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BOOK REVIEWS

Augusztinovics, M. (ed.): *Körkép reform után. Tanulmányok a nyugdíjrendszerről (The Post-Reform Scene. Essays on the Hungarian Pension System)*
Budapest: Közgazdasági Szemle Alapítvány, 2000, 424 pp.

Pension reform in modern welfare states is a challenge for both politicians and experts. Pension systems face financial difficulties all over the world, and consequently are under reform pressure. The provision of pensions has a significant impact on the welfare of both the present and future voters. For this reason the change of the system under the circumstances of political democracy is of high importance for vote-maximising politicians.

In the countries going through the painful process of postsocialist transition, the pension system was not only burdened by the financial problems stemming from the maturity of the former system, but also by the effects of the transformational recession. Due to these effects the expenditures of the pension system increased, while its revenues substantially decreased.

The governments of the post-socialist states faced a difficult dilemma. Their commitment to creating a market economy required economic rationality and a financially balanced pension system. At the same time, their commitment to political democracy required the avoidance of a legitimation deficit and pressed the political decision-makers toward cautiousness against radical changes. The actual changes in the pension system can be explained to a great extent by the way decision-makers try to avoid the simultaneous and contradictory dangers of rationality and legitimation deficits.

M. Augusztinovics and her co-authors deal with the complex issues of the Hungarian pension system and pension reform in their valuable book. The *first part* is about the history of the Hungarian pension system. D. Szikra analyses the social security scheme introduced in Hungary at the beginning of the 20th century. She points out that while the Hungarian legislation closely followed the Western trend, the coverage of the Hungarian scheme was more limited. K. Szabó-Csemniczki writes about the history of the Hungarian pension system between 1929 and 1997. She demonstrates how the pay-as-you-go (PAYG) pension system was built on the ruins of the former funded system and how the PAYG system changed until the 1997 reform.

The *second part* of the book deals with the present pension system. K. Major and B. Martos examine the inequality of pension benefits in the last decade. They find that the substantial decrease in pension inequalities was linked to the strengthening of the insurance element at the expense of the socially oriented redistribution. This outcome can be explained less with the change in pension regulations and more with the decreasing inequality of incomes serving as a basis for pension calculations. M. Toldi analyses the relationship between pension benefits and income time series, the impact of distinct components of the pension formula on the calculation of benefits. His conclusions include that among the pensioners receiving benefits on their own rights, disabled people and especially disabled males were the losers of the changes in the 1990s. J. Stahl discusses the problems of calculating pension benefits in relation to the new private funds constituting the second pillar of the new pension system, and proposes further reforms. R. I. Gál, A. Simonovits and G. Tarcali examine the pension reform from the point of view of generation accounting. They point out that the pension reform substantially reduced the former tensions of the pension system, about three-quarters of the net contributions to be paid by future (not yet born) generations has been eliminated. The costs of this improvement will be borne by the presently active generations and to a lesser extent by present pensioners.

The *third part* of the book deals with the theoretical background and international connections of the pension system. Simonovits introduces the Life-Cycle Theory and the Overlapping Generations/Cohorts models. The author points out that the application of theoretical models in empirical reality is far from being trivial.

Augusztinovics is looking for theoretical concepts for the analysis of redistribution within pension systems. The author distinguishes between actuarially correct and incorrect redistribution in pension systems, and draws attention to the importance of the relationship between a pension system and its environment. Specifically, analysis should not only deal with income flows within the system, it should also be extended to the study of income flows leaking out of, and streaming into, the system.

This overview does not do justice to the richness of this book. The editor won over a great many experts in the pension system by preparing a book containing different topics and approaches, allowing the book to be read from a number of perspectives. In this review, the rich set of topics and ideas will be used to reconstruct the political economy of the Hungarian pension reform. This choice was dictated more by the interest and the limitations of the reviewer than by the edited volume itself.

The pension system can be interpreted as a social contract between the government and the citizens. Social security systems tend to be the outcome of a blurred social contract – writes Zs. Ferge. This is the strength and not the weakness of these contracts, she adds. What should a clear social contract look like? It should follow only one distributional principle. Relying on the works of K. Polányi and T. H. Marshall, Ferge distinguishes among four possible principles of distributions: that of altruism, reciprocity, market, and social citizenship. The problem with all these principles is that none of them in itself provides full access to, and proper standard of, social services, and does not guarantee social security for everyone. Social provision by altruism gives only for a few, does it incidentally, and on a relatively low level. Reciprocity generates similar problems. The self-regulating market selects among the individuals according to their purchasing power, and excludes the poor from access to social provisions. Market contracts are also laden with uncertainties rooted in the functioning of the market mechanism. The principle of social citizenship covers everybody, but the level of social provisions depends on political decisions, and it also generates uncertainty.

Ferge proposes that the limitations of the transactions following a single principle may be resolved by complex social schemes combining several principles of possible entitlements. The system of social security in general and the mandatory pension system in particular may be considered as a system based on blurred social contracts mixing different principles. The mandatory system of pension insurance supplements the market principle with solidarity, and violates the right for free contracts and profit maximisation.

This results in the strengthening of social stability, argues Ferge, since behind the social contracts following a pure market logic there are those power relations that link formal (legal) equality with substantive (economic) inequality, while through an open intervention into power relations the blurred social contracts may reduce the extent of substantive economic inequalities, may contribute to the formation of a strong middle class in society and as a result may increase social stability.

One can accept that the principle of freedom for the market should be combined with that of social solidarity in the defence of social integration. However, it can still be questioned whether the contradictory principles of efficiency and equity may only be integrated in a way that blurs them into a single social security system. It is an important result of the discussions on the pension reform that the market principle and the entitlements on the basis of social citizenship may be combined in a way that puts the different provisions following different logic into separate subsystems within a comprehensive pension system.

