

Three Dimensions of Modern Social Governance: Markets, Hierarchies and Kinships

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ABSTRACT

The paper is based on the analysis of economic and social systems in the last 80 years that ended up both in the processes of transition, and globalisation. The paper is theoretic with an illustrative material on new features of social governance, including the comparison of transition economies with advanced EU countries.

Author challenges the dualistic view of social, political and economic governance, where markets and hierarchies (i.e. the state and governments as agents) dominate the theoretical fields. This is also a problem of new frontiers of economics. A classification method for analysing the “fundamental ways” in organising and governing human societies is developed and the authentic building blocks for a three-pronged policy-making are found in the objectives of individuals and their micro-organisations (kinships). The issue is how individuals are included into the macro-systems of markets and hierarchies.

No instruments of socio-political governance can dissociate themselves from the patterns of behaviour where justice, solidarity, altruism, reciprocity, consensus, cohesion, local networks, human capital or ethics play important roles. The demise of communism, the hardships of transition and the differences in the performance of capitalism can be explained by their particular involvement of the third social pillar (the network of human micro-world) into the working of state hierarchies and economic markets.

Paper illustrates the particular developments of real societies by using the historical evidence on growth and institutional developments related to our third pillar of governance (cohesion, social inclusion, culture, redistributive coalitions or rent-seeking). We will concentrate on the countries of Europe and particularly the transition countries. The long-run economic developments depends not so much on the proportion how markets or hierarchies are used in the socio-economic governance (e.g. contrasting the present situation in Denmark with Ireland, or Germany with Sweden; or Estonia with Czechia) but how the individuals are included or excluded from the governance.

There can be observed several principles of a new organisation of social governance, as seen from the analysis of our amalgamated social systems:

- Interaction of markets, hierarchies and institutions of social culture.
- Cohesion of organisations (enterprises, public administration, political parties) and individuals.

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- Bridging the interdependencies between the future (normative visions) and the past (experience).

All these phenomena call for a wider “endogenisation” of theories explaining modern social order, for achieving further integration of social sciences and for a more varied portfolio of choices offered by political parties. The sharply rising weight of globalisation in both the markets and the supra-national hierarchies posits a threat of their dominance over the grass-roots of the society at the level of individuals.

This inclusive character of civil society and democratic checks and balances in the performance of markets (e.g. for securing the equity of opportunities in the entrepreneurship or employment) is at least as important as their role in improving the performance of state hierarchies. This is a crucial challenge that all societies share in common in the globalised world. It is a quest for new frontiers of freedom and coexistence at the levels of kinships (e.g. families), enterprises, states or world communities.

Omne trinum perfectum.

1. Alternative Meanings of the “Third Way”

Coming up with an alternative definition of a “Third Way” in practical politics and real economics, which has appeared and disappeared many times in human history, has always drifted between being an objective phenomenon and a speculation. Cynics may comment that a “third way” is simply a natural strategy of all outsiders in politics who avoid challenging the existing order of power by way of direct confrontation, instead offering an eclectic “third option” that would allow them to step in by side doors. We argue in this paper that this is a confused meaning of the “third way”.

Our first task is to define what we mean by “ways” and how the standard dual interpretation of “ways” can expand into a three-pronged choice of policies. Let us assume that the strategic set of ruling policies (political objectives and its instruments) is labelled as **A** and the opposition to them is labelled as **B**. If **B** is claiming that non-**A** is a better arrangement, then an emerging third party, who wants to win the political race alone, has a logical problem how to define its policies **C**, once the non-**A** is already occupied by a strong player. This problem has two levels of interpretation.

First, we may say that the “third way” to politics is a mere variant of a marketing differentiation technique used on oligopolistic political markets. In this case, it is used for challenging an existing political duopoly, which is most probably well entrenched in their strategy of influencing the median voter. One may judge that if **A** is described by a vector with n policy instruments², then the set of all clear-cut policies (including the non-**A**) can be expanded to a combination of 2^n programs (“ways”). Thus if the set of strategic policies has just one nominal element (for example, a referendum if there should or should not be a monarchy and the power struggle is between royalists and republicans), then no third party is in a position to advance a very original alternative. There must be a second strategic element (for example, a democracy) introduced that would create a niche for a third (and even a fourth) party offering an original programme³.

² *The best reference is the modelling technique of Tinbergen (1952 and 1956), where a “policy” set is characterized by variables describing the present and the past state of exogenous fundamentals, their effects on the economy, policy instruments and a criterion (based on endogenous “target variables”) for assessing policy alternatives.*

³ *These can be mutually exclusive programmes for constitutional monarchy, autocratic monarchy, republican democracy or republican dictatorship. In Germany in 1933 the nationalistic alternative*

Of course, if there are too many policy instruments in the vector of political programmes, the number of niches for party differentiation rises exponentially. However, at the same time, the political appeal of these parties downgrades proportionally. At this level of interpretation, the alternative policy proposals are viewed as a mere different combination (or dosage) of existing standard policies, which are in their substance subjective. They depend too much on the personalities who claim it. The “third ways” and their political credibility as a “new way” dissipate if the devil is merely in the details. The weakness of political programmes aspiring to be an alternative to standard bipartisan power struggle rests in its subjectivism. It is a mere promissory declaration for attracting an attention of the electorate by using a differentiated slogan.

The subjective definition of the “third way” can be contrasted by a definition based on objective criteria. What matters here is the exogenous ontological nature of the third alternative. For example, it can be associated with emerging new **objective processes** changing the present social order and its existing bi-polar constituency of interests. It is not a mere aberration of existing politics. We may call it a political break-through at the level of such fundamentals as the wealth and the power.

This problem has also deep roots in the economic literature and philosophy. Hayek (1973) came up with a supposition that all functioning economic systems must be based on a concept of “order”. He distinguished two sources of order: Cosmos and Taxis. The former is given exogenously (i.e. spontaneously) and is represented, among others, by technologies, factor endowments, free markets, informal rules and behavioural patterns. The latter is created artificially, reflecting the aims (i.e. the vested interests) of certain social groups. Taxis is represented by organizations, their hierarchies and institutions. Hayek claims that it is impossible to introduce a new order by force - just by manipulating Taxis. We can use Hayek’s reasoning and argue that our first interpretation of the “third way” is an attempt to introduce a new political order by merely reorganizing Taxis, while Cosmos was unchanged. Our second interpretation is based on changing politics in response to changes in Cosmos, while the two incumbent opposing political structures did not reflect the change. We think that both interpretations are too superficial to earn a label of innovativeness.

The strength of the third way would be magnified if it came up with a non-orthodox **alternative to existing fundamental policy variables upon which the present institutional superstructure was built**. Such a superstructure would be subject to a typical institutional inertia, even though previous fundamentals have lost the reason for existence. We are entering the ground of historical breaks and their institutional shakeouts. What kind of variables might these be? We are dealing with politics – i.e. with the ways of determining **social governance** related to **hierarchies of social organisation** and their **decision-making**. Politics of break-through is therefore addressing not only certain vested interests but also the basic principles of their functionality.

In the European history the functionality of social governance was long dominated by a duality of hierarchies: that of the Church and that of the Sovereign. Both were associated with the tenure of land. As was best described by A. Smith, D. Ricardo and later by K. Marx, a mighty third power emerged at the end of 18th century: that of capital and markets. The dualism of previous hierarchies became obsolete and was gradually replaced by a single hierarchy of the secular state. As capitalism matured, a new dualism was established: that of markets and private property rights on one hand and that of the state hierarchies and redistributions on the other.

Marx, however, made an unexpected move in an attempt to outwit both Ricardo and the reality by denying the legitimacy of the new political duality. He disclaimed unilaterally the

offered by A. Hitler can be classified as a third way – a non-democratic alternative to the power struggle between traditional democratic right and democratic left.

viability of both markets and states, declaring a very politically attractive third way: that of a final expropriation, common ownership and the nirvana of communism. Taken from the hindsight of the history, the latter was a visionary utopia, which more pragmatic Lenin and Stalin returned later back to a model akin most to the feudal duality by superseding the Church by the Communist Party and the Sovereign by the autocratic state bureaucracy. In parallel, Mussolini and Hitler also pushed social organisation in a similar direction – towards the hierarchies. Throughout 1920-1990 the world became split between two mutually antagonistic “ways” – that of the market and that of the central command. The split was also manifested in the ideology of capitalism and socialism, and backed by opposing military powers. At this moment we are ready to turn our attention to the polemics about the purity of economic fundamentals that created this social split.

