Constraints and Driving Forces in Economic Systems

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Constraints and Driving Forces in Economic Systems:

Studies in Honour of János Kornai

Edited by

Balázs Hámori and Miklós Rosta

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Preface

Balázs Hámori

What do the diametrically opposite tendencies in the height of the North Korean and South Korean population over the past sixty years, the paternalism in the current pension systems and the Greek crisis have in common? Readers should not promptly reply "nothing", because they are in for a quick and strong rebuttal when they start reading *Constraints and Driving Forces in Economic Systems*. The studies analyzing various topics actually all discuss the same point: the forces driving development and the constraints hindering progress in economic systems and subsystems.

The study written by Karen Eggleston, "Innovation, Shortage and the Economics of Health Care Systems", demonstrates that before the division of Korea, North Koreans were on average taller than South Koreans, but during the six decades that elapsed since the division, this trend has reversed in such a way that the average height of North Koreans has not changed. Is there an argument more convincing that the elimination of a market economy leads to stagnation (even in biological acceleration), banishing the driving forces and putting thousands of obstacles into the way of development?

However, all studies are consistent in stating that economic systems and their radical changes cannot be simplified into the claim that the mere existence of a market economy and the establishment of the institutions thereof automatically guarantee efficiency and promote development in all areas. Studies prove that the scheme is much more complicated than this mechanical approach, since – as László Csaba notes in his introductory study – "The economy works as a system, more like a living organism than as an engine as postulated by Walras and others". Even in the most advanced market economies, characteristic traits that were previously associated with socialism can appear, as proven by the study written by András Simonovits on pension systems and the study by Dóra Győrffy discussing the Greek crisis.

While examining pension systems in the duality of paternalism and autonomy, András Simonovits contrasts private and public retirement savings. In his opinion, a well-functioning and secure pension system cannot be based solely on one of the types. "Private saving is more efficient than the public one", but due to the short-sighted stakeholders who do not think about the future, “its size may be insufficient”. On the contrary, the state is able to force the members of society to provide larger pension contributions, but does not implement it efficiently enough. The study’s important conclusion is that there is no optimum mix of paternalism and autonomy that would be valid under all circumstances; in addition to making efforts to minimize paternalism, the “mandatory” public savings are always maintained and their desirable “mix always depends on other parameters as well, such as the discount rate”.

The study written by Dóra Győrffy analyzing the Greek crisis draws attention to a neglected impact of the soft budget constraint as defined by Kornai. “While the term was originally applied to the enterprises in the socialist system, the financial crisis illustrates its relevance in market economies as well.” According to Győrffy, “the theory of soft budget constraint helps to understand why subsequent bailout packages failed in Greece and why the recession was so severe”. To which we may add that not only the crisis, but also the health care system analyzed by Eggleston, and the pension system described by Simonovits all exemplify that severe efficiency problems by far do not only exist in socialist countries. It cannot be proven that the market economy goes hand in hand with efficiency, but then, neither can it be proven that the soft budget constraint is characteristic solely of socialism, which is restricted to ever-decreasing regions.

The entire book underscores the point that there is no straight-line progress to a market economy. There are three studies in the book that indicate the halt of the promising development and the appearance of the ghosts of the past in Hungary. Miklós Rosta’s study, “Janus-faced Public Administration Reform in Hungary”, provides several examples for phenomena that seem to already belong to the past such as over-centralization and the soft budget constraints. (An example of the former is assigning all Hungarian primary and secondary schools under one centre, which is the employer of 120 thousand primary and secondary school teachers in Hungary. The state forcing banks to allow the final repayment of foreign currency loans on an artificially low exchange rate can serve as an example of the persistence of the soft budget constraint.) A similar turnaround is described in the study written by Eszter Rékasi on the higher education reform presently in progress in Hungary: “The reform headed in a direction opposite to that which is generally seen as desirable for the success of European universities: more resources, more autonomy and increased market competition, alongside accountability”. As a consequence of the above, the responsibility of market players decreases, they are faced with shortage of information, instructions weigh in more in coordination and not only does efficiency weaken, but equity also prevails to an increasingly smaller degree.

Gábor Klaniczay evokes the history of a unique institute in his study, "A New Kind of Academic Institution: the Institute for Advanced Study. International and Hungarian Experiences". His writing can serve as a case study describing how an autonomous institute – operating as a catalyst for social science research in Hungary for nineteen years, in whose establishment and development János Kornai played a decisive role – can be destroyed at the stroke of a pen, with a central administrative decision.