The stability of the pension system is a value in itself. In the views of Ferge this stability can be challenged both by the market and the state. O. Czúcz deals in his paper only with one of these factors, the causes and mechanisms of state intervention into the pension system. He distinguishes among three possible variations of state intervention:

1. *The situation of irresistible temptation*. If the pension system accumulates reserves, political decision-makers are tempted to ease the financial tensions emerging in other fields by depleting the reserves of the pension system. Reserves may be accumulated especially in that early stage of pension systems, in which the sum of contributions still exceed the sum of benefit payments.

2. *Unavoidable situations of exigency*. As a result of demographic and economic changes the pension system may face financial difficulties. It incites the state to intervene into the affairs of the pension system. In the debates about the Hungarian pension reform passed by the Parliament in 1997, an important argument for establishing a new mandatory private pillar within the system was that this new pillar may increase the protection of the pension system against state intervention. According to these expectations by separating a certain part of pension savings, by keeping these savings on personal accounts managed by private pension funds, these savings get out of the sphere of government regulations.

Czúcz does not agree with this argument. He calls attention to the fact that due to the decreasing contribution of those who switched to the new system, a substantial deficit of the PAYG pillar has been built into the transition to the new, mixed system. The deficit should be financed by the state budget. As a consequence, the pension system is forced to draw on the financial resources dependent on the outcomes of a politicised process of redistribution. Furthermore, the economic intangibility of the pension funds is nothing more than an illusion, says the author. Political decisions applying the means of financial regulation – by changing the rules of investment and taxation for the private pension funds, and by influencing interest rates – may have an impact on the financial performance, the yield of savings of the private pension funds.

The author's conclusion is that by and large the pension reform has increased the dependence of the mixed pension system on the state instead of decreasing it. However, this conclusion is not an obvious one, because it presumes that state interventions into the PAYG and the private pension system are of the same kind, and therefore can be added.

3. *Interventions justified by changes in political values*. In this respect Czúcz mentions those reforms that are not only related to internal temptations and external exigencies, but also to changes in political values and political paradigms. The author examines the structure of these changes by using the conceptual tools of public choice. In the spirit of the public choice school the author is looking for the factors that may explain the formation of majority coalitions either enforcing or enabling structural reforms. Social coalitions may be different, depending on

the dimensions the researcher uses for defining the groups forming these coalitions. In relationship with the pension reform the author examines the role and effect of coalitions from the point of view of one, although not the only possible, dimension – that of different age groups. The pension system generates asymmetric distribution effects for different age groups.

The coalitions formed by specific age groups would like to redistribute the losses and gains stemming from this distribution. For instance, the transformation of a relatively immature funded system into a PAYG system would be advantageous for the middle and higher age groups, because it would convert the previously accumulated savings in the system into pension benefits. The burdens of this transformation would fall on the young age groups, and as a voting minority they would not be able to prevent this reform.

The change of the pension system may also follow from the threat of the ultimate "generation situation", as the author calls it. If the stability of the existing pension system is put to risk either by disadvantageous demographic processes or by the consequences of economic recession, the social support behind the system may also be endangered. Present pensioners and employees close to retirement are interested in maintaining the system, since they have paid most of the contributions. In contrast, younger people paid into the system relatively little, therefore the losses of leaving the system would be relatively small for them. Thus they have more incentives for changing or leaving the system. If the contributions paid by this age group are vital for the survival of the pension system, this group will enforce the change of the system.

How can the pension system be defended against political risks? The
author presents four different ways of doing this:

a) *Strengthening equivalency.* Political intervention into the pension system may be reduced if the burdens of intergenerational redistribution could be shifted on those who caused them. For example, if a generation has fewer children, the number of active wage-earners and consequently that of contributors to the pension system will diminish in the future. This generation should be made financially responsible for this, thus its pension should diminish. This way the financial crisis triggering state intervention can be avoided. However, the author is correct to note that the strengthening of equivalency may also be the result of political intervention, although its chances are reduced by the opposition of the age groups of pensioners and active elderly employees.

b) *Incorporating the most important parts of the regulation into the constitution.* Fixing the main elements of the system in the constitution offers the advantage that the system cannot be changed easily, only by a qualified majority vote, that is close to consensus, argues the author.

c) *Bringing the elements of self-governance into the decision process.* A strong self-governance based on the agreements of social partners can react to the problems in the functioning of the system with the necessary flexibility.

d) *Political self-restraint*. Arbitrary political interventions may be cut back if the political actors include those into the process of decision-making who are affected.

Looking at the situation in Hungary on the basis of these four points, it can be stated that the Hungarian pension system is little protected against political intervention. The reduction of political risks – as we can see from Czúcz's argument – can only be the result of political intervention. One of the explicit aims of the Hungarian pension reform of 1997 was the reduction of political risks. L. Gerencsér wrote an interesting overview about pension systems and pension reforms in Europe. His essay shows that the member states of the EU were rather cautious in resorting to institutional reforms. By contrast in Hungary a mixed, multi-pillar pension system was introduced. How can this relatively radical pension reform be explained? This is the question that Katharina Müller seeks to answer in her essay.

Müller connects the reform that combined the public and the private pension system and broke with earlier plans that limited the reform to changes within the existing PAYG system to the failure of previous pension reforms. The reform plans aiming at the internal modification of the PAYG system made explicit that the changes would inflict losses for a great number of people. The government did not intend to initiate reforms that would have cut existing entitlements of the citizens. The reform of a mixed pension system diverts attention to the erection of a new private pension pillar. It is a popular proposition, since the citizens' trust in the old pension system has been worn out, while they regard the money accumulated on the accounts of the new private funds as their own.

The reformers advocating the mixed pension system make the intended restrictions less visible, but they also hide the risks and costs of the privatisation of the pension system. Müller shows that the partial privatisation of the pension system in Hungary has been made possible by the change in the balance of power among the political actors. In 1995 there was a real or imagined crisis of public finance in Hungary that increased the manoeuvring room for the Ministry of Finance committed to neoliberal reforms, and substantially diminished the capacity of the Ministry of Welfare committed to internal reforms of the existing PAYG system to represent its interests.

