challenge follows from the need to ensure impartial third party enforcement of contracts. This used to be the exclusive prerogative of the judiciary. However, with the growing importance of self-regulation, including the *lex mercatoria* type of unwritten but enforceable arrangements, as well as the broadening scope of the IT economy and of financial services, self-regulation becomes more widespread. Also, the newly adopted Basle Two Accords on sound banking allow differentiated risk assessment by individual banks. In sum, the usual concerns of impartial third part enforcement and transparency re-emerge, while answers to these are less than trivial. It seems clear that the regulatory and judicial functions of public policies cannot and should not be 'outsourced', while this is already happening, *inter alia* because of the slow and costly operation of the state-run judicial system. The latter is completely out of tune with the new business realities.

Under these circumstances, though the new EU members can declare proudly the completion of their transition to the market, there is no reason to sigh and wait for the EU to settle these issues. Similarly, the EU as such does not have a common line, policy or competence over the public sector, and new and innovative solutions need to be found.

With the completion of privatisation in the competitive or tradable goods sectors, privatisation is likely to continue in no less weighty or valuable areas such as health care, transport, environmental protection and the former natural monopolies. This follows from at least two factors. One is that technological change has rendered the concept of natural monopoly out of date even in such areas as electricity production or military sourcing. The other is that the low efficiency of the state-run sector as well as the limited willingness of societies to pay high taxes put severe limits on an ever-expanding state in general and on the 'productive state' à la Buchanan in particular. If these services are to expand and develop, the entry of private and other forms of non-state actors, such as civil society groups, churches, cooperatives and many more, is inevitable.

The interesting feature in Central Europe is that these seemingly ultra-liberal propositions actually reflect realities. In a number of areas, from waste management to construction and running of prisons, private capital has already entered. It is paradoxical that the idea of public–private partnership, already somewhat overused in Britain, has only emerged in the explicit policies of the post-2002 government in Hungary. Private capital and private initiative have proved much more innovative in all these areas than regulation.

From the above at least two points follow. One is that the state should rethink its regulatory functions so as to be able to act in a pre-emptive rather than a reactive fashion. Computer piracy and trading in personal data, terrorism, regular congestion on major air routes and many other features already call for this. Second, the public sector as a whole can surely no longer be managed along the lines of traditional statist concepts. New public management, not just a slogan but a practical approach, needs to be introduced.

The starting point of the new approach is that the public sector has been and will be in growing competition with domestic and foreign alternative suppliers for the same services. Likewise competition for human capital will be intense. Not least fierce is the competition for scarce resources. The EU practice of co-financing is becoming the name of the game for any major investment in any area, including defence and internal security, as the examples of British defence purchases or private Hungarian prisons already testify (not to speak of private security services firms). It may well be argued that, if in the pre-2004 period the desire to be admitted to the EU was crucial, from now on a different factor will push marketisation: competition among localities for scarce foreign investment, a component that has emerged and become ever stronger since the conclusion of large privatisation in the mid-to-late 1990s across the region.

From this viewpoint it is a sign of delay that the very concept of public–private partnerships gained acceptance at the level of government policy from 2002 only in the case of Hungary. While the practice has been observable at the level of municipalities since the early 1990s, central organs have been anxiously guarding their prerogatives in terms of control. For this reason, as a recent case study on road building has indicated (Torontáli, 2004) the Ministry of Finance agreed to the practice, supported by the Ministry of Economy (i.e. of relying on private financing in managing public road building projects), only when it was reminded of the fact that the EU accounting rules allow the costs thus incurred *not* to be included among the items of public debt.

Likewise the reform of the judiciary requires more and better equipped and also better remunerated judges and courts. The inadequate progress in this area has been a recurring feature. Instead of the five medium-level courts (*táblabíróság*) that were to be set up by 1997, only two had been established by 2004. The continued financial stringency led to the resignation of the minister of justice, one of the most popular members of the centre-left government, in September 2004. The slowness of courts has remained a cause for concern, with various private ways of serving justice on the increase. These include the more civilised versions, such as extra-court agreements using arbitrators, but also the less civilised versions of pressure on debtors, forcible collection, intimidation and mafia-type practices, even if not to the degree observed in Italy or China—or Russia for that matter.