The development of capitalist market economies was accompanied by an emergence of theoretical reasoning claiming that the State (or any similar hierarchy) should be nearly completely discarded. The ideology of *laissez-faire* was brought to an astonishing perfection in the models of general competitive equilibrium by Walras, Arrow and Debreu (see Weintraub, 1983). Nevertheless, as a response, the model of perfect markets was soon challenged by models of imperfect competition published in 1933 by Chamberlin and Robinson (see Hart, 1985). At the same time, the reality of Big Crash (1929-1934) and further empirical studies of industrial organisation confirmed that a convergence towards perfect competition was not a natural state of affairs and that oligopolistic markets or market imperfections pervaded. The role of the State was steadily increasing throughout 20th century, as could be measured by the share of taxes or government expenditure on GDP. In the 1980s, in some Scandinavian countries and in all countries of “real socialism”, the tax quota appropriated more than 50% of GDP. The theory of second best was an attempt to reconcile the orthodox neoclassical economics with empirics.

2. The Theory of Second Best and Constrained Optimality of Real Social Systems

According to the theory of second best (Lipsey and Lancaster, 1956), absolutely perfect markets lead to Pareto optimum and assure the unrivalled most efficient usage of resources. In contrast, distortions of the market cause deadweight losses and less efficient outcomes, as is shown by stylized facts in Figure 1. The policies of *laissez faire* should then strive to bring the economy to a state A with zero distortions. But is it ever possible? According to Friedman, 1981, p. 4, there are no pure market economies, even in the anarchist-libertarian ideals. All real economies are actually mixed economies where both elements of markets and command co-exist in various degrees.

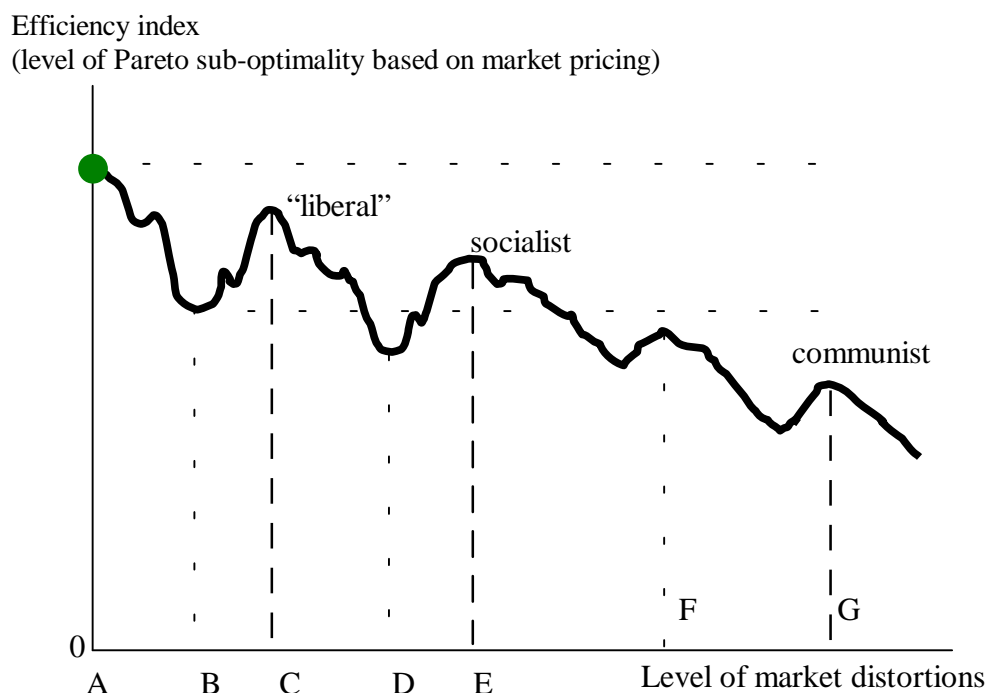


Figure 1: Theory of second best and fluctuating decline of efficiency with increasing market distortions

- There are several problems in comparing alternative states of the markets:
- The intensity of “market distortions” can be defined only by a vector. Therefore the sequencing and ranking of distortions is not unique.
 - The comparison of efficiency on the vertical axis in cases of many non-homogenous products cannot avoid using prices and exchange rates. But these must be based on free trading, otherwise the prices are distorted. Thus closed economies with distorted markets have a tendency of developing a large gap between the GDP per capita based on commercial values and GDP per capita based on subjective estimations of purchasing power parity.
 - A change in distortion is not always linearly and monotonously associated with a change in efficiency. There can be unexpected local maxima and minima. The politics may prefer to guard their local maxima only (see points C, E, F and G).
 - The transaction costs of moving to perfect markets may be so large that moving from point C (“neoliberal” arrangement) or E (socialist arrangement) towards A would be both economically untenable because of the negative slope in segments to the left from local maxima. The policy of social democrats based on market interventions, regulation and public property in E could be therefore vindicated because a transition from E to C may end up in D, which is a worse position than in E or even F.
 - If the economic optimum in A is not a state of self-sustaining natural equilibrium, it must be man-contrived and thus dominated by some hierarchy, what implies transaction costs and distortions. Point A is therefore unattainable in reality.
 - Economic optimum in A must be therefore different from potential social equilibria (e.g. in C or E) and therefore it is dominated by social governance.

The problem with this approach to neoclassical market fundamentalism rests in its tacit assumption that there are only private goods produced and that non-linearities are caused by behavioural irregularities in the process of incremental changes in the level of market distortions. Unfortunately there are various externalities to private activities. Keynes (1936) was among the first

who claimed that free markets could be hit by low expectations and the resources need not be fully employed. State interventions on the side of aggregate demand may be therefore rational. Then Coase (1937) added that even though markets are the most efficient instruments for trading, production requires an organisation inside of firms that is based on hierarchies. Naturally, the growth of firms towards world monopolies crowds out the markets. Already Marx was aware of this phenomenon and it inspired him and his followers that the whole society should be thus organised like a big firm. Finally Schumpeter (1947) proposed a reverted explanation why the rule of the markets is not an exclusive way the politicians should follow. The mere combination of market efficiency and growing scale economies will finally weaken the markets since monopolists, technocrats and bureaucrats will finally dominate the economy, becoming the closest allies to politicians.

Although the definition of point **A** is extremely important as an academic concept, mixing it with reality and real policies is a normative illusion of human engineering. Any interest at bringing the reality to state **A** would require a forceful disruption of the socio-economic order where many alleged “distortions” are its naturally developed parameters *sine qua non*. The transaction costs for eliminating them might be higher than the gains in efficiency. Markets do not have a built-in tendency of converging automatically to a state of perfect competition. In reality, we even observe an opposite natural tendency – towards imperfect markets and visible hands ruling on them. Market distortions are not caused only by regulations of the government – there are also regulations and collusions coming from other sources of power.

Let us now turn our attention at the central command (as the potential alternative to markets), at the controversies between markets and central planning, and at their impacts on a search for the third way. Analogically to Figure 1, we can apply the theory of second best on the pure system of central command. We could argue that, hypothetically, the command system could perform best in a completely collectivised system where subsistence consumption and high investments would lead to the highest growth on a von Neumann optimal path. According to Friedman, 1981, ideally that would be a hierarchy of agents only – the top one being the God. A new serfdom of *nul homme sans seigneur*. There could be two vindications for its existence, both based on a scholastic argument of justice and efficiency. The first one is the necessity of redistribution, promising to bring in the alleged intellectual and financial harmony (de Jouvenel, 1990, p. 23). The other one is the totalitarian belief in social engineering where the visible hand of the elite is more rational than the blind (or amputated) invisible hand (*tatonnement*).