The World Bank was also an important actor in the reform process. Its influence came from the heavy external indebtedness of the country. The World Bank played a role mainly in the formation of the content of the reform strategy and not in dictating the conditions of the reform.

The success of the reform was also brought about by the fact that the social actors opposing the privatisation of the pension system – first of all the trade unions and the Pension Fund – were not in a political position to be able to veto the change in the paradigm of the pension system, claims the author. However, one might modify and supplement this insightful and important analysis in the following two points.

(I) It would be difficult to explain the *postponement of the pension reform* at the beginning of the 1990s directly with a political opposition against the reform. In the eyes of the citizens the reform was obviously not popular, but due to the underdevelopment of civil society, organised opposition did not evolve. Conversely, one could also argue that although the pension reform did not have a well-organised opposition, the reform did not come about. This situation had also to do with the effects of the transformational recession: by increasing the number of early and disability retirements, the existing pension system served as a tool for easing the tensions on the labour market, slowing down the increase of unemployment.

(II) The *role of the Ministry of Finance and the World Bank* in the pension reform can only be partially explained by the fiscal deficit of the pension fund or by the external indebtedness of the country. First, the annual deficit of the pension fund was not significant, and was especially unimportant in comparison with that of the health care fund. In the sphere of health insurance, financial problems were much more serious, and in spite of this the Ministry of Finance was unable to introduce radical reforms. Consequently, the financial tensions in themselves do not explain the significant influence of the Ministry of Finance on the pension reform. Second, the pressure of external indebtedness could neither be the cause of reform, nor explain the role of the World Bank. This indebtedness existed already at the beginning of the 90s, when reforms were postponed, while from 1995 onward the indebtedness started to diminish.

The missing link in Müller's argument is the threat of a financial crisis in 1995. This threat resulted in the strengthening of the positions of the Ministry of Finance and it made this institution the predominant actor in the pension reform. The fact that the Ministry of Finance shared the ideas of the World Bank about the course of the reform may be explained by the expectations of the Ministry of Finance about the possible consequences of the partial privatisation of the pension system. This privatisation would result in the withdrawal of the government from financing a social provision that may generate legitimation deficit if the level of the benefits is not high enough. If the same benefit were provided by the market, this legitimation deficit could be reduced, since the state has no direct responsibility for the performance of a private pension system. As a result, partial privatisation of the pension system may reduce the political pressure on the government in general and on the Ministry of Finance in particular to increase the budget expenditures and/or the revenues.

The pension reform introduced in 1997 created a new situation in Hungary. However, the reform should not be considered to be complete. On the one hand, the internal transformation of the PAYG pillar did not happen, on the other hand the process of setting up a second, private pillar cannot be regarded as a finalised process. The essays in this book give several clues about the unfinished character of the reform. For instance, L. Máté demonstrates that the PAYG system keeps applying the techniques of forced solidarity, partly because it determines the relation of the pension benefit to incomes in a non-linear way, partly because of the application of a minimum rule biased by the solidarity principle. The result is a compressed structure of the starting pensions that on the expenditure side makes the Hungarian pension system originally aiming at income maintenance similar to the Anglo-Saxon pension systems aiming at providing a minimum standard, while on the revenue side it keeps the proportionality of the contributions.

I. Antal, R. Borlói and J. Réti also emphasise that the pension formula in the PAYG system needs to be changed in a way that serves better the actuarial principles of pension insurance. Á. Matits points out that the market share of occupational pension funds is very low. She thinks it is the most negative feature of the new Hungarian market of private pension funds. Réti warns that through the institution of "heritability" the law on private pension insurance shifts the risks linked to the pension provisions for widows on the PAYG system. P. Bod demonstrates that the second pillar is not suitable for treating disability risks.

In sum, the essays in this volume have contributed considerably to the knowledge on the changes in the pension system both for the profession and for the political decision-makers. The book has demonstrated that the operation of the pension system is based on complex relationships that the politicians making the final decisions may not be able to grasp. Therefore, the reforms lead to a great number of unintended consequences that induce further changes and further reforms, etc. As a result, the post-reform situation is always a pre-reform situation. However, the analyses of the pension experts have also demonstrated that pension reform is a too complex matter to be left only to experts. The reform of the pension system should be put to the test of both professional rationality represented by the experts and political rationality making possible the political equalisation of different interests.

Péter Gedeon

Dickinson, D. G., Ford, J. L., Fry, M. J.,
Mullineux, A. W. and Sen, S. (eds):
Finance, Governance and Economic Performance
in Pacific and South East Asia
Glos, UK & Massachusetts, USA: Edward Elgar Publishing Ltd., 2000, 391 pp.

The last two decades indicate relatively high world economic growth, fuelled by spectacular growth rates in Pacific Asia and credible growth performances in both EU and the USA. At the same time, the increase in global capital flows led to the rise in the size of the international financial sector. In this respect, there has been growing discussion about the relationship of financial development and economic growth in the framework of the globalisation perspective. To what an extent did the fiscal stance of the government contribute to the economic success of the various countries? Was financial liberalisation beneficial? Were any successes a result of the combination of good monetary and fiscal policies, without creating inflationary pressures? These are some of the questions, which the book considers. It is a collection of fifteen papers, in which Japan, Taiwan and Thailand receive primary focus. Indonesia, Korea, Malaysia and the Philippines are also included for comparative studies, with regard to the position of governance in capital formation, financial and economic development, and economic growth.