In terms of administrative reforms, four consecutive governments in Hungary failed to come up with decisive and broad concepts that could command a degree of social consensus. Instead, short-term measures such as personnel cuts to predetermined but arbitrary numbers, or securing the position of politically selected bureaucrats, were on the agenda. As the most recently appointed plenipotentiary for administrative reform (Sárközy, 2004) noted, the constant pressure to economise (not least following populist calls for a cheap, rather than a lean, state administration) have always been in contrast to the need for good-quality public services and meritocratic selection of persons willing to serve in the public administration for a large part of their career.[11] Efficiency and transparency often imply something other than the cheapest solution. In a way, the overextended higher echelons of bureaucracy and the less than adequately organised though equally numerous lower levels produce a costly but not very efficient public administration. As long as the employment buffer function can not be given up, not least owing to pressures from the opposition of the day and the related media campaign, it is hard to see any progress. Likewise as long as the idea of outsourcing and multisectoral provision of services gains social acceptance there is not much hope of rolling back the all-prevasive 'productive state'.

From this angle it seems justified to observe (Verhijen, 2004, pp. 392–393) that two major areas of public administration, civil service capacity and policy management, remain weak points in the new EU member states, a point that is likely to affect the efficiency of their involvement in European policy making. A similar conclusion has been reached by the self-assessment of the study group under the office of the prime minister (as reported in Forgács, 2004, pp. 59–60), noting that this will constrain the ability of this frontrunner country to rely on EU funds. But as the previous source rightly notes, this inability is likely to become a problem for the enlarged EU itself, given the limited if any reforms in the decision-making process and the forseeable limitations of inter-state redistribution.

There are at least two more forces potentially inducing reforms of the public sector:

- Fierce competition for FDI among emerging economies on a global scale, not only within Central Europe. Here the ability of the administration to make credible commitments and deliver on the promises can be a decisive factor (reducing the need for the excessive incentives currently in use);
- The need to retain high value added exports, investments and jobs as FDI attracted by low labour costs shifts eastwards. The latter acts also as an incentive to create and even retain highly skilled labour.

Last but by no means least, mention should be made of the lack of reform in two major areas. One is the large state-owned monopolies, such as the railway company and the national airline. Privatisation has been slow, and in the case of the railway company it is not even allowed by the sectoral law. The crisis of the air transport sector is likely to speed up adjustment and reorganisation, probably leading to joining strategic alliances, as has already been the case at Czech and Polish airlines. Several further economic sectors, such as nuclear engineering and waste management, require fresh blood. The second, no less important area to be reformed is public services in the traditional sense, such as defence and health care. It seems clear that the cost explosion of medication and the need to spend more at the macro level on health is hard to achieve via means other than partial privatisation. This of course triggers social resistance no less than in Germany or Britain. In the defence sector the switch-over to a professional army is a must that follows from the change of security threat and doctrine. This factor alone calls for more cost consciousness, transparency, outsourcing and career planning, that may mean just as much introduction of a managerial approach as of commercial spirit. Professional soldiers capable and willing to take part in expeditionary operations must be properly paid and insured. Likewise procurement of arms should follow business principles; otherwise a balance between combat capabilities and financing possibilities will hardly be struck.

This list is far from being exhaustive. Our taxonomy of the tasks that are already on the agenda of policy makers today is indicative of at least two circumstances. First, privatisation cannot be declared to be over, as a recent declaration (adopted by a vast majority) in the Polish parliament would have had it. It is spreading to new areas, even if we must refrain from the radicalism of the early days, and take into account the lasting presence of public ownership and policies in most of the areas. Second and no less important, the public sector itself is in need of a major reassessment. In the latter area a large number of non-trivial tasks have to be faced. There is no straightforward way, for instance, of working out a well functioning railway or health care system, where the appropriate mix of social, regional and financial consideration could be found. Likewise there is no simple way to solve the problem of impartial third party enforcement and the ensuring of transparency in the interest of the public (rather than in the interest of the guild only). This is particularly so when self-regulation by the profession may be more powerful than any (non-enforceable) regulatory attempt by the state authorities, especially if transnational processes are at work (on the latter see Szalavetz, 2004, pp. 41–74).