How is it with the reality? Although the idea of central command (planning) could have been an appropriate technologically-dictated organisation of scarce resources during any large-scale war ⁴, an economy at peace had to yield to the pressures from the civil sector, i.e. from the interests of individuals and their need for personal freedom and initiative. That implies negotiating, auctioning, ranking by voting and a resurrection of markets. Therefore markets, along with hierarchies, remain an intrinsic factor in both real systems, even though their combination is not subject to random rules.

For example, the controversies after the War Communism (1918-22) in the Soviet Union (Bukharin and Preobrazhensky, 1969) and their final solution by Stalin re-introducing the central command, assumed that money (as a symbol of markets) as a means of exchange will cease to exist,

⁴ Any universal war, such as the World War II, modifies the objective function of the society – from the recognition of individuals’ freedom or felicity, to a social /national/ survival where the choice of individuals is often debased to zero. The crucial problem here is that markets and hierarchies are different social organisations serving to different objectives. A common mistake is to assume that both purport to the same objective (e.g. to the satisfaction of individuals) and therefore they could be assessed by a unique single criterion.

and production and consumption could be provided “scientifically” from the centre ⁵. The assumption of objectivity in determining the structure of demand was a completely different theoretical principle than was the principle of a subjective theory of value and marginal utility, as explained by market economics. The systems based on planning and on markets differed in one additional aspect: the former was dependent on collectivism and the latter on individualism. Therefore both the objectives and the institutions in both systems must have developed differently.

Stalin was obliged from the start to make a concession by accepting that money should be retained in order to have an anchor of hard budget constraint effective at least in the area of transactions of households. That was a concession accepting the existence of individualism in tastes for consumption and of inequality in the productive performance of individuals. Also the firms were linked to the state budget by money, though used only as accounting units. These “distortions” of the purity of planning command had to be accepted also here on grounds of objective reasons, similarly like it happened with the real market economies, where the state hierarchy was retained.

Guided again by strong academic assumptions, we could redraw Figure 1 also for the pure command system. By combining the graphs of second best for both alternative systems we arrive at the hypothetical relationship between them as is presented in Figure 2.

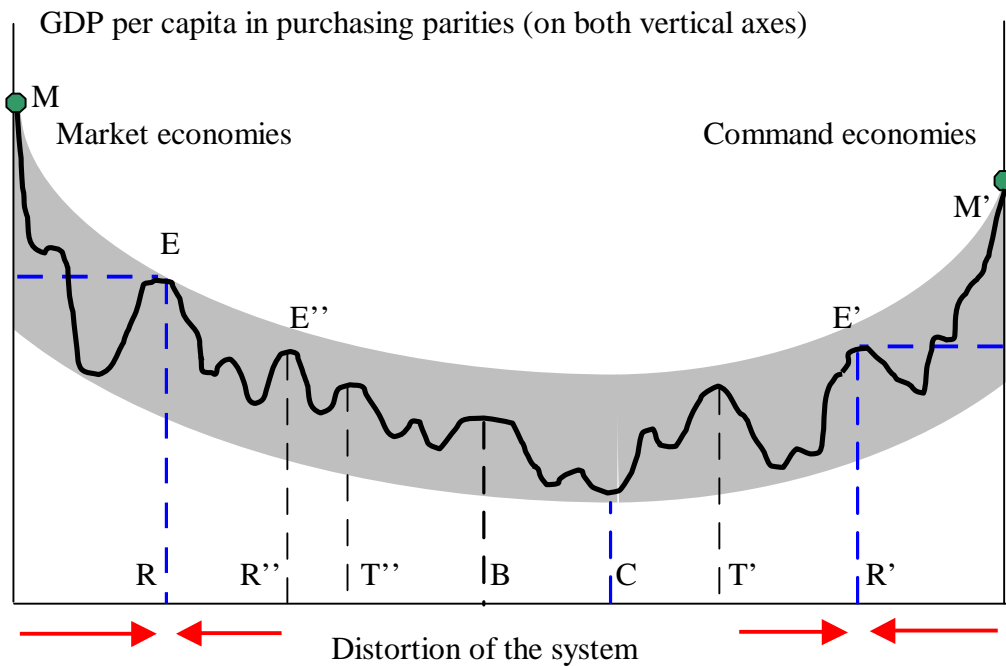


Figure 2: Trade-offs between markets and hierarchies

We interpret the shaded stripe as a smooth quadratic envelope for the fluctuating efficiency indicator. If the search for optimum is constrained by transaction costs, imperfect information and short-run expectations of decision-makers, then rationality becomes bounded and the quest for an optimum is terminated if the solution is “satisficing” (Simon, 1947). For example, although the

⁵ For example, production can be managed by mere optimal technological requirements, as was modelled by the input-output tables and consumption of households can be subject to scientifically prescribed dietary and housing norms. The war economy and the military command supported the sustainability of such arrangements by empirical evidence.

global maxima ⁶ are in M and M', points E and E' may be compatible with local maxima, pointing to arrangements to which the real system might converge and where the eclectic combination of both markets and hierarchies is sustainable. Appeals for returning back to systemic purity in M or M', called for by market or planning fundamentalists, would not be compatible with real politics. For example, a social experiment with abandoning all government regulation and transfers in any contemporary economy would end up in a state of intolerable uncertainty, risks of anarchy and a burden of social costs that would be vetoed by vested interests entrenched in politics. Also a call for an alleged "third way" propagating a heavily mixed economy in B would have little chance for success because such arrangement offers no guarantee for efficiency either.

Figure 2 can be also interpreted as a path for "transition from planning to markets", i.e. from R' to R, which must result in a fall of GDP until the build-up of market institutions is not prevailing over the legacy of direct command. There could be an uncertainty here, too, as the whole process can run out of steam and get stuck in inefficient local maxima T' or T'', a situation illustrated by the cases of Belarus or Czechia in 1996.

A dramatic change occurred in the 1950s when the successful post-war recovery in democratic (market) economies led to the idea of welfare state. The affluence of material things and social peace in the West was a great challenge to planned economies, which were able neither to solve the supply shortage nor bring the quality of products to internationally competitive standards. On the other hand, planned economies could concentrate on some partial targets whose growth impressed many superficial observers. The quantity of steel, cement, electricity, heavy trucks and weapons per capita reached the top of world statistics. Surprisingly, the success was also evident in some more technical branches, like in the cosmic, nuclear and sports programmes.

If we compared the performance of these two basic social systems (as we tried in Figure 2) we might find that the objectives they followed diverged so significantly that a simple comparison would not be impossible. The alleged GDPs per capita (necessarily adjusted to non-market purchasing parities), which served for their comparison, were products emerging from virtually different demands. While the market economies satisfied the subjective demand of individuals, the planned economies satisfied the (subjective) demand of top hierarchies. Granted this inconsistency, both systems could be assumed to be efficient in their functioning *sui generis*. The problem of the latter was that once the hierarchy without Stalin /or Mao/ became less authoritative and the choices of individuals had to be granted certain autonomy, the criteria turned in favour of the market system and the planning system commenced to falter in both its aims and its means.

In the early 1960s Tinbergen (1961), a supporter of indicative planning of the market economies, came with a message that both systems might improve if they borrow the better parts of the alternative system. His idea of "convergence" received a wide support on both sides of the warring camps. Galbraith (1967) proposed to level the unequal distribution of riches through more powerful public domain and he envisaged an end to the perfect market economy due to the rise of a "new industrial state" dominated by hierarchies. The "third ways" proposed in the 1960s looked like a combination of the previous two prevailing systems, but they were based on an analysis of deep changes that the Western societies were undergoing.

Similar attempts of finding a changeover to a third way occurred in the Communist countries. The discussion was initiated by ideas of Lerner (1937) and Lange (1937) about simulations of markets and competition by the planning mechanism itself. The advances in optimisation algorithms of operations research (Dantzig-Wolfe, Kornai-Liptak and many others) and in computer technologies supported such schemes – see Malinvaud and Bacharach (1965) or Koopmans (1993) for an overview.