Overall, however, the studies do not give any reason for pessimism regarding the future of market economies, despite the aforementioned winding development paths of some Eastern European economies such as Hungary. The study by Katalin Szabó and Balázs Hámori analyzing the latest innovation trends convincingly justifies János Kornai's thesis that the advantage of market economies over all other social structures is undeniable in terms of innovation potential. Analyzing the two remarkable new innovation trends, crowdsourcing (i.e. involving the crowd in the innovation process) and reverse innovation (i.e. innovations flowing from less developed countries to more developed ones), the authors point out the common features of the two phenomena. In both trends, ICT, and mainly the Internet, play a definitive role. ICT is obviously the achievement of the market economy; at the same time, it incredibly expands opportunities for less developed countries, including the ones that are progressing on the rocky road towards a market economy and a democratic structure. The combination of inventive ideas coming from remote areas, professions or marginal stakeholders, which is typical of both reverse innovation and crowdsourcing, increases innovation potential on all levels and in all areas. Another common characteristic of crowdsourcing and reverse innovation not to be neglected is that both cut the costs of innovation and mitigate the risk. A highlighted element of the study is the statement that innovation is marked by the features of the socio-economic system it is implemented in. Therefore, the radical changes taking place before our very eyes may not be truly understood based on a narrow partial analysis, since as it is proven by Kornai's entire lifework, the related phenomena may only be understood when viewed in a system.

The same approach is applied by Gérard Roland's study, "Individualist and Collectivist Culture and Their Economic Effects", which is "a comparative analysis of the economic effects of individualist versus collectivist cultures". According to Roland, "individualist cultures will create a demand for the protection of property rights, for the rule of law, for institutions that limit the powers of the executive. Individualism will be associated with more openness towards immigration, higher geographical mobility, weaker family ties and more market-based social relations. Collectivism will be associated with higher ability for coordination leading to better public good provision and higher efficiency of government organization. Collectivism will be associated with higher demand for political and social stability and a lower taste for institutional experimentation." The following conclusion can be drawn from Roland's analysis: individualist cultures are more favourable for innovation and growth, and are more in harmony with the openness of the global world than collectivist cultures. However, individualist cultures often lag behind in terms of offering public goods, and by increasing disparities, they often threaten stability. Nevertheless, it is obvious that societies may not choose their cultures since these are the products of thousands of years of evolution.

The study written by Péter Mihályi also discusses the evolutionist approach and describes János Kornai's *Anti-Equilibrium* as the forerunner of evolutionist economics. Mihályi's study justifies the following German proverb quoted in László Csaba's introductory study "*Das Neue ist die gut vergessene Alte*", that is, new theories often only revive old ones. Mihályi convincingly demonstrates that since the 1970s, several economic schools proposed theories similar to Kornai's. One good example of this is Daniel Kahneman's explanation of the subsistence of the status quo. According to Mihályi, the gist of the explanation using the loss aversion behaviour is the same that was written by Kornai when writing about the inherent cohesion forces of socialism and capitalism. The study summarizes Kornai's impact on international economics, pointing out that he is the Hungarian scholar with the greatest impact on international economics, and he can be deemed as the forerunner of several "new wave" economic schools that flourish today.

László Csaba's introductory study, "Constraints and Driving Forces in economic systems", has the same title as the book and can be regarded as the summary of this broad-spectrum book. An important statement of the study is that "No compelling evidence … brings us to expect that democracy and market economy will always go hand in hand". Several studies in the book prove that the establishment of democratic institutions by political measures does not guarantee by far the normal operation of a market economy, not even the development into the direction thereof. Democracies born this way are very fragile. "The most recent experiences in Ukraine, Libya and Venezuela indicate that a change which may start as a corrective, at the end of the day, culminates into decay and disintegration."

Since Adam Smith, the poverty and prosperity of nations, and the development traps or their lack have been some of the key questions in economics. Csaba regards this question – neglected by the mainstream – as the central dilemma of comparative economics and development economics, and so do the authors of the book. Almost all studies – directly or indirectly – contribute to answering the question by analyzing the driving forces and constraints of development, whether pertaining to higher education, or the innovation of innovation. According to Csaba, “Comparative economics has a great advantage over the neoclassics in terms of its ability to endogenize technological change and its broader concept, innovations”. Csaba’s study underlines the relevance of path dependence and path creation, too. Only by taking these categories into consideration can we understand the Greek crisis, or Hungary’s turn back from the path leading to the building of an advanced market economy. In the final part of his study, Csaba highlights the relevance of the political element in the economic analysis. The term “political economics” sounds bad, especially in former socialist countries, since a lot of people associate it with apologetic pseudo-Marxism. Actually, the legitimacy of political economics is indubitable. The political element is incorporated into decisions on the pension system, just like into the ones on the reorganization of higher education in Hungary leading to a dead-end street.