DESCRIPTION

Somnath Sen's paper (Chapter II) opens with an overview of the theoretical still-disputed relationship between financial and economic development period. He then outlines the key points of the analytical discourse through the years in this debate. At the very outset, the author notes that financial intermediation is "an essential input into aggregate output and vital for production of GDP" (p. 9). Thus financial development, which involves services of financial intermediaries, financial sectors and institutions, is so vital to growth theory as it is the capital output ratio. To support his contention Sen reflects to McKinnon (1973), Shaw (1973) and Tobin (1965). According to this line of thought money is not neutral and could have an effect on the transition path by the presence or increase of monetary and financial variables. However, Sen argues that this model's major deficiency is that it looks at money and monetary variables as inputs into a production function. The second drawback is that such a model allows only for exogenous growth. The alternative model, according to Sen, is to have endogenous growth. An economy with Cobb–Douglas technology can have a positive long-run steady rate of growth, even if the supply of efficiency of labour is constant. Sen's conclusion and central concept of the book is that liberalisation of financial system, expansion of financial intermediation and overall financial development have a positive impact on growth. And even the Asian crisis of 1997 proves that. First, just as financial expansion is helpful, adverse financial sector shocks are harmful for growth. Second, empirical evidence shows that long-run economic growth will recover. Third, as the author turns to Stiglitz (1994), the quality of financial development is just as, and even more, important than the quantity of financial development.

Ford's paper (Chapter III) in a way continues the discussion introduced by Sen. The focus is on the relationship between financial and economic development in Taiwan for the period 1960–1995, following the attempt of the government to deregulate and liberalise the money and financial markets in late 1970s. Two indicators of financial development (monetisation ratio and total financial assets to GNP) are employed in the model to show that the causal link goes from financial to economic development.

Fry's paper (Chapter IV) concentrates on the financial crisis which is a result of the institutional development of domestic markets for domestic bonds and the restriction of purchasing of such bonds by foreign investors. The author finds examples of high-risk premium in New Zealand after 1984, great foreign participation in emerging fixed-income securities market in Mexico (one-third of Mexican government securities was held by foreign investors by 1994) and a negative relationship in the Korean case between the efficiency of the domestic bond market and the economic growth[1]. Marcus Noland (1996) claimed that faster financial and capital account liberalisation in Korea could be beneficial, but it would not be accompanied by macroeconomic destabilisation. Thus, Fry makes three suggestions to countries on the threshold of opening their markets: (1) to promote interest rate flexibility through monetary control and to ensure that the Central Bank is never the lender of first resort; (2) to ensure that there is a functioning, adequate system of regulatory control; (3) to abolish reserve and liquid asset requirements on financial institutions.

In the following Chapter V, Hurayama explores the Japanese experience. The author analyses the link of financial liberalisation with the burst of bubble economy in the 1980s, examines the consequences from the bubble crisis and draws lessons for financial institutions. He finds that increased bank lending to the real estate industry and non-banks was one of the decisive factors in forming the bubble. The conclusion is that the changes in bank lending from traditional

[1] In the case of Taiwan, efficient use of the factors of production explains high growth rates (pp. 26–63).

clientele to real estate sector came as a result of financial liberalisation and the absence of adequate corporate governance of the banks.

In Chapter VI, Shin'ichi Hirota explores the bank–firm relationship as a corporate governance mechanism in Japan, using data from the 1960s to the 1990s. He finds that the lending ties between the bank and the firm increase the productive efficiency of the firm, while shareholding relations lower corporate productivity. It is inferred that the Japanese downsloping economic growth in the 1990s is due to the decrease of corporate efficiency of domestic firms, because governance mechanisms, rather than financial markets, do not fully discipline the management.

Wang's paper (Chapter VII) brings us back to Ford's discussion about Taiwan, but from a different perspective. This time, there is an analysis of the recent reforms in the financial sector, which include the deregulation of the interest rate, the relaxation of foreign exchange control, privatisation of the banking industry and financial internationalisation. Moreover, there is an acknowledgement of the contribution of the financial sector to the real economy, thus keeping within the framework of the central concept of the book. The last section concentrates on the influence of the Asian financial crisis on Taiwan and the response of the monetary authorities. Wang suggests several lessons from the crisis: establishment of a flexible exchange rate mechanism, while at the same time strengthening the discipline within the financial sector; savings being promoted to raise capital to maintain financial market stability; further development of the capital market, and on a sound basis.

Yin's work (Chapter VIII) adds to Wang's contribution. The focus is on the financial crisis from July 1995 to March 1996 and the successful experience of Taiwan in handling the consequences: (1) Taiwan had fewer financial institution failures, as opposed to Japan and Korea, because there is a ceiling of 20% net worth of bank holding for listing stocks; (2) the real estate market in Taiwan did not collapse as it did in Japan, because the Central Bank adopted the "hot air balloon" strategy[2]; (3) there is no banking *keiretsu* in Taiwan, therefore the banks were giving the loans at their own risk, without governmental guarantees; (4) the Central Bank limited the foreign debts (quantitative control in FOREX Market). The Taiwanese business ability to borrow from abroad was restricted by forbidding its use in the domestic market; (5) as far as both crises occurred as a result of huge capital outflows, with the stock market plunging and stress in financial institutions. The author's conclusion is that the sounder financial structure and regulatory system helped Taiwan to escape faster from the depth of the Asian crisis.

[2] The Central Bank provides more loans for first-time home buyers in case of threat of major falls in the real estate market (pp. 146–147).

Thailand is in the focus of Chapter IX, written by Yos Vajragupta and Pakorn Vichyanond. The country's financial evolution for the period 1972–1987 is discussed, emphasising that the monetary authorities did not put significant attention on the development of the financial system. Nevertheless, the Thai economy grew on average with 6.6 per cent. The authors argue that factors like worldwide liberalisation of trade and services, EU, Indochina's market orientation and fiscal readiness, induced the financial liberalisation in the years following 1988. Foreign capital flooded the Thai financial market as a result of liberalisation. The funds created microeconomic imbalances among the borrowers, and caused macroeconomic disequilibrium. The government then intervened unsuccessfully to preserve the stability of the financial system. Finally, a flexible exchange rate was incorporated and IMF financial package was called. The crisis was attributed to three policy errors: liberalising foreign capital flows while keeping exchange rate rigid, liberalising financial institutions when they were not yet ready and finally, failing to supervise financial institutions carefully.