It would be reasonable if we could conclude on an optimistic note on the future, with the EU turning its spending and regulatory priorities to meeting the Lisbon Agenda. This, however, does not seem to be the case: traditional sectors and priorities, traditional redistributory concerns over farm subsidies and regional aids are likely to dominate the 2007–2013 agenda as well. What is known about the current projects is that an upper limit, capping the amount of joint spending to 1% of GDP, is unlikely to trigger major reforms in expenditure priorities. Agricultural supports are likely to requalify as regional, environmental and other ‘green box’ elements in WTO parlance, while structural funds will gain in importance. Although the latter could well contribute to improving the administrative capacity of the new members, in reality a reverse causality is stronger (as the sources quoted above have also demonstrated by marshalling empirical evidence). Better administrative capacity is becoming a precondition for the new members’ ability to draw on EU funds, but also more broadly, for becoming successful parts of the process of Europeanisation. Thus the contribution of the EU and its funds to mastering the major task is likely to remain limited and indirect at best.

Conclusions

Transformation in Central Europe and, to a much lesser degree, since 1999 also in Eastern Europe has been by and large a success story. The classical agenda of stabilisation, liberalisation and privatisation has been accomplished. None of the transforming economies is now struggling with hyper, high or even moderate inflation. None of these countries has a closed economy. The Central Europeans have joined not only the WTO (a task yet to be mastered by Russia, Ukraine and most New Independent States) but several of them have joined NATO, the OECD and even the EU. The latter required capital account liberalisation and reasonable exchange rate stability. Finally, privatisation has progressed considerably. In some countries, like Hungary, the share of the private sector exceeds that of many Western counterparts. Such ‘strategic’ sectors as energy generation or banking have also been privatised, often to foreign owners.

Meanwhile the redefinition of the role of the public sector has remained partial and relative indeed. When it comes to a positive vision, a feasible project other than letting the erosion or transformation of public firms predominate, then concepts and policies remain vague. The dangers of over-regulation and under-regulation, resulting from poor formulation of the aims, scope and means of public policy, are very real indeed. The social resistance to privatisation, the inability to come up with a major overhaul of the welfare system and other areas requiring broad social consensus, such as the environment, defence or transport, are indicative of a need for a new, third phase of transformation. In this phase the tasks of Eastern and Central Europeans and of EU incumbents largely overlap.

However, contrary to previous stages, this time there is no ‘European model’ to be emulated; it is yet to be elaborated and tested. Moreover, the EU as an organisation is unlikely to contribute in an immediate way to overcoming these challenges. With the ongoing preoccupation with redistribution, neither political attention nor funding is likely to be focused on those areas of public sector reform where it would most be needed.

This state of affairs is reflected in the limited ability and willingness to spend on such crucial areas as judicial reform or defence against terrorism, the continued marginalisation of research and development as well as high-quality education in most EU states, and the slow pace of progress in various fields of public–private partnerships. Reforms of big public corporations, such as Alitalia in the West or the railway companies in the East, are saddled with conceptual unclarities, social resistance and excessive financial consequences. It is clear that making headway in the more traditional areas and coming up with conceptual innovations in the unconventional areas are equally needed in order to find proper, that is financially viable and socially accepted, answers to the challenges facing the public sector.