All the studies in the book are closely related to János Kornai’s work whose decisive impact on economic sciences and the individual professional development of the authors is highlighted by each author. Several Hungarian economists and their foreign colleagues can also say: “We all came out from Kornai’s overcoat”. Instead of paraphrasing the saying about Gogol, let me quote Jameson, whose words perhaps grasp Kornai’s mission most vividly: “To evoke originality, to kindle the fires of genius, to regularize, to criticize, to restrain vagaries, to set a standard of workmanship and compel men to conform to it.” This is what the authors of this book have realized and recognized with the studies dedicated to János Kornai.

Introduction

Economic Systems: Constraints and Driving Forces of Change

László Csaba

"*Das Neue ist die gut vergessene Alte*" – the new is mostly nothing more than the well-forgotten old, says the German proverb. Indeed, economics of the post-World War 2 period tended to be ahistoric, not caring even about its own traditions and venerated history. It all started with the breakthrough of formalism in the 1950s and 1960s. Already four decades ago, Axel Leijonhufvud (1973), one of the major figures reviving and interpreting Keynesianism, joked about true economists being the only tribe where not even high priests cultivate the myth of their own past glory. In the past quarter of a century, this situation has only been aggravated by the deep disrespect for history, contextuality and applications. As the intro to a recent special issue of the *Cambridge Journal of Economics* rightly observed (Freeman et al., 2014) – and other contributors only expanded – the mainstream of the profession has been carried away by Samuelson's perceptions about the proper conduct of economic science.

In this interpretation – which is by now under heavy attack – the current state of the art is always its best. Axiomatically, it is the peak of previous knowledge, written by the victors of intellectual debates. By now, seeing the dismal performance of neoclassical mainstream theories, both as analytical tools of understanding, and even more as useful instruments for improving social practice, the contempt for practice, the public and professional perceptions have changed. For the majority, the Samuelsonian maxim is that coherence tests may, and indeed should, replace testing on the ground, i.e. a reality check. But this (still widespread) practice has been discredited for an ever-growing crowd of theorists and policy-makers, business executives and curious intellectuals, coming from other professions alike.

Related to these voices we may add a recent study of the PhD programs of top American universities. The latter have been shown – via a detailed analysis of their empirical results – to be rather weak at producing good quality researchers and research, as measured by their own standards, i.e.

AER[1] level journal publications and their equivalent (Conley and Onder, 2014). This is clear evidence of the failure of those practices, which are portrayed as exemplary, and the only path to be followed by catching-up societies the world around.

As a consequence, the imperialism of the neoclassical mainstream prevailed in most European and American universities, – inter alia – to the closing down of established comparative economics departments in many leading universities, and similarly oriented area studies centres outside of them. This has hardly been justified in most cases. The United States, as the lonely hegemon, is increasingly being confronted – and not only in the past few years – by a variety of challenges coming from other civilizations and other economic regimes supportive of dictatorial or autocratic regimes. Failing states have allowed for the creation of terrorist organizations, which in turn allowed for the spread of a variety of criminal activities unknown of a few decades ago. The double challenge – economic and security – would have called for an expansion, rather than the actual divestiture of those centres of comparative and regional studies – a trend observable ever since the first Clinton Administration.

Similarly, in Europe the idea that "we are back on track" and a false feeling of "the end of history" created similar trends. Centres for comparative and regional studies have been closed down or marginalized in all countries, under two slogans. Number one was the alleged new age of "eternal peace", where the so-called frozen conflicts, let alone open warfare, as experienced ever since the Libyan and Syrian uprisings, or the armed intervention of Russia in Georgia and later in Ukraine, were deemed highly improbable. Thus, funding for "esoteric", non-mainstream economic activities dwindled.[2]

Second, no less importantly, the more widespread the idea became that economics is like medicine, where established general insights rule over country-specific or simply contextual knowledge, the farther standardization may and does go. This has turned economics and business teaching,

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1 *American Economic Review*. Note, that the no. 1 journal in official/IDEAS etc. rankings is not the flagship of the American Economic Association, but the *Quarterly Journal of Economics* of Harvard University.

2 Two telling examples from Germany are the severe cutback of the Institute for East European Studies at the Free University of Berlin to about a fifth of its original staff and merging it into the faculty. The second case is the relocation of the traditionally prestigious Institute of East European Studies from the Bavarian metropolis of Munich into parochial and distant Regensburg, where it leads a shadow life, attached to a regional – not a top research – university.

from BA to PhD levels, into factories of transmitting standardized, vulgarized and modularized American mainstream insights, themselves strongly contrasted in the literature. Certainly, massive increases in student numbers also contributed to this end. But the unfounded capitalist triumphalism – suggesting "normal economics for normal countries"[3] – also had its share in shaping the outcomes.