⁶ One should resign from comparing the utility differential between M and M'. The objective functions of these two incongruous systems are so different (e.g. maximal consumption versus maximal military build-up) that neither the resultant numeraire of the GDP per capita nor the "lists of achievements" offer a sound base for global ranking.

During 1970s and 1980s, there were extensive academic discussions of “optimal planning” by the Soviet followers of L. V. Kantorovich and V. V. Novozhilov, where enterprises were supposed to compete in bidding to fulfil production targets announced by the central authority, not dissimilar to modern public procurement schemes. Thus prices could get an economic meaning, what would allow the minimisation of costs or maximisation of profits to replace the decisions of planning bureaucrats. In 1968 Czechoslovakia and Hungary started implementing a new type of economic reforms, called “third way”, reconciling state ownership with markets and local initiatives. That brought them closer to the already existing Yugoslav model or to the more general model of labour-managed firms (Vanek, 1970), where the collective governance of employed stakeholders (workers or managers) acted independently from investors, be it the State or private investors.

Collective choice dilemmas, lack of accountability for losses, undercapitalization, incentive to wage overshooting and underemployment, problems with ownership transfers and inflexibility in restructuring made firms with closer worker-control still less competitive internationally than firms under the control of private investors (Dow, 2003). The Darwinian selection turned the odds against them in the long-run whenever they were faced by a direct market confrontation with an authentic private sector or even with a centrally-planned economic system. It is clear then that economies with firms under the dominance of labour operate in the field of opaque markets, unstable governance, risk of defaults, and reliance on State interventions. In Figure 2 we should locate them somewhere into the middle of the graph where the economic efficiency is low⁷.

The assumed convergence between the market and the hierarchical systems, as conceived by Tinbergen, did not take place. The swing of the pendulum to neoliberal policies in the 1970s and 1980s had wide repercussions throughout all market economies and the reforms in all European planned economies failed. The wishful thinking in redefining our Figure 2 from convex into concave, where the minimum of the shaded envelope at C would elevate to become a maximum, did not materialize. The search for a sustainable “third road” failed throughout the period 1956-1989. There were no real economic forces that would support a hypothesis that a balanced combination of markets and planning could lead to both stable and efficient systems. This would mean that such a system had a potential for a positive synergy. History has shown that highly amalgamated (mixed) economies in the West were relatively inefficient (e.g. the Swedish model or the “welfare state” model in general). It was even worse with the East European promiscuous social systems based on “market socialism” that complemented inefficiency with instability.

We can formulate the following conclusion: if the dominance of one pillar in a naturally developed social system (marked by local equilibrium) becomes crowded-out by a policy-induced expansion of the second pillar, then its synergy becomes negative and the resultant mixed system becomes unstable until certain critical mass of changes is not able to anchor it in a system dominated by the other pillar. The reason for this is that both the objectives and the means of a “forcefully converging” system are not compatible with the preferences of its society (i.e. the social equilibrium). The society is hurt by mounting internal conflicts, clashes over the economic and social governance, uncertainties with ownership and its productive collective actions become paralysed by rent-seeking strategies.

The idea that a society cannot be built **exclusively** on one-pillar system is crucial for our argument. We will consider its pros and cons in more detail here. Let us formulate a hypothetical conservative manifesto that (under the impressions from falling domino of communist societies) inspired many social observers in the early 1990s: “The episodes of central planning were just a blind alley of the human history. It is the market principle alone, which will remain the unhampered

⁷ *It is not without irony that an attempt at creating an instant capitalism by mass privatisation, for example by vouchers, employee or managerial buy-outs and loans without capital hedging, run into similar problems at a time where the access to an authentic private ownership was just around the corner (Mejstrik et al., 1997).*

pillar underpinning economic development and the structure of politics after the fall of communism". We will have to discuss the issue for transition economies and advanced market economies separately.

3. Untenability of One-Pillar Social Systems: from Command to Market

If we look at the pillar of the government, the Communist countries relied heavily on the centralised hierarchies and the dominance of upper nomenclature (party "apparatchiks") over the members at the executive levels of hierarchy (e.g. over the authentic economic agents in enterprises). At the same time there was an informal network formed at the grassroots that was based on direct interaction that was non-hierarchical. The result was a sort of imperfect social interaction that, by means of compromises, aimed at reaching a sort of a sustainable local optimum where neither the central command alone, nor the quasi-market bargaining over the "plan" could explain the functioning of such systems.

In transition economies the growth of the private sector became the central political issue. Politicians interpreted it as a problem of a speedy privatisation. Thus the majority of these societies became obsessed by mass redistributions of equity shares in state firms (Ellerman, 2001, Benacek, 2001). At the same time it was politically not accepted that the creation of the private property and private entrepreneurship could grow alternatively from the grass roots (Kornai (1989, 2000) and Sato (1995, 2000)). Such alternative would offer lesser space for redistributions of existing capital and windfall rents associated with them.

The majority of early reforms in transition economies were marked by the belief in unfettered markets that would not only lead infallibly to high growth but also that these markets were self-contrived and self-enforcing entities. According to the principles of neoclassical economics embodied in the "Washington Consensus", privatisation of (antiquated and inefficiently allocated) physical assets, liberalisation of trade and prudent macroeconomic policies would lead the transition economies automatically to growth.

The actual developments in transition economies, in direct contrast to that, followed the path of unprecedented economic slump, stagnation and slow growth for many years. Out of nineteen countries undergoing transition in Europe, only three (Poland, Slovenia and perhaps Eastern Germany) were able to recover the output recorded in 1989 after 10 years of changes. We could gather that the build-up of the market environment was much slower than expected because otherwise we could not explain why the gains in efficiency were so small. For example, in Figure 2 we could depict that the actual transitions reached the critical level of depression in C during approximately 2 years after its start in point E'. But it took the most successful transition economies another 7 years to reach the state of high distortions approximately at E'', instead of ending in the ideal arrangement of M or in the more realistic point E, closing thus the end of transition in mere 5 years altogether, as many analysts presumed.

After 1996 the approach to transition, guided by a couple of simple macroeconomic imperatives of the Washington Consensus, was slowly fading away and an approach based on institutional economics (e.g. Stiglitz, 1995, Olson and Kahkonen, 2000) gained grounds. These two moves had far-reaching consequences not only for the policies of transition but also for the re-shaping of modern economics, social governance and the re-invention of public policies. Discarding of the Washington Consensus gave the crawling evolution of new economics a very important impetus because it finally broke the clasp that neoliberal economics had on human development. Actually it allowed the re-shaping of the paradigm of economics and diverted it from the legacy of neo-classical auto-regulation to the fields, which stressed the role of embedded institutions.

Economic transition was originally viewed by many as a final empirical proof that hierarchies, planning and all sorts of "human engineering" were detrimental to economic development. It was assumed that the demise of central planning implied an existential negation of the principles of hierarchy as objective categories relevant for social governance. Then it would

follow that it was only the markets that retained an exclusive right to existence. The series of neoliberal/neo-conservative economic programmes, implemented in many post-communist countries after 1989, did not bring the ideologically anticipated outcomes. Surprisingly at the end, when the Washington Consensus lost ground, it turned out that the contrary was true and that it was some of the institutional anchors of neoclassical economics that failed in underpinning the emerging markets.

The hypothesis that the development of markets was self-enforcing was refuted by factual outcomes when some of the markets in transition economies collapsed. One of the most ostentatious examples was the Czech capital market, which was designed to become a showroom of new emerging neoliberal capitalism. Out of over 1750 equity shares and securities that were traded on Czech capital market after the mass privatisation in 1992-94, less than a dozen could be considered tradable (see Blaha, 1994). The prices of the rest did not contain any objective economic information because traders and speculators were able to influence their value and turn the price losses on outsiders. The value of the assets was not derived from expected productivities but from hidden asset-stripping activities (Ellerman, 2001).