In Chapter X, Suppakitjarak and Theobald discuss the currency hedging in Asian equity markets. Specific attention is given to the impacts of the use of forward and future contracts upon the risks and returns of individual country investments and the portfolio return moments of Asian equity portfolios from the perspective of foreign investors. It is shown that hedging with forward currency contracts led to reductions in risk. Currency hedging in portfolios did not lead to statistically significant improvements in risk-return space as measured by Sharpe ratios. The performance improvement was achieved by assuming currency exposures via the forward contracts.

The two papers by Mullineux (Chapters XI and XII) summarise several issues touched upon in the preceding chapters. The first paper calls for better supervisory and regulatory controls of financial institutions. According to the author, banks should be required to hold sufficient capital to cover non-diversifiable credit and market risks. Banks should also abide by overexposure and overconcentration rules. Supervisors should encourage diversification of lending and diversification into wider financial services (universal banking) in order to reduce average risk. The author also suggests the supervisor's adoption of the US CAMEL (capital adequacy, asset quality, management quality, expected earnings and liquidity). Another trend is to require greater transparency, which would create market discipline. The author recommends particular attention be paid to disclosure rules relating to bad debts, which banks should not hide. The last key point discusses whether one independent body should regulate a single financial service. UK and Japan were given as examples for states, which incorporated national regulative bodies, responsible for supervising the majority of the wider financial system, while their central banks concentrated on setting the monetary policy.

Chapter XII goes into corporate governance and finance in UK and Germany as benchmarks for the discussion of good governance. The author bridges the reforms in the transition economies from CEE region with that of Pacific and South East Asia because the economies faced similar problems. The bank bad debt problem, asset price bubbles in stock and property markets, and the *lock-in* effect into lending relationships with increasingly poorly performing large enterprises (the *chaebol* in South Korea and SOEs in China) are some of them. In addition, both regions have suffered from capital account and financial sector liberalisation. In the case of Japan, there are small numbers of strategic shareholders, who developed a corporate Mafia. Capital locks in the group, which usually includes banks and other financial institutions. These institutions are not allowed to fail since political influence is bought.

In Chapter XIII, Bende-Nabende, Ford and Sen continue the discussion of good governance. The objective of the study is to find whether governance in terms of level and distribution of government activity affects the level of GDP. It also tests whether government activity was similar for countries in the same region. The overall result shows that government activity has a strongly positive and significant impact on levels of GDP and hence on economic development. But governmental activity does not have impact to the same extent on the level of GDP. The country’s population size, its level of economic development and size of the economy, tend to be the dominating differentiating factors. Labour positively influences GDP levels, but in cases where the country is at the higher end of development. Results shared in the paper indicate that government activity plays an important role in economic development.

Osaka’s essay (Chapter XIV) tackles an important and controversial aspect of the growth process in the “tiger” economies. The question is whether the success achieved can be attributed, at least partly, to increased productivity. According to Krugman (1994, pp. 62–78), the Asian tigers’ rapid economic success has been a once-and-for-all phenomenon. Osaka reviews this suggestion and tests for the exogeneity hypothesis. His comparative analysis embraces Japan, South Korea, the Philippines and Thailand for the period 1960–1991. Using growth accounting methodology, cointegration tests and a dynamic version of the Cobb-Douglas production function, the paper finds that Krugman’s hypothesis fails. Total factor productivity trend in South Korea and Thailand is positive. The decreasing trend for the Philippines vanishes once the economy recovers from the political turmoil of the 1980s.

In the following Chapter XV, Bende-Nabende, Ford and Slater address the impact of FDI on the economic growth of the ASEAN-5 economies in the period 1970–1994. The authors refer to recent research, which underlines that the key determinants of long-run growth are endogenous. However, the first endogenous models had deficiencies, encompassing such factors as improvement in the quality of the economy's labour, better health, more education and access to training, technological change, international trade and government policy. Using the multiplier methodology, the paper evaluates the contribution of FDI, through the positive spillover effects on the factors mentioned above. An emphasis is put on one policy variable – *liberalisation*. The results demonstrate that the impact is immediate in the more developed, politically stable and foreign friendly countries, and while there is a time lag (wait-and-see strategies) in those economies which are less developed, politically unstable and hostile to foreign capital.

The final paper by Dickinson draws attention to the importance of financial structure in determining the firm's behaviour. Therefore it falls into the group of those numerous researches, which oppose the conclusion of the seminal paper produced by Modigliani and Miller (1958, pp. 433–443), who argued that financial structure does not matter. The chapter claims "the interaction between the macroeconomic conditions in the ability of financial markets to provide appropriate corporate control mechanisms were central to the causes of the financial/currency crisis". Dickinson considers the arguments, which explain the failure of the MM propositions in the first section of his paper. The second section concerns the interaction between firm's decision-making and financial structure influenced by external events. The third reviews the recent developments in the financial structure of firms in Southeast Asian economies, and contemplates the influence of corporate governance mechanisms (or the lack of them) on the recent problems. Finally, the author concludes with policy recommendations. The major finding is that the Asian crisis is not the result of international capital markets failure, but of domestic financial markets, regulation and policy (p. 377)[3]. Dickinson successfully elaborates on the conceptualisation that domestic firms over-invested in pursuit of growth rather than of value maximisation, thus precipitating the crisis.

EVALUATION

The framework of the book builds on the endogenous growth model premise, through which the authors test the impact of financial intermediaries, financial sectors and institutions on economic growth in Pacific and Southeast Asian countries. The reader is convinced that financial liberalisation is conducive to growth,

[3] In accordance with this point of view, Martin Khor argues that the constituting factor, which caused the East Asian crisis was the preceding financial liberalisation and deregulation (p. 62).

however, only in case when there is transparency in the financial sector and adequate supervisory and regulatory control on behalf of authorised institution. Two points, omitted in the book discourse, can be made in this respect. On the one hand, the authors neglect the fact that business transparency can be also dangerous, because firms that reveal their profits become subject to arbitrary government audits and expropriations (Hilton, 2001, p. 12). On the other hand, the domestic companies should learn to better manage the risks in the international economy, without relying on the government bailouts (Hilton, p. 14)[4] in order to reach the long-term growth perspective[5].