Therefore, it is hardly surprising that with the advent of global challenges, the inadequacy of those options has become manifest, for the supply and demand side alike. Top "pure econ" classes fight for survival in many universities, not least because of the lack of student interest, both at the MA and PhD levels. In business and state administration, i.e. on the demand side, jobs previously filled by econ graduates are being filled with persons with different degrees, be those in maths, physics, law or political science. The time for change has come, and one area, where heterodox economics has something of immediate use to offer, is precisely in reviving the comparative-institutionalist approach. The latter has always been a key ingredient in the study of economic systems.[4] Thus, our proposals may serve both as a re-assessment of what counts as academic excellence – in terms of promotions and useful knowledge – and as suggestions for improving the curricula, making those more responsive to the needs of employers. The fundamental claim in this paper is that there are at least six – and potentially much more – issue areas, where comparative economics might be a useful tool for improving both research and education at the university level across the globe. Although these insights count among the least controversial from within the subfield, they might still sound indeed revolutionary or path-breaking for the standardized uniform curricula and those delivering/studying them.

(1) Crisis on the global financial markets and in the European Union alike have repeatedly called for a complex approach to economic and social issues. It borders on the platitude to claim that the reign of unintended consequences, typical of policy interventions, must

[3] The "most cited economist of the globe" (according to a Wikipedia entry and IDEAS, both retrieved on October 11, 2014), infamous for his role in managing shadowy deals in Russian privatization, Andrei Shleifer (2005) has gone perhaps the farthest in advocating this line. This happened in the face of mounting evidence to the contrary, already at the onset of the first Putin Presidency. For the latter, cf. Bugajski and Michalewski, 2002; Rosefielde, 2005.

[4] János Kornai has been an iconic figure of this approach, ever since the publication of his first book nearly six decades ago, in 1957. It was the first book published in English from anyone working in Hungary in the post-war period in 1959, reprinted in 1994 (Kornai, 1959).

be attributed to the lack of comprehensiveness of treatment. Needless to say, comparative statistics was overused in Samuelsonian economics. Likewise, treating economics as a sheer methodology of calculating anything, rather than a proper social science, had a role in allowing for the very narrow and overly technocratic approaches. This holds not only for IMF or Troika type interventions, but also for the usual instrumentalist views on how to improve taxation, how to balance the budget, or how to improve higher education. The "new" policy is a comprehensive, *systemic approach,* which used to count among the axioms in comparative economic systems' research. This approach originates with the German economist Walter Eucken (1940/1989) criticizing interwar and wartime Soviet and Nazi policies of ad-hoc interventionism and replacing incentives with brute force/oppression. In doing so, he developed the concept of *Ordnung und Ordnungspolitik.* These terms hardly lend themselves to a proper translation, but imply two major insights, which are still relevant today.[5]

(a) The economy works as a system, more like a living organism than as an engine as postulated by Walras and others. Thus, an intervention at one point inevitably triggers changes in many wholly different areas. Most of those interactions can be studied and incorporated into a – largely restrained – set of policy measures, which should never aim at defining which horse is to win the race.

(b) Policy interventions should be exceptional, general, and relating to the overall fabric of the economy, or the business cycle in particular, but not to micro-managing sectoral, regional, or other particular grievances. It seems that heeding those insights could have saved many ills of the crisis management in Europe (Csaba, 2009).

(2) Economic systems are liable to change if they are to survive, like any other living biological or social structure. The past century saw a series of transitions in this sense: from laissez-faire to managed economy, from Keynesianism to a kind of rules-based orthodoxy, from market to plan and vice versa, and, more recently, from untamed globalization to managed transnationalization of global exchanges.

[5] The ex post analytical framework, developed by Kornai (2008) lends empirical as well as theoretical support to sustain the unchanged – or even heightened – superiority of systemic thinking over the currently ruling narrow approaches, both in theory and in applications.