The hypotheses that stock prices are market-clearing, that demand generates supply or that arbitrage can establish just one equilibrium price, did not hold. This was because impediments to competition, information asymmetries, long agency chains and unclear property rights were so widespread that using highly distorted market signals for long-term decision-making was not compatible with an improvement in the reallocation of resources. The financial intermediation through banks and capital markets did not manage to allocate a vast proportion of savings to meaningful investment projects. In some countries 30-40% of bank credits became bad debts because of the moral hazard.

The argument here is not that markets would not be able to generate information for the optimal allocation of resources, but that this process is not guaranteed. Under some circumstances markets become vulnerable and unreliable: their resultant information may be biased, or too costly to get, or the chain of decision-making agencies is too long and thus is unable to act properly. As was pointed out by Olson (2000), many modern markets are not self-enforcing and a large part of production and exchanges cannot be self-protected. It was somehow forgotten that the functioning markets were subject to long-lasting evolution and that markets could not be declared simply by a decree. Even though markets are everywhere, not all market economies are rich. Thriving advanced market economies require socially-contrived markets, production guarded by property rights and certain mechanism of governance. The role of State, governments and other institutions assisting markets in their functioning are crucial guarantees of economic prosperity.

Modern economies also require the availability of public goods, the provision of which by markets alone is either insufficient or none. It depends on some public authorities (e.g. on the government or NGOs) that the supply is provided at a higher level. Some public goods are actually public “bads” (such as pollution, crime or corrupt bureaucrats), which are over-supplied without proper regulation, and the society should shield itself against their destructive impacts. Economic transition has revealed that fields where public goods and externalities require intervention by visible hands of some authorities or by some institutional socially-contrived mechanism are much more numerous than was assumed by relying on experience from functioning liberal market economies. Their “natural” authorities and institutions were suddenly absent.

The lists of problematic fields in transition countries show quite clearly that they all are associated with some **aspect** of public goods present in the following fields: information, environment, pollution, health of the population, medical care, hygiene, education, science, R&D, technical standards and norms, culture, arts, agriculture, forestry, landscape, housing, water resources, security of individuals, national defence, public security, regulation of monopolies, competition among firms, public utilities, energy networks, transport infrastructure, telecommunication, legislation, judiciary, care for children, youth, disabled and elderly, social security, stable currency, job security, property rights enforcement, public administration, public

procurement, bureaucracy, fiscal system and political system. In a wider sense, public goods of paramount importance are the markets and the human values themselves. In the former we can name commodity, factor and political markets, which are just information networks that can be easily distorted by power. In the field of human values there are ethics, justice, charity, benevolence, cognisance of social coexistence and human dignity, social equality, solidarity and tolerance of cultural, racial or religious differences. Their negative form (as public “bads”) is also crucial in shaping the economic co-existence: violence, malevolence, terrorism, etc. Their elimination can be neither left on markets alone.

At this moment we can conclude that the collapse of communist regimes and of their system of social governance based on hierarchies and non-democratic authorities was based primarily on a sudden outburst of public choice. It was because of these countries’ inability to comply with some highly demanded “post-modernist” human values, such as the provision of consumer goods, leisure, innovation, private initiative and democracy. In a search for the common denominator, we may say that it was the systemic inability of the communist system to support individualism as a value, or if reverted, to receive a public approval of an idea that collective subordination to the authorities and posthumous reward are the true reasons for life.

The collapse of communist totalitarian regimes did not mean at all that it implied also a demise of hierarchies as instruments of human organisation and cooperation. Just the opposite: experiments with the dismantling of hierarchies and reliance on the monism of markets revealed the frail nature of markets and their failures, once the required properties of private goods and the relevant institutional support for them were not present.

Having that in mind, one can put forward another crucial question: once the combination of hierarchies and markets (i.e. the mixed economy) are necessary complements, how can we separate from such systems that part of their relationship that is causing rivalry and substitution between them? Here we should return back to the nature of public and private goods and their interpretation under capitalism and communism.

The subordination of the whole economy to a hierarchic command would be objectively legitimate only in a system where:

- all goods are public goods (preferably with absolute externalities);
- the central authority (due to perfect information) is able to rank all alternatives;
- objective functions of individuals are not autonomous (i.e. there is no free individual choice).

That would be a case ideally inverse to the “selfish world” of Adam Smith. In a perfect command economy individuals cannot have any autonomous subjectivity for both making “private” decisions and accumulating private property. Thus the optimal economic ordering in this metaphysical world could be enforced exclusively by Providence as the final authority exogenous to the world of kinships. For a suboptimal, but still uniquely ordered social choice function Providence is replaced by a dictator – exactly how it was proven by Arrow in his “impossibility theorem”. Because there is an objective need for creating an absolute subjective authority in any system of central command, reaching of the point M’, that is the only system’s maximum, is thus a completely subjective declaration. It is just a myth. Since there may be a conflict between the dictator’s optimum and the viability of the society, even the most radical central commanders are again forced to split the economy into a dual system – leaving the allocation of private goods to the competing bidding of simulated markets while the provision of (alleged) public goods would be administered by public governance.

Chinese more recent reform of the market socialism is an advanced liberal form of a dual command system. The amendment of the Constitution in 1999, where the original statement that “private sector is complementary to the public sector” was changed to “... private sector is an important component of the national economy”, was its most logical step. Economic sustainability of the new Chinese non-public sector required privatisation at a much larger scale than just at the level of family businesses, what no other communist system realised before them. The Scandinavian system of a large public sector was a similar move towards a “balanced” dual system,

but coming from the market side. Calling the highly mixed dual systems “a third way” therefore hinges on highly subjective treatment of the borderline between private and public goods and on institutional constraints of levied on the performance of markets. Although such arrangements can be socially (or politically) preferred, the solution of trade-offs between private and public goods is hardly compatible with criteria for Pareto-optimality.

The progress of reforms in the European centrally planned economies was impeded by the hierarchy monopolised by the Communist Party. Its relinquishing would mean an acceptance of parallel centres of power coming from the private sector, what means a creation of an implicit multi-party system, the spillovers of which into the public choices could not be suppressed. Once the “orthodox communists” would lose control over the rise of the new private sector, the transition to an economy dominated by markets and the loss of their political monopoly would be unavoidable.

Nevertheless, the dualisation of the communist economy was slowly progressing since 1953. The network in the pyramid of “formal” commands was ever deeper undermined by “informal” links. While the former were associated with the official structures of enterprises, state institutions and the Party itself, the latter were formed by “stakeholders” that informally “privatised” the decision-making and production. This was a similar problem known for long from dual (mixed) market economies where principals (owners) became dominated by their agents (e.g. managers and bureaucrats). The informal sector of stakeholders in the command system gradually spread like an inverse pyramid parallel to the formal hierarchy (Mlcoch, 1995). Its problem was that it could not rely on undistorted markets, the prices were distorted and the build-up of private ownership was impeded by a rule that personal appropriation of profits was illegal. The resulting schizophrenia and hypocrisy became so intensive that the whole social arrangement earned a nickname of “Absurdistan”. The official hierarchies were so deeply undermined by informal links that in late 1980s the whole European communist empire depended just on the alert of the Soviet Army’s high command.

Except for the link to official hierarchies, the informal society in communist countries had another link – that to enterprises, production and trading. This was the shadow economy that became ubiquitous and whose functioning was based on markets. It was spread from large state enterprises (which were able to convert state commodities to private commodities for corrupting the planners and bribing the employees) down to families, which were engaged in a myriad of barter and domestic production. Except for that, there was present a booming sector of informal networks active in sports, hobbies, travels, culture, science and R&D. This informal sector developed spontaneously and its decentralised autonomy, based on an organisation similar to the internet’s web, made it resistant to the police state. Its weakness was in a lack of leadership and central coordination. It was only in Poland where the informal structures succeeded to form a foothold by establishing Solidarity as their own parallel hierarchy.

4. The Untenability of One-Pillar Social Systems: from Market to Market

Why cannot even countries with an advanced market system adopt it as a single factor dominating politics and social governance? The markets imply a myriad of conflicts among economic agents. Their organised pressure or defence against them implies politics. Big players in this game (corporations, unions, governments, states) mean big politics. But there is a paradox here: the objective reason for an active economic role of the government comes from the existence of public goods and not from the politics as the rent-seeking opportunistic actions of pressure groups.

There are most diverse conjectures about the dividing line between public goods and private goods, where neoliberals and conservatives stand adamant for a minimal definition, while the traditional left wing would preferably include all products among the public goods. Let us start with less controversial items. According to Olson (2000, p. 196), the first preoccupation of any economies is the property rights protection. If a society agrees on directing its preferences on

prosperity as a function of production, investment and trading, then the most important incentive for achieving that rests in protecting private property: “there is no private property without government”. Closely related to that is the protection against predation – be it autocrats, mafia, monopolies, cartels, re-distributional lobbyism, free riders or malevolency, ranging from slanders to terrorism. The government is thus an identity with legislation, judiciary, police and defence – all of which guarantee the minimalist set of public goods, as defined by A. Smith.

All what is above this narrow definition of public goods is controversial, at least in the economic sense. If markets are not perfect, and if private goods are not exclusive objects forming GDP, then markets are sub-optimal. It then follows that alternative institutions, more appropriate to the nature of the problem, should be activated. It is not an accident that economics in the last 40 years have been gradually shifting its attention from technicalities behind the optimal allocation of given private resources to inter-human relationships and their institutions, which may result in economic behaviour full of conflicts, locks-in and disequilibria⁸.

Some of the most important advances in economics in the last 20 years were dealing with transaction costs, externalities, asymmetric information, moral hazard, free riding, rent-seeking, incomplete contracts, adverse selection, signalling, uncertainty, incomplete or missing markets, altruism, oligopolies, re-distributive coalitions, increasing returns to scale, public choice, law, ethics, endogenous growth, environment, inequity and human capital. All these challenge the markets as universal instruments of economic organisation and governance, and call for an additional pillar supporting these changes. The governance over the public goods looks now wider than ever before – becoming the dominant economic problem in modern societies.

In the past the answer was simple: it should be the State represented by the Government (as the top hierarchy) who should become the second pillar (parallel to markets) in such a world. The problem was whether the government should retain the strategic surveillance and indicative coordination over the public goods provision only, or whether it should also become an agent producing these services. Is this dualistic co-existence of private and public sector the final word? We should look again at the history in order to unveil the dynamics of change.

Since the time of physiocrats economics was obsessed by material production – first by agriculture and later by manufacturing, which dominated the economics of production until the end of 1970s. The number of products was small at the beginning and their technologies evolved also from a very narrow base. However, the innovation cycles were accelerating and the product differentiation was increasing exponentially. The number of varieties competing for the consumers was increasing as the trade was becoming more liberalised and globalised (Krugman and Obstfeld, 2003, p. 120-155). According to Engel’s law, the weight of food and material products on GDP was steadily declining. The importance of human activities in services required that the concept of GDP had to be redefined several times since 1950s and more services were allowed to be included. Now in some countries merely 2% of employed workers are enough to provide for self-sufficiency in agriculture and 25% in manufacturing. The remaining more than 70% of employees work in services. Services became objects, which were difficult to deal with in standard economics. The majority of them were “invisible”, like banking, insurance, communications, education, consultancy, health or entertainment. The aspects of non-excludability, parallel consumption, externalities and scale economies were present in too many of them.

⁸ For example, an influential research of Rajan and Zingales, 2003, posited some of the most powerful defense of the free markets ever written. In the best innovative tradition of the University of Chicago, he emphasised the role of institutions and market imperfections in economic development. After the fall of the competition with communism, the corrupt socialism can be superseded by corrupt capitalism. He found the chief culprits in the lobbies of big businesses colluded with government hierarchies. Once they are able to interfere with economic competition, they may thwart local entrepreneurship and prevent capitalism from producing optimal outcomes and high growth rates.

For long, there was a tendency in economics to ignore their existence. Economists were accustomed to treat markets as a pure global entity (e.g. represented by the law of one world price), incorruptible by acts of individuals (as the basic economic agents, in difference to colluded cartels as dominant players) and not fragmented to autonomous localities and differentiated products. If the real markets were found imperfect, than usually only the large firms (industrial corporations, multinationals and their cartels) were blamed. The role of institutions, inter-human linkages, traditions, trust, institutions, ethics and norms were taken as counter-productive “noise” from which the pure general equilibrium models should abstract. In that case the sociologists and politologists, who based their approach on empirics of political economy, were more successful in dealing with this essential phenomena than economists.

The role and problems of small and medium-sized enterprises, which produce more than half of GDP (even in the majority of highly developed countries), and whose role has been increasing with the information technologies, was for long disregarded by the “high” economic theory. Similarly the peculiarities of housing, pensions and leisure – most probably three biggest single attractors of national expenditure – remained at the margin of attention. The performance of contemporary economies depends largely on the organisation of its similar “shadow” segments: on the way how various mixed (impure) public goods are governed in the interplay between markets and social intervention. Modern theories of endogenous growth are a part of that story.

The existence of public goods and the autonomy of politics outside of economics – these are main reasons why the market system could not become a single pillar dominating the social organisation and governance. Similarly, no system of command alone could take over such an exclusive role in modern societies based on performance. However, once we grant the public goods an important place in modern economies we also open the Pandora’s box with its mixed blessings.

The parallel co-existence of markets and hierarchies in capitalism became its permanent systemic feature ever since the feudal system exhausted its potential. Unfortunately, the problem of co-existence is further complicated since it is not just a mere decision about their “optimal mixture” (set, for example, by alternative levels of taxation), what directs the pace of social development. Crucial problems of public good is the problem of allocation of national resources: how to measure the net benefits of public projects or the social costs of government regulations, how to organise the public governance without the risks of moral hazard, and how to avoid crowding-out and waste of resources that are not under the governance of governments.

5. The Structure of Two-Pillar Systems

The structure of two-pillar social systems differs substantially between the command and the market economies because the position of their economic agents is substantially different. It is dependent on the way how the governance elite is recruited, how their objectives are set, which algorithm of the decision-making is used and what policy instruments are selected. At the same time the nature of control mechanism in the dominant pillar spills over into the functioning of the other pillar. The command economies are thus dominated by insider high politics and the crushing spillovers from politics (in form of power interventions) into market-like competing negotiations are then unavoidable.

The spillovers from economic markets of capitalist countries into the hierarchy of the government are most visible in the creation of political markets based on representative democracy. Considered strictly from the point of view of economic markets, the political markets are often highly imperfect – what actually is their strength. In the majority of functioning democracies there is a political market based on a party duopoly with some fringe competitors. The core of such traditional politics was based on the right-wing/left-wing taxation alternatives, implying alternative sizes of the welfare state policies: how generous the pension system should be, what will be the growth rate of subsidies to health-care, education, defence or public administration.

Another problem with representative democracy is that political markets are opened just once in 3-7 years for a couple of weeks around the time of elections. After that there is usually not much space left for challenging the positions gained by means of public surveillance (i.e. by checks and balances). This type of politics lost a great deal of public appeal in the last 30 years and we can speak about the present crisis of representative democracy.⁹

The two-pillar socio-economic systems are therefore bi-polar, as depicted in Figure 3, where there is a tendency to dominance by one of the poles (pillars). The pillars may be represented by “money” and “authority” – as the driving forces in the liberal and the totalitarian models. Each pure model has its specific mechanisms of organisation, governance, objectives and inducement mechanism, enlisted also in the figure. As we explained it above, the pure models cannot exist in reality and there is some degree of complementarity. Therefore we can also speak about a balanced (“Scandinavian”) model where there is a tendency to countervail the power between pillars. Actually it is a balance between the sizes of private and public sectors, and the pillars “specialise” in the control of them.

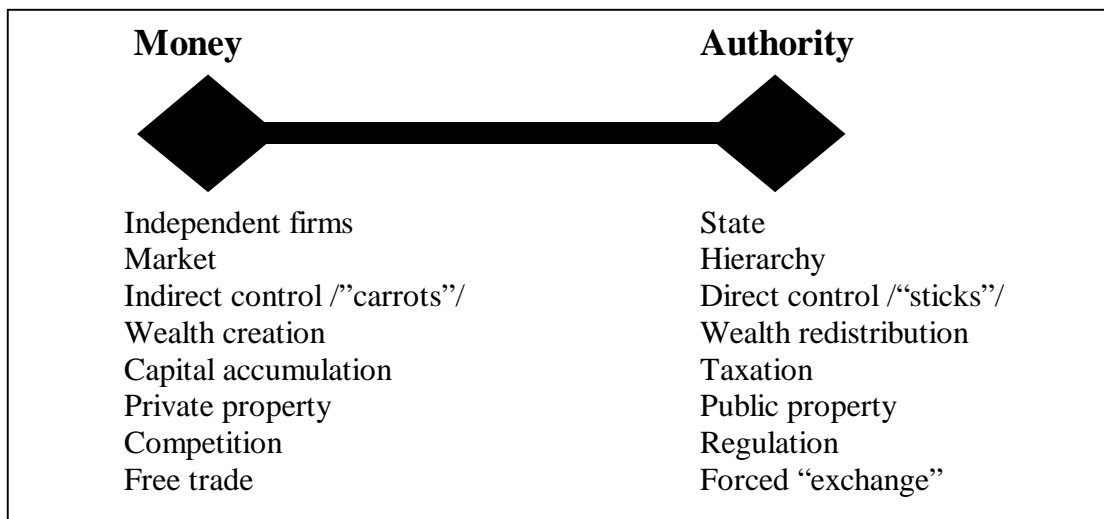


Figure 3: Traditional bi-polar orientation of politics and their instruments of governance

It should be noted that the extreme (Hobbesian) interpretation of these two pillars is by taking them as competing substitutes of a zero-sum game and not complements. Granting more weight to one of them means stripping the other of its influence, as was shown in Figure 2. Actually Figure 2 represents an extreme polarised concept of a two-pillar society where the envelope of performance between two poles is deeply convex and narrow. It could be admitted that such model fitted best the period of emerging industrial capitalism and the militant stages of communist industrialization.

According to the traditional theory of growth, development is a function of capital (the main factor constraint) and the availability of labour and natural resources. Technical change was considered completely exogenous with a status of a constant (the so-called Solow residual). In the

⁹ According to Eurobarometer no. 59, 2003, (see http://europa.eu.int/comm/public_opinion/), only 42% of EU citizens trusts the local parliaments and 37% trusts the national governments. At the same time the national political parties in the EU received a 75% vote of non-confidence, while the confidence was confirmed by merely 16% of respondents. As was observed by Giddens (1998), it was the government hierarchy and its bureaucracy that dominated the governance strategies by building the welfare state, instead of promoting the welfare society.

neoliberal case, the State should protect property rights only by means of police, judiciary or army. For that, the Government could levy some taxes (10-20% of GDP) and thus finance its services of collective agencies. Additional activities of the government are supposed to be counter-productive (Buchanan, 2002). In centrally planned economies, the accumulation of capital was monopolized by the State, as was also the command over the labour force. Thus any involvement of the market in the bureaucratic decision-making was an alien anti-systemic element. The efficiency of the central command eroded quickly when its prolonged war economy had to be transformed into a more civil governance (Kornai, 1980).

The biggest paradox of the developments in the last 15 years was that both traditional pillars of the society were losing its credibility. The central planning lost the last residuals of practical appeal after the collapse of the Soviet empire and the subsequent fundamental transition in China. However, though gradually, also the beliefs in neoliberal market models joined the losing side. There were the following real developments, which became a challenge to the functioning of both the neoliberal and the “mixed” economics:

- a) Expansion of the “weightless” service sector and declining share of material production;
- b) Increasing fuzziness between the “formal” and the “informal” (shadow) economies;
- c) Growing importance of increasing returns to scale and product differentiation;
- d) Cartels and monopolistic competition raising the market transaction costs for the outsiders;
- e) Globalisation of the world economy and the rise of multinational corporations;
- f) Chains of governance in the corporate sector becoming longer, leading up to a separation between ownership and control;
- g) New styles of management required by technological break-through and globalisation;
- h) Dramatic changes in the IT technologies;
- i) Increasing role of human capital as the main constraint of growth and the rise of the knowledge economy;
- j) Weakening of physical capital and natural resources as production factor constraints;
- k) Rising demand for public goods accompanied by sharply rising rates of taxation and bureaucracy;
- l) Environmental pollution, crime and terrorism (as “public bads”), countervailing the gains in material affluence;
- m) Importance of social networks and institutions, reflected in the theory of social capital;
- n) Rising awareness of the importance (and the scarcity) of ethics, trust and consensus in economic interactions;
- o) Market failures accompanied by government failures;
- p) Increasing unemployment, income inequality and social polarisation;
- q) Rise of hierarchies parallel to the national government: bureaucracy, police, army, mafia, business oligarchy, religious or environmental fundamentalism, international organisations);
- r) Individualization of the society;
- s) Declining trust in politics, governments and democracy in capitalist countries since late 1960s.

As a result, the worlds of “money” and “authority” were losing on their polarity, becoming co-integrated more closely. Not only that the intra-enterprise hierarchies grew in their size and influence on decision-making as the globalisation progressed, they became interlocked with the parallel hierarchies of the states. The most striking evidence is provided by the rise of transnational corporations. According to UNCTAD, 2002, p. 14, there are now in the world 65,000 such firms with nearly 1 million subsidiaries that produce 10% of world GDP and 30% of world exports. Their internal mechanism of governance is based on the existence market imperfections, globalised rent-seeking and co-ordination by hierarchical commands (Dunning, 1993). The value added produced by some multinationals (Exxon, GM, Mitsubishi, Volkswagen) is often higher than the GDP of less developed middle-sized countries (Grauwe, Camerman, 2002, p. 6). Thus the systemic disjunction

between markets and governments became smaller and the interdependence between them grew in intensity. The explanatory power of bi-polar graphs, like that one we depicted in Figure 2, has been becoming ever fuzzier to interpret (Marcusen, 1995, Arndt, Kierzkowski, 2001).

In contrast to the big organised players in the economic and social fields, the role of individuals in influencing their own “governance” declined. The obsession with consumerism (i.e. with the one-way flow of external provisions) on one hand, combined with growing uncertainties in employment on the other hand, made the people highly dependent on enterprises and governments. It led to a paradox as if without these two pillars the people (originally conceived as the sovereigns of the capitalist/democratic society) had no reason for existence. **What are the limits of impotence of individuals? Has the authenticity of their unique existence become superseded by the more efficient virtual world of organisations and markets?**

In many aspects the marginalisation of individuals in the modern societies seems very deep. The approach to politics by representative democracy undermined its pro-active orientation that would require visions, prevention of future defaults and offering the people more space for their own initiative. Thus modern representative democracy turned to treating the effects and not the (expanding) causes of social conflicts. The people were turned into objects and were deprived the status of being subjects of policies. Thus the people in the traditional model of politics are subject to subordination from three domains: they “belong” to the hierarchy of some firm (as employees commanded by entrepreneurs), to the hierarchy of some State (as citizens commanded by authorities) and also to the motivation system of the markets. In accordance to such logic, it seems as if the development of the world depended just on the collusion between the commanders of (big) enterprises and the top officials of the State. Our argument is that the rule of “money” and the institutionalised power of “authority” are far from being closed.

6. The Missing Third Pillar for Stability

The result of our search is that a prolonged existence of theoretical systems based purely on markets or on hierarchies is refuted by reality. No such pure systems have ever existed in history. Money and authority do not control all human creativity. Attempts for their artificial introduction by “human engineering” were stricken by inefficiency and non-viability by natural selection. They are unable to address the real social demands at the grass-roots level. Their concepts are thus limited either to a mere ideological manipulation or to pure model thinking aimed at some abstract descriptive benchmarking. Thus the labels of “market economies” or “planned economies” implied neither that the real systems are based on a mono-pillar system of governance nor that they naturally converge to either of them.

The conclusion of Figure 2 was that the pillars of markets and hierarchies must act in parallel in order to explain the functioning of real economies. It was also stressed that the structure of markets and hierarchies in societies are not able to determine the level of GDP by means of a deterministic function. We had to use the concept of an envelope in order to extract the general features, what also revealed the degree of indeterminacy and the spread of efficiency outcomes. The use of a random term (in order to describe the extent of indeterminacy of the function) is only a spurious approximation. The correct approach is by adding a third pillar representing additional factors that actually act behind the seeming variations and “uncertainty”.

This problem has certain parallel in economic literature. For example, in the traditional growth theory the GDP growth is explained by production function of capital and labour where the state of markets and hierarchies is assumed fixed and the technical change is fully exogenous. As a first empirical warning, the direct estimation of production functions from time series of factors is often plagued by autocorrelation of residuals and the coefficient of determination is low. That indicates that the model may not have been properly specified and some important factors have been omitted. But the problem remains even if we disregard the problems with random terms. The interpretation of such production functions depends on a constant that is called “total factor

productivity” (or Solow residual). It includes all non-random processes that cannot be explained by specified input factors. This presumed constant explains 50-90% of all growth in modern economies. The “autonomous” growth need not be explained by a mere technical change in organization or R&D alone. It may be as much the role of morals or informal inter-human cooperation. The theory of endogenous growth (Aghion, Howitt, 1998)) offers a large list of additional factors that point to tacitly excluded list of relevant variables.

In Figure 2 the reality depicted by black line MM’ is a very complicated relationship between economic performance and organization, full of reversals in slopes and discontinuities. Its explanatory power had to be wrapped into a shaded envelope in order to explain the smoothed-out trends. The width of the envelope thus suggests how important the third factor could be, not included in the original two-pillar world. In highly stabilized conservative societies it may be very thin, but in societies subjected to shocks of social reversals it may become the decisive explanatory factor for a suddenly improved or collapsed performance. The study of post-communist transition economies is a prime object of such studies.

The logical outcome in a quest for our missing third pillar of social governance is to concentrate on individuals as autonomous economic and social agents. It can be represented by citizens organized in families, households, clubs and other types of micro-communities, looking at the world from their down-to-earth position. Actually this is the archetype of any human interaction and its objective function is of paramount importance: the human survival as both a biological and a social entity.

It commences with the Darwinian aim for survival of the fittest and extends to the aim of the preservation of species. The social outcome of it is a co-operative behaviour at the grassroots of social organization based on the principles of trust, morals, solidarity, altruism, long-run individual stability, consensus building, satiscing barter and “reasonable” reciprocity. This system of exchanges and cooperation is based neither on the principles of money nor on the principles of authoritative hierarchies, although its interaction with both is evident. Economic literature that points to that interface can be found in Simon (1947), Sen (1987), Meade (1989), Buchanan (1994) and Rowls (2001), among many others. According to them, the nature of modern economics downgraded when its link to individuals was limited just to an abstract *homo economicus*. Also, the growing distance between the world of colluded markets and hierarchies on one hand and the solitary individuals on the other hand, resulted in further crowding-out of people from their role sovereign economic decision-making agents. The role of individuals in such economic systems degrades once their “usefulness” is defined only in their (usually subordinate) relationship to capital or to hierarchies of power. The integrity of such systems becomes distorted. For example, the development is limited to GDP growth and the value of individuals is measured by their disposable income only. The remaining human activities are not interpreted as a wealth creation.

Once the number of social pillars is extended to three, so that markets and hierarchies are complemented with the civil sector as the third pillar, we arrive at a concept that is more compatible with reality. The third pillar represents individuals, their authentic relationships (“kinships”) and exchanges. Actually this brings economics as a science closer to its Greek original concept conceived as “*oikos nemein*” – i.e. teaching about household management.

Such three-pronged systems cover all three levels of organization and exchanges: micro (at the grassroots of families or citizens), mezzo (at enterprises) and macro (at the national level). It is also evident that the interests at these three levels can be disjunctive and autonomous, even though in principle it was individuals who agreed to have both markets and governments as their instruments caring for their well-being. Another parallel can be raised with the democratic ideals of

French revolution: *liberté - égalité – fraternité*, which can be interpreted to involve liberal markets, equality of people in hierarchies and brotherhood of individuals.¹⁰

The crucial question in the three-pillar system is how the authentic interests of individuals are revealed through markets or through the representative democracy. As to the latter, it was revealed by the public choice theory and by the practice of communist “democracy” that this transmission may fail and a bureaucratic or an autocratic degeneration of such systems is a real threat. The situation is also complicated with the pure market “voting” and the equilibrium of individuals. Competitive market equilibrium solution is definitely the most efficient one, as far as the given endowment of labour input factors is concerned. Unfortunately the maximization of GDP (and with this the maximization of individual incomes) as an objective function may be in conflict with our third pillar. For example, in the pure private goods world this would lead to an acceptance of the Darwinian (or Malthusian) selection and the reconciliation with one’s own extinction, once the market criteria assign the labour too low marginal product.

It also implies resigning to the existential threat coming from the widening inequality, for example, when 0.1% of inhabitants receive 11.6% of all income, as Atkinson (2002) estimated for Britain in 1913 (while for 1974 it decreased to 1.45%). Another market threat to individuals comes from the condition of daily adjustments of labour and capital allocation to factor yields. That implies high uncertainty in employment and a need for migrating. If we extend the theory of pure markets to the existence of public goods and externalities then failing markets can become an existential threat through the emergence of environmental damage, kleptocracy and general crime.

Even though both the State and the Market can be extremely useful servants, they are seldom accepted as universal masters if the revealed interests of individuals are considered. Although the feedback loop from individuals to markets and governments is crucial for the functioning of markets and governments, the society cannot end up with only that. Individuals have their autonomous economic objectives that cannot be measured by GDP. They are called “human development” (Ranis et al., 2000). They relate to attainments in freedom, health, education, security, equality and creativity. In addition, a large part (if not directly a dominant part) of individual utilities and “disutilities” is realised from sharing and exchanges inside of families, partnerships and localities that are neither mediated via public markets nor provided by governments. Nevertheless, their efficiency is largely influenced by the social set-up, public policies and markets.

The three-pillar socio-economic system based on markets, hierarchies and kinships allows altogether eight (2^3) vectors of fundamental alternative policy strategies, of which four are involved in the support of the individual/civil society (see Table 1). Remaining four political strategies take the existence of autonomous interests of individuals for irrelevant. The “old third way” then gets on an equal footing with the policies addressing markets or governments. We will call it a **three-pronged principle of social governance**. Now we arrived at a nominal criterion for testing whether some declared policies can be labelled as politics based on three pillars. For example, we can test a list of features designed for British Labour Party, as proposed by Giddens (1998) and compare it with politics of “old social democracy”, as is indicated in Table 2.

Table 1: Classification of political systems based on three pillars

¹⁰ *As a speculative exercise in the philosophy of religion, let us mention the following interpretation of the Christian Trinity. With the help of some tolerant imagination Father, Son and Saint Ghost can be associated with the principles of hierarchy, brotherhood and market rational autonomy.*

Markets	Hierarchies	Kinships	Characteristics of the political system
1	0	1	Liberal
0	1	1	Syndicalist
0	0	1	Trotskyist /anarchistic/
1	1	1	Balanced /renaissance/
1	0	0	Business fundamentalism
0	1	0	Etatist /communist/
0	0	0	Nihilistic
1	1	0	Elitist /oligarchic/

Table 2: Classification of the “Old” and the “New” politics ¹¹
(according to Giddens, 1998)

Old politics	New politics
Welfare state	Welfare society
Collectivism	Individualism
“Objectivist” consumption pattern	Personal choice
Critique of capitalism and markets	Synergy with capitalism and markets
Dominance of the State	Dominance of