The key presumption inherent in the book is that the financial sector contributes to the real economy growth. The policy lessons which come out from the Asian crisis and its consequences are that financial liberalisation should take place at a time when financial institutions are ready; liberalising foreign capital flows should be complemented with flexible exchange rate and financial institutions should be supervised. Therefore, the authors explain the reason for the Asian crisis as a result of failure in domestic market intervention, thus deviating from the conventional wisdom that the international financial market was the determinant. This position goes in accord with Djankov and Xu (2000). The latter found, building on analysis of more than 850 listed companies from the East Asian region that the crisis occurred because of institutional weaknesses in the sphere of property rights, poor bankruptcy and accounting procedures, lack of transparency and perverse incentives.

To conclude, the book is not only constructive for explaining the Asian miracle, but also could be instrumental in discussing issues of financial liberalisation, corporate governance and FDI inflow in CEE region. The lessons from the Asian crisis and the consequent policy steps also represent beneficial practical guidelines for the IMF and domestic government relationships, regarding the negotiations for the parameters of the rescue-financial packages.

Evgeni Evgeniev

[4] South Korea being the "leader" in this respect.

[5] In the US, short-term interest rates were reduced in the early 1990s to almost negative levels in real terms, thus providing relief for economic agents to refinance their debt. This measure produced a boom in the securities market (Khor, 2001, p. 61). There is a contrast in IMF policy towards tight credit and high interest rates imposed on Asian economies affected by the crisis.

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Wintrobe, R.: *The Political Economy of Dictatorship*

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Ronald Wintrobe uses rational choice theory to characterise the dictatorships – how they have come about, what are their major constraints and why are they popular despite opposite expectations. The author observes that the dictatorships have been successful in accumulating the power, and considers it necessary to explore the strategies and primary tools of dictatorships to stay in power, rather than merely exploring "why they fell", an approach used by many other authors. His main theoretical assumption is that there is no essential difference in the rationality of individual actors in democracies and in dictatorships – in both cases they are self-interested in the economic sense. With this framework Wintrobe can successfully answer a wide array of other challenging questions – how does the level of political repression respond to economic forces such as changes in the regime's economic performance and to political forces like what factors contribute to the (in)stability of authoritarian regimes, can the latter be "good" for the economy, and who should be held responsible for the crimes against human rights after the fall of dictatorships?

In the first chapter Wintrobe opens the discussion by distinguishing between four images of dictatorship – totalitarianism, tinpots, tyranny and timocracy. The first category – totalitarianism – is defined as a political system, which strives for the total domination of each single individual in each and every sphere of life. Totalitarian regimes achieve this by atomising human relationships, and destroying the classes, interest groups and other relationships between people (pp. 9–10). The most prominent examples are Nazi Germany and the Soviet Union. Secondly, he names the so-called “tinpots” regimes in which the ruling government does not disturb the traditional way of the peoples lives (pp. 11–12). The ultimate goal is to keep the office and enjoy the benefits of being in the power. The examples are many Latin American and African dictatorships. As a third category, Wintrobe proposes the tyranny, a regime in which the policies are not directed towards improving the material interests of the people, and power is kept through the violence of the leader, who is the tyrant (pp. 12–14). Some Latin American (Haiti, Chile in 1970s) and African (Mobutu, Idi Amin, Haile Selassie) regimes fall into that category. As a fourth image of the dictatorship, Wintrobe distinguishes the timocracy, a regime which has “the benevolent dictator”, where there is a “reciprocal love” between the dictator and the people (pp. 14–15). As examples the author mentions Chile under Pinochet, Singapore under Lee Kwan Yew and even Cuba under Fidel Castro.

In the second chapter Wintrobe continues the discussion with the dictator’s dilemma. Based on examples from both the distant and more recent past, the author observes that this dilemma results from the fact that by increasing the threats a dictator applies to his or her people, he or she can actually increase the threat of being removed from the post. Whereas a dictator can control most aspects of the people’s lives, the human minds can never be entirely inspected or controlled (p. 20). The dictator can therefore never be sure what his or her subjects are thinking, and increasing the threat will further contribute to the effect that people will become more afraid to speak out or do anything which might anger the ruler. From the other perspective, if the subjects can convince the dictator of their support, then there is no reason to fear.

Wintrobe then observes two problems: first, the accumulation of trust between two sides who are extremely unequal, and second, the problem of enforcing promises and obligations. Furthermore, the inability to account for the costs of enforcement is for Wintrobe something that links together the economic and political science (p. 32). One of the possible solutions to the last puzzle would be the use of a price premium to encourage loyalty or what he calls the overpayment, which he discusses in the context of labour market and democratic politics. Wintrobe concludes the chapter with explaining how the autocratic rulers have sought to resolve the problems. He discusses Roman Emperor Augustus, Mobutu and Stalin and argues that their solutions could be classified into two categories: repression and loyalty.

In the third chapter Wintrobe uses the economic theory to compare two extreme types of regimes – tinpot and totalitarian dictatorship – and builds a model for their political behaviour. Whereas the former seeks no more power over its citizenry than it is required to remain in power and collect the benefits associated with being there, the latter uses all the instruments of repression and loyalty to maximise the power over the population. Although Wintrobe does not believe that any dictatorship, even a totalitarian one, could entirely capture the souls and minds of the people, his argument is that the dictatorships can still obtain considerable support from their subjects, while sticking to the assumption of rationality of the people. In order to show this, he first develops formal models with the equilibrium levels of power, repression and loyalty for both two types of dictatorship. This analysis enables him to explain the relationship between those political variables and economic performance. Wintrobe's conclusion is that, unexpected as it might seem, improvement in economic performance tends to lower the level of political repression in a tinpot regime, but to raise it in a totalitarian regime (pp. 53–55, 62–64) .

In case of the tinpot regime, the author also explores how those often military-backed or -based regimes function, and why they are so unstable (pp. 56–58). All political regimes are assumed to reward their supporters once they are in the power. In case of military regime rewarding the supporters means weakening their own footing and eventually voluntarily transferring their power to civilian regimes. In case of the totalitarian regimes, Wintrobe observes that average level of repression and average level of loyalty are positively correlated, which implies that as long as the repression methods are effective, the level of loyalty tends to be higher in totalitarian than in tinpot regimes (p. 64).