Observing the variety of changes, both in terms of circumstances and outcomes, and allowing for the varying experiences of the interrelationships of those changes with political democratization, we would tend to agree with those analysts who foresee a lasting diversity of experiences, efficient methods and outcomes (most explicitly and lastingly: Rodrik, 2007). No compelling evidence – over and above our own value judgements – brings us to expect that democracy and market economy will always go hand in hand, or that the victory of these "inclusive institutions" would be in any way a historical necessity, either in terms of time or especially in any concrete regime change. The most recent experiences in Ukraine, Libya and Venezuela indicate that a change, which may start as a corrective, at the end of the day culminates into decay and disintegration. Perhaps economists should bet less on the predictive power of their arsenal, once singled out by Milton Friedman (1953) among the preconditions of academic soundness. Perhaps we should listen more to the ruling sceptical voices in historiography, in sociology and political science, where no outcome seems to be a given, not even in the constructivist and post-modernist approaches. Also, the more we take the system paradigm seriously, the more one would need to accept insights from complex systems theory (and even chaos theory). Both would caution us from making direct policy-relevant or even predictive inferences from simple, or more complexly constructed, econometric models based on the replica of 19th century physics. These postulate linear or uni-dimensional causation, predictable paths and/or outcomes. The Russian economic system nowadays, in any account, is a far cry from Soviet-type planning, and the decisive co-ordinative mechanism is undoubtedly the market. Still, it sounds naive and premature to assert – as it happened a decade ago – that Russia would be "a normal country" (Schleifer, 2005) in the western sense, or that its model would not differ, in terms of comparative economics, from those in EU economies. Hopes for its convergence, vividly entertained by many of us in the 1990s, have clearly evaporated in any account of events.[6]

[6] It is indeed ironic to read during the Ukrainian-Russian border war, the oppression of the Belorussian dissident movements, the recurring harassment of the opposition in central Asia to the point of repeated torture and imprisonment without jail, the lifelong Presidency of Kazakhstan and many others that leading American scholars deem these as part of their perceived "normalcy" even at the time of writing (Shleifer and Treisman, 2014).

(3) Comparative economics has a great advantage over the neoclassics in terms of its ability to endogenize technological change and its broader concept, innovations. The major trick (more recently in Kornai, 2013) is twofold.
  (a) In comparative economics, incentives are endogenous, a part of the classical description of what entrepreneurship is all about;[7]
  (b) In employing institutions, explaining how the idea is turned into economic – and, more importantly, also to social – use, or how knowledge is used in society.[8]

  While those insights count among the axiomatic propositions in comparative economics, the technocratization of the mainstream has fully crowded out such insights from both academic discourse and the curricula. Such broad approaches constitute a U-turn against the Samuelsonian view of treating economics as a value-free analytical instrument, or of the practice of Gary Becker, often termed as "economic imperialism" (Lazear, 2000), which attempts to create micro-foundations for everything. Moreover, it attempts to explain literally everything – from marriage to discrimination – along those lines and following the logic of the micro.[9] By the same token, reliance on sociological insights, on industrial organization or even on empirical psychology becomes a must. This, in turn, severely limits the conventional freedom of economic modelling to employ assumptions not justified by anything (or being positively dispelled by the sister disciplines). One such idea is rational expectations, the other being the symmetry of loss and gain in terms of elementary calculations.

[7] It is telling that the *Journal of Economic Perspectives* (Vol. 28, No. 3, 2014), the flagship of the American Economic Association targeting a broader audience, devoted a special symposium with three long articles to explaining the relevance of the Schumpeterian insight to contemporary economics, both regarding theory and the real world.

[8] It is no less telling – and a sign of changing times – that the long-forgotten seminal paper of Friedrich August von Hayek (1945), himself marginalized and ridiculed most of his lifetime by the neoclassicals, has been included among the twenty most influential papers ever published in the *American Economic Review,* in its retrospective selection (Vol. 101, No. 1, 2011, 1–8).

[9] The requirement to provide micro-foundations to any claim is, of course, much more widespread than indicated in the main body of the text, although one would consider as axiomatic the age-old insight that any structure – of the macro – is by definition more than the simple sum of its constituents. Therefore, psychology cannot be reduced to biology, the latter to chemistry, the latter to physics, as 19th century thinking would have liked it.

(4) One of the oldest and most contested issues in comparative economics has been that of development traps or their lack. Economics as a discipline and development economics as its sub-discipline has always been concerned with "why some countries are rich and others so poor" (Landes, 1998). These issues cannot be answered in a generalized fashion, as we indicated above. In a modern, formalized, neoclassical economics environment this would not even count as an economic question. True, answering those weighty – and evergreen – issues does require reliance on the sister disciplines of history, geography, public administration, psychology, sociology and international studies.

It is indeed reassuring to observe that in the flagship of the mainstream, after a long hiatus, we again find an extensive and deep analysis of this issue (Kraay and Mc Kenzie, 2014). Not that the issue per se would not be relevant, but – following the external shock of the crisis and the sustaining dissatisfaction with the neoclassicals – we do find the return of this age-old subject to the sanctuary of economics. The broad analysis cited above is an excellent case in point, illustrating how the revival of the comparative and institutional approach may be indispensable if weighty and policy relevant subjects are to be analyzed. The nuanced analysis cautions against the "usual suspects" in development economics such as the "big push", i.e. opting for extremely high investment rates, or the focus on external aid and micro-finance.

What comparative economics may add to those – highly welcome – new insights is its traditional focus on the competition among economic systems. This exists both on the micro level – across firms and individuals – as well as on the macro level, across various institutional solutions, country-specific options. This focus follows from an age-old and sustaining observation that most of us constantly measure our well-being "against the Joneses". As indicated more recently by the collapse of the Soviet Empire, but also by the recurring strains in Hong Kong versus mainland China, that differing output/performance does translate into collective political action in the long run. Certainly, we may only speculate, and make more or less informed guesses about if and when a leadership is willing to opt for change, rather than resort to violence or simple procrastination, wishing to put out the fire in time.[10]

[10] The bloody crackdown on the Tiananmen Square in June 1989 served as a wake-up call for those advocating "inevitable" liberalization scenarios in China. On the contrary, Germany could fundamentally reform its labour markets and come out of the doldrums of the late 1990s, though the odds for this were quite bad.

(5) Perhaps one of the more intriguing insights, which may and does come from comparative economic studies, is the relevance of path dependence and path creation, one of the reasons for sustaining the field across the ups and downs of political and professional fashions. If we analyze – as it is anything but customary in the myopic approaches of the mainstream – developments *á la longue durée,* the relevance of those insights becomes evident. Let us think about such cases as those of Spain and Italy, when long-standing traditional weaknesses – in terms of public finance, in terms of structures and competitiveness – seem to have been addressed by and for EMU entry. In both cases, history seem to have mattered more than policies, though one may always blame politicians for not being tough enough. And conversely, if one considers the relative success stories like Slovakia, Estonia, Turkey and India, it is clearly possible to see a chance for moving out of the vicious circles of historic determinism. It remains, of course, something of a mystery, when and which element dominates. Thus, it is always a most intriguing task for the theorist, economist, sociologist or historian to figure out the chains of causation and limits/possibilities of generalizations. What seems to be an uncontested point for us is that history matters, although it is not quite clear when and how, and what way we may operationalize this insight for individual cases. Alas, traditional case studies are also back in vogue, in more mainstream journals as well, if we take *Journal of Development Economics* or even *American Economic Review* as a standard of evaluation.

(6) Finally, one may want to bring back the political in meaningful economic analyses, especially at the macro level. Traditionally, macro was understood and even officially termed as Political Economy, and many Nobel laureates from Phelps to Mirlees occupy professorial positions in political economy even today.

Once we overcome the quantity fetish of the 1950, 1960s and 1970s, and accept the economy being a complex system, run by free – or less free – individuals, the need for the political re-emerges.

Let us note: the political is not the same as references to public choice. In most cases, it is impossible to define both the “public” and the conscious “choice” element in the actual processes, be those macro or micro level options.

Involving the political means respect for individual and group preferences as well as for the democratic process of aggregating those. As we know already from the classic piece of Kenneth Arrow (1950), there is no such thing as a social welfare function, which could either be postulated or aggregated from the micro-level preferences. Thus, the respect for the process of selection, the need for reliable information to make informed choices, the institutional support for public good are all vital for meaningful, efficient and feasible economic decisions to be taken.

Once we appreciate democracy as a major precondition for informed economic choices, the horizon of economic analyses must open up considerably. In line with already ongoing experimental economics and behavioural economics research programs, one needs to appreciate the significant impact of seemingly non-rational – and thus traditionally neglected – items such as perceptions, expectations, herd behaviour, the impact of discourses (which cannot be centrally shaped), strategic behaviour and non-cooperative games, and losses of information, or even disinformation, all being parts of the power game. Power-hungry political agents are not extremes and mere distortive factors to economic rationality, but an integral part of the analytical frame.

Having gone so far calls for the re-habilitation of such age-old concepts as solidarity, personal integrity, calculability, honesty, commitment to the public good. Good governance as understood by the World Bank – and by a broad body of management literature – is a basically qualitative concept, not liable to quantification.[11]

If quality is back on the agenda, it is perhaps no longer heresy to profess one's preferences, stated in an explicit fashion. Others may or may not share them, but at least the line of the argument becomes clear.

Even with this more sophisticated arsenal of economic analysis, we may not have a Wunderwaffe at hand. The collapse of communism in the Soviet Empire and its gradual, but visible demise in countries still under the rule of communists, such as Vietnam and Cuba, have shown the limits of how far centrally managed systems can go. But similarly: a quarter of a century of experience with market economy and democracy reminds us that this option may, and indeed, does have its ugly face as well. We are not free to cherry pick the good items from each at will, as János Kornai (2013) reminds us in his sceptical notes. But the room for improvement is indeed there.

What we may conclude from this sketchy *tour d'horizon* over the state of comparative economic studies, is the room for reformist steps. While these will be a long way from the dreams of social prophets, as well as from expectations of many ordinary people/voters, these improvements could

[11] It is ironic to see the widespread use of composite indices for assessing what is basically a qualitative, intuitive item. Love cannot, and perhaps also should not, be measured by the amount of gifts we exchange, not even by the time we spend together.

civilize the unbridled market. These would induce the social into the market economy. More precisely: subjugating the economic to the social, as envisioned by the German founding fathers of the social market economy, Röpke, Eucken, Böhm and Erhard, should be theoretically feasible. However, it remains a topical task to be managed over the coming decades in Europe.

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Part I

Innovation as a Driving Force

Innovation, Shortage and the Economics of Health Care Systems[1]

Karen N. Eggleston

Introduction

In a career as illustrious at János Kornai's, research on the welfare sector (e.g. Kornai, 1997), and health care systems in particular (Kornai and McHale, 2000; Kornai 2001; Kornai and Eggleston, 2001a, 2001b; Kornai, 2009), may seem only a tangent or footnote. Yet, as a health economist, I would argue that there is a deeper logic and challenge in this arena than is widely understood. We are all indebted to his "tangent" for illuminating health systems as islands of shortage within surplus economies. Health and health systems serve as microcosms for reflecting the underlying truth of Professor Kornai's analyses of comparative economic systems, soft budget constraints, and the drivers of innovation. In the final section of this short paper, I offer a mildly provocative hypothesis regarding the policy- and innovation-created "shortage" within contemporary health systems. No centrally planned economy felt compelled to set up a decision-making body to select from among innovations only those deemed cost-effective, like the NICE in the UK's health system. The "shortage" of health systems in high-income capitalist economies is itself a product of surplus: it is only because the economy is constantly sustaining innovative breakthroughs in all aspects of health and medical care that the health policymakers continually face a dilemma of financing access to innovations.

[1] This article is based on my presentation in Budapest in January 2013 at the conference in honour of János Kornai's 85th birthday. I am deeply indebted to János Kornai as my teacher, mentor, co-author, and friend. Indeed, I am forever grateful to have studied at Harvard precisely when he started thinking about welfare sector reform. The Chinese term 缘分 (*yuanfen,* or fate) is apropos. It was such an honour to co-author our book *Welfare, Choice, and Solidarity in Transition* (2001). In addition to the material discussed in this paper, my presentation focused on the importance of János Kornai's research for understanding China's economic development and reform. (I am probably one of the few westerners who first read Kornai's *Economics of Shortage* in Chinese, when I was studying at the Hopkins-Nanjing Center in 1988.)

Health and Comparative Economic Systems

Health systems can be viewed as important laboratories for comparative institutional analysis (Eggleston, 2009). Health and appropriate medical systems are inherently valuable; they are also increasingly important for economic performance, since health spending accounts for about one-tenth of GDP in many high-income countries, and a growing share (from a smaller base) for the developing world. The sustainability of health spending raises a difficult conundrum for society, and helps to bring into keen focus the economics of innovation that Kornai's research has highlighted as such an important feature of capitalism. I will return to this theme below.

Another reason that health systems are intriguing arenas for comparative institutional analysis is that cultural norms and beliefs strongly influence health and medical care decisions; yet rapid technological change disrupts those traditional norms and beliefs; and market failures are rife in health care financing and delivery (Arrow, 1963). Indeed, the health sector arguably is the only remaining sector of market-based economies where lively debate continues about the relative merits of state and market in delivering better performance (Eggleston, 2009), a debate that could learn much from Kornai's pioneering work on comparative economic systems.[2] Soft budget constraints (Kornai, 1980; Kornai, 1986; Kornai et al., 2003) are also rife in the health sector, and that sector proves an intriguing illustration of the benefits and costs associated with this ubiquitous challenge of economic policy under uncertainty (Kornai, 2009), brought into bitter focus recently by the bailouts of the financial crisis.[3]

Finally, population health itself can be a useful metric of comparative economics systems and systemic transition. Consider, for example, the life expectancy in East and West Germany from 1958 to 2008, as reflected in the demographics database well-respected and used by demographers around

[2] I have also argued in recent research that health systems provide a useful microcosm for studying the resilience of institutions during system transformation during socialist and post-socialist transitions, using the example of physicians directly dispensing medications to patients (rather than writing a prescription that is later filled at a pharmacy) that is so common throughout East Asia (Eggleston, 2009). Physician dispensing survived from pre-modern China through socialist governance during the Mao era through to today's market-based economy, where it is now under reform.

[3] Inspired by Professor Kornai's research, I have studied the theory of soft budget constraints and ownership, as well as the empirical manifestations of soft budget constraints in health sectors of the United States and China; see Eggleston, 2008; Eggleston and Shen, 2011; Shen and Eggleston, 2009; and Eggleston et al., 2009.

the world, the Human Mortality Database. Figure 1A shows that male life expectancy under socialism in East Germany was comparable to that of West Germany. Indeed, socialism may have raised male life expectancy among the lower social strata initially more than in the west, raising the average to slightly above that of West Germany in the 1960s.[4] The trends in life expectancy thereafter reflect stagnation under the socialist system, compared to continued improvement in the west. The large human costs of the initial transition (transformational recession in much of the post-socialist economies) is also clearly evident in Figure 1. This population shock was so substantial that even after the resumption of health improvement in unified Germany, men in the former East Germany had lower life expectancy than their West German counterparts – although for women, the gap had closed.

The Korean peninsula presents an even more poignant example of health as a metric of comparative economic systems. The Korean peninsula, once a unified state that successfully resisted Chinese absorption and Japanese invasion for thousands of years, has been tragically divided for about six decades, providing stark evidence of comparative systems in action. The Republic of Korea (ROK, South Korea) embraced capitalism and its economy developed rapidly after recovering from the devastation of the Korean War. South Koreans experienced a dramatic 28-year increase in life expectancy between 1960 and 2010, achieving a life expectancy of 80.7 years (above the OECD average of 79.8). In stark contrast, the Democratic People's Republic of Korea (DPRK, North Korea) has suffered economic stagnation and reflects all too fully the "genetic tendencies" of the socialist system that Professor Kornai has so thoroughly exposited (Kornai, 1992), from political power to daily life. Health measures have substantially declined since the DPRK's devastating famine of the 1990s, with some recovery more recently. Although accurate population health data is scarce, several careful and innovative studies have used adult stature (height) as a biometric measure for comparing the standard of living in the northern and southern parts of the Korean Peninsula (Schwekendiek and Pak, 2009; Schwekendiek et al., 2009; Pak, 2010; Pak et al., 2011). Sunyoung Pak, Daniel Schwekendiek, and Hee Kyoung Kim (2011) study the adult stature of 6,512 North Korean refugees born from the 1930s to the 1980s to assess living standards in North Korea over that time period. They find that "the height of North Koreans born before the division of the Korean Peninsula exceeded that of their South Korean peers. All North Korean cohorts born

[4] One should note that Cuba's health system, and that of China under Mao Zedong 1949–1976, also demonstrated substantial improvements in health that later stagnated.

thereafter were shorter than their South Korean counterparts. North Koreans did not experience a meaningful secular increase in height during 60 years of communism" (Pak et al., 142). According to the DPRK's own population census of 2008, life expectancy in the north is 65.5 for men (down from 68.4 in 1993) and 72.2 for women (down from 76.0 in 1993; Zellweger, 2012). By contrast, average life expectancy in the south (ROK) was 79.9 in 2008, according to OECD Health Data 2010, and experienced the sharpest increase since 1960 of any OECD country.

Innovation in the Health Sector

Kornai (2010) argues forcefully that innovation is one of the greatest strengths of capitalism. His extensive listing of innovations over the past century across a variety of sectors excluded medical care. I thought I might make a small contribution by helping to fill this gap, as part of the tribute to his scholarship and 85th birthday that the January 2013 conference and this volume represent.

Admittedly, any listing of medical innovations since 1917 can be criticized as arbitrary. Some that are included may not be deemed worthy; some not on the list may be considered even more important than any that are. Nevertheless, I offer a few different possible shortlists of medical innovations over the last century in Table 1A (by mass distributing organization[5]), Table 1B (by inventors), and Table 2 (on Nobel Prize winners in medicine). These glimpses at various aspects of innovation in the field of medicine further reinforce Professor Kornai's main point: the vibrant innovations that have greatly improved our health and longevity have virtually all been conceived, inspired, and put into clinical practice in capitalist economies.[6]

[5] Numerous complications confront anyone attempting to identify the pioneer mass distributors of innovations in public health and medicine. The most widely used and biggest innovations for human health are not necessarily patented drugs or devices, nor the best-selling, "blockbuster" drugs among those that are patented by the large multinational pharmaceutical firms. Even among breakthroughs most widely used in the high-income countries, some of the most important – such as new surgical procedures like heart surgery – are not patented and mass produced by any firm or agency, for example. Another interesting example is penicillin, never a "blockbuster" patented drug; it was the US government that pushed chemical firms to mass produce it for the troops in World War II.

[6] I was delighted that Professor Kornai was interested to include some of this material, in modified form, in the final version of his latest magnum opus, *Dynamism, Rivalry, and the Surplus Economy*.