There are at least two areas where reflection and action seem urgent. One set of issues relates to regulation of an increasingly dematerialised and delocated process of value creation. Here both considerations of taxation and public services and of jurisdiction and impartial third party enforcement come to the fore. With the weakening of the nineteenth century sovereignty of nation states this issue becomes a problem at the global level, and it is less than certain where the EU can or should come in. The second area is the active or positive role of public sector agents, firms and other institutions, other than in their capacity as an employment buffer. The latter requires conceptual innovation and regulatory and financial solutions little known in the traditional approaches (but already emerging in practice). In the latter area ways of financing, as well as the new co-existence with non-state actors, the separation of the state as an authority from the micro-management of public firms as equal actors in a market game may be a challenge.

In conclusion it may be emphasised that meeting one challenge has only created new ones, which is anything but surprising in the area of transnationalisation. Redefining the role of the EU in this process may be a formidable task on the basis of all we know about the backward-looking nature of preparing the financial guidelines for 2007–13.

Notes

1. The Hungarian economist Jánossy (1969) spoke aptly of quasi-development insofar as the appearance of modernity (in terms of macro-structures) never translated into micro-economic substance (in terms of competitiveness and living standards).
2. Thus occasional, though in some countries quite frequent, doctoring of statistics apart, the tendency to over-reporting under communism was followed by an incentive for under-reporting, especially by the new small private business, but also by inability to capture the irregular economy, accounting for 15–40% of total output in the emerging economies.
3. In this study I use Hungary, a frontrunner in the period under scrutiny, as a test case to illustrate more general points pertaining to transformation. Obviously, the country experiences vary, and elaborating them would require a monograph—an attempt I made in a recent book (Csaba, 2004). Certainly, like any example, the Hungarian one serves only as an illustration and suffers from circumstantiality of evidence.
4. The Polish *Sejm* adopted a resolution, by an overwhelming majority, in September 2004 to stop privatisation, especially of the largest savings bank, Pekao. The largest Hungarian opposition party initiated a referendum in October 2004 on halting privatisation.
5. A similar disaster emerged from the sale of Czech Airlines to Air France. The deal had to be reversed already by the mid-1990s, since when a state-led restructuring seems to have turned the company around, allowing a new privatisation (the latter reported in *Világgazdaság*, 12 November 2004).
6. True, as in any non-market activity, waste and shortage co-exist. While top universities, like ELTE in Budapest, have been struggling with constant financial difficulties over the past decade, basically each and every bigger municipality established a university or college of its own. Likewise, as qualifying as a city requires a hospital, establishments named as such proliferated, irrespective of their professional and technical capabilities. In sum, while the amounts spent are sizable, their excessive dispersion translates into poor hospitals and poor universities as a rule.

7. Similar adjustment packages were later introduced in the Czech Republic, Romania and Slovakia, and in an extreme way, partly triggered by contagion, in Russia. These events allow us to use the Hungarian experience as an example.
8. This was one of the explicit requirements of the EU for membership, and progress has regularly been monitored and reported not only in the *Regular Reports* of the EU Commission but also by such authoritative organs as the EBRD in its *Transition Report*, the OECD *Country Studies*, as well as the IMF and World Bank assessment of country performance, published annually.
9. The latter is when the new financial guideline will have expired, and transitory solutions for accession such as differential treatment of direct income supports in farming will have been phased out. Also the institutional innovations of the draft Constitutional Treaty, such as the diminishing number of Commissioners, will come inter effect from 2014 according to the original schedule.
10. This consideration holds even if the German Chancellor rushed to admit that the Lisbon goals were too ambitious and needed to be revised downward, as reported in *Financial Times*, 4 November 2004. However, it is hardly chance that former Dutch premier Wim Kok, chairing the EU review committee, warned against such an interpretation, according to a news item in the issue.
11. It may well be objected that new public management is precisely about abolishing the cemented seniority principle of traditional bureaucracy. However, in view of the crucial role of tacit knowledge and the time needed for acquiring it, proper pay and high social status, and even a degree of insulation from the ups and downs of democratic politics, should count among the preconditions making public service a serious career option, against obvious private sector opportunities, for any ambitious individual, especially young and multi-degree professionals. For more on this see Thoonen (2003).

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