The author goes on to explore the other features of totalitarian regimes, the preferences of their leaders for the economic growth, and the structure of the totalitarian party. Wintrobe also examines how the exogenous shocks such as the imposition of external sanctions and the offer of aid or trade influence the vigour of dictatorships. He concludes with the implications on what the Western democracies should do in order to improve the conditions of human rights and freedoms. The main normative suggestion out of his analysis would be to give aid to the dictatorships or allow them to engage in international trade only when there is a concrete constraint on the dictator to improve the human rights conditions. As Wintrobe acutely observes most of the dictators are unwilling to do that, since they know that improving the conditions of human rights will eventually decrease their power.

In the fourth chapter Wintrobe extends the model he used for the totalitarian and tinpot regimes to the two other images of dictatorship: tyrants and timocrats. The author takes the dictator's point of view and asks whether it is rational for him to be a tyrant or a timocrat, and on the other side, whether the subjects of the regime really support the dictatorship, or just pretend and waiting for the right moment to overthrow it. Wintrobe discusses briefly the examples of Mobutu's and Papa Doc's regime in Zaire and Haiti respectively, and concludes that these regimes are the best examples of tyranny characterised by extraordinary high level of repression and public support. In both cases (Wintrobe calls them "immiserising" dictatorships) the leaders did not pursue any kind of strategies to achieve the economic growth, but rather those regimes impoverished their people, and the main means of building the national support was to demolish any kind of attempt to oppose the dictatorship.

Wintrobe goes even further back in history and discusses the Roman Empire. His main argument is that even then the political support was built through the gifts to the subjects of the ruler and invasion of foreign countries, rather than through economic development. "The gift" is an important concept to the author and he argues that it had many political functions such as signalling, providing a barrier to entry into politics (against those who could not afford it), and establishing ownership (improve the legitimacy of the ruler and his right to public funds according to his will). Wintrobe's ultimate conclusion is that most Roman emperors were tyrants who were solemnly disliked by their people.

In the same chapter Wintrobe analyses the possibility of timocracy. He uses the economic theory of the family to show that the whole concept of benevolent dictatorship is flawed. The first problem is the minimal likelihood that "a generous dictator" would come to the power in the first place. Secondly, such a dictatorship would be extremely unstable and dependence-oriented as the people devote most of their energy to receive the gifts, and this might be a source for another conflict. Thirdly, there is a high likelihood that the dictator, despite of his "love towards his subjects", would still use his or her power to prosper in the office. Wintrobe maintains that if he still had to pick a model of timocratic rule, he would choose Roman Emperor Marcus Aurelius. Wintrobe points out that the only irony with Aurelius is that despite his benevolent rule, his son and successor Commodus depraved the timocracy to absolute tyranny.

In Chapter 5 Wintrobe generalises the model developed in Chapters 3 and 4, and shows how four types of dictatorships may be thought of simply as special cases of a general model. He develops the utility function of the dictator according to which the dictators do not simply maximise their consumption or power, but rather aim to maximise their general utility, where power and consumption appear only as variables. The variables are constraints on the activities of the dictator: the resource costs (organisational and financial) of accumulating the power; the costs of power to accumulate the wealth and the preference of the dictator over the money and power. Wintrobe solves the model for the equilibrium levels of power and budget, the dictator's consumption and the level of repression and support, where neither the price of loyalty nor the budget constraint are fixed, but rather endogenously determined. He concludes with comparative static analysis and policy implications of his model and discusses how do external shocks influence the change of power and budgetary revenues.

In third part of his book Wintrobe looks at how the economy functions under the dictatorships. He tries to explore whether the dictatorships are more likely to achieve superior economic growth and whether they are less subject to rent-seeking or redistribution pressures than the democracies. He also tries to answer the question whether the introduction of free markets will inevitably lead to the decline of political dictatorships. Chapters 6 and 7 make the theoretical elaboration, and in next three chapters he uses this framework to analyse the not unknown dictatorships of South Africa, Soviet Union and China.

In Chapter 6 Wintrobe discusses alternative versions of autocratic economies and their fundamental principles. He suggests that it might indeed be true that only from the point of view of economic growth and efficiency, the autocratic forms of economic organisation can be superior to democratic ones. Wintrobe maintains that little time has been devoted in contemporary economic literature to discuss the relationships between authoritarianism and efficient economic systems. He distinguishes among four contemporary models of autocracy – dictatorship as suppression of redistribution (capitalist authoritarianism), dictatorship as redistribution (kleptocracy), dictatorship as command economy and dictatorship as shadow economy. He argues that only the first dictatorship does not play any significant economic role. Having said that, Wintrobe discusses potential capacity to create a loyal and disciplined labour force, which is one of the mechanisms that dictatorship can use in order to directly influence the workings of markets. The author indicates how this model can be used to develop a political economy perspective to the political dictatorship and how the former interrelates with the economy.

In Chapter 7 Wintrobe tries to fill the gap in the literature between the capitalist authoritarian society and economic growth, and compares the redistribute tendencies of democratic governments and dictatorships. He examines the superior performance of some free market dictatorships, and seeks to answer the question whether it is reasonable to argue that their better performance results from the fact that they are less subject to rent seeking or redistribution pressures than other forms of government. From the real world examples he addresses the issue of redistribution in the capitalist authoritarian systems of Pinochet's Chile and South Korea. With his more theoretical analysis, he examines the equilibrium level of redistribution in three well-known models of democracy – the median income voter model, interest group model and the probabilistic voting model, and describes the situation of what would happen if the dictator would take over. His conclusion is somewhat surprising: more redistribution is more likely in dictatorship rather than in democracy. Wintrobe has two explanations for that. First, the authoritarian economies perform indeed well, but not because they do not redistribute, but because of other reasons. Secondly, the redistribution in the authoritarian regimes seems to be biased in favour of the groups who benefit most from the economic growth.

Chapter 8 discusses the redistribution under the apartheid regime in South Africa. Wintrobe develops two models. According to the first one, black labour was exploited for the benefit of white labour and according to the second one, the exploitation of blacks benefited white capital. He then goes on to develop the model of South African polity and shows how two central institutions of apartheid economy – job reservation and the pass systems – work. Later he combines this analysis with the model of polity to show how politics and economics worked together in the apartheid of South Africa. Wintrobe also discusses how the operation of the system was influenced by the black resistance, sanctions and other variables, and why eventually the system ultimately became unprofitable and was dismantled.

Chapter 9 and 10 discuss the communist dictatorship and its economic foundations. In chapter nine he develops a model of communist economies and argues that the economic system was part of the totalitarian society, with the production being controlled by the communist party. Wintrobe elaborates on a model, which assumes that there is a logic in communist economies, a logic which is basically similar to that of any bureaucratic organisation. The demonetising of the economy, which was one of the most crucial aspects of the Soviet economic system, was rational in the sense that enabled to politicise the economy. The problem with this, as accurately pointed out by Wintrobe, was that like any bureaucracy, it does not run primarily by command but through exchange. Whereas in a market economy the exchanges were based on the property rights and law, under communism they were supported by party loyalty. The loyalty was important to the party, as this, combined with the party's capacity to repress opposition, became the main source of its power. Wintrobe also observes that in the Soviet-style system there was a positive correlation between the power of the party and measures of economic performance such as economic growth. Wintrobe then describes the working of the system in both its productive and unproductive phases, and shows how each of these phases can be generated from a single model of communist system. According to him the basic problem with the communist economic system is in the conditions for running any large bureaucracy efficiently.

He notes that there also exists a fundamental contradiction between the promises that makes communism, especially between equality and solidarity on one hand, and efficiency on the other.

In Chapter 10 Wintrobe picks up what he discussed in the previous chapter. He shows how the contradiction among efficiency and solidarity and equality in the Soviet economic system became more and more apparent with the development of time. Wintrobe describes the working of the communist system, its central dilemma and Stalinist solution of the Party purge. He goes on to elaborate on the decline of the system between Stalin's death and the era of Brezhnev, compares the attempts to reform the economic system in the Soviet Union and China, and explains why the latter was successful and the former failed. He argues that the basic difference between the former Soviet Union and China is not that reform was gradual in one case and radical in the other case, but rather that the reforms in China were accompanied by maintaining the political repression, whereas it was significantly relaxed in the Soviet Union. At the end of the paragraph Wintrobe analyses three critical problems of the transition process – the control of managers, supply diversion and inflation, and shows that tight political control is necessary to find a solution to all three.

In Chapter 11 Wintrobe models the breakdown of democracy in terms of a failure of democratic competition. He shows that under certain circumstances political party competition ends up in the "inaction zone", a region in which both sides favour doing nothing just to propose an action controversial to the other party in the competition. Wintrobe argues that this is more likely when voters' preferences are relatively polarised and inflexible, and when there is little trust between voters and politicians. This political polarisation tends to exacerbate the incapacity of the political system to solve important problems, and its eventual failure often leads to the breakdown of the democratic system and turning to authoritarianism.

In Chapter 12 Wintrobe goes on to investigate how nationalism arises and why dictators promote it. He develops a model of ethnic group relations and shows why there is always a potential for conflict among ethnic groups, as well as why this conflict is not reduced by market forces. He argues that if political competition is based on conflict or competition among ethnic or racial groups, it is particularly likely to lead to polarisation instead of compromise solutions. Wintrobe introduces the concept of "ethnic capital" and discusses the attractiveness of ethnicity or nationalism as way of reducing transaction costs. In this model ethnicity is modelled as capital good that reduces obstacles to both political and market change among those who have invested into it. Investments in ethnic capital naturally increase the importance of the group relative to the individual, and therefore give rise to a demand for political leadership to manage the capital stock.

Wintrobe argues that this concept of ethnic capital is useful in explaining the economic, political and psychological origins of fascism.

In Chapter 13 Wintrobe proposes a very challenging question: what is the responsibility of bureaucratic functionaries for crimes committed by the regime? Wintrobe argues that the logic that "I acted under the orders, I cannot be held responsible" does not hold, and in most of the cases the bureaucrats were themselves very competitive and entrepreneurial. He discusses the famous example of Eichmann and argues that he was as much guilty in the Nazi crimes as were the Nazi politicians who planned them.

"The Political Economy of Dictatorship" is one of the most challenging books I have read in recent times. It most probably will take a lot of effort for most readers to understand and digest Wintrobe's work, still, if one does that, he or she will be greatly rewarded. What I consider very positive is that Wintrobe adheres to his profession – as an economist – and uses the modelling of economics to describe the behaviour of dictatorship. The assumption that dictatorships have the same traits as people in democratic societies, that is they are rational and self-interested in an economic sense, enables the author to explain many crucial aspects of dictatorship. There are many reflections that I have on Wintrobe's book, but here I would like to focus on two of them. First, I appreciate his views on foreign aid and trade. Indeed, the developed Western democracies should emphasise more the domestic conditions and set constraints on human rights abuses, when going to the trade agreements (or aid) with the less developed dictatorships. This would indeed improve the human freedoms in those countries and would eventually even make democracy possible. The problem is of course how to convince the leaders of those countries to follow that path, as often they oppose any kinds of interventions to their "domestic affairs." Second, I completely agree with Wintrobe that the state incumbents of the terror regimes like Nazi Germany and the Soviet Union should be held responsible for their actions, despite excuses that they were just following orders.

I would like to conclude my summary by recommending the book to anyone who is interested in the interrelations between economics and politics in countries where the form of government is dictatorship. Ultimately, Wintrobe's book has something for everybody – for those who are interested in more theoretical elaboration, for those who are interested in the history of dictatorship, and for those who are interested in the present day dictatorships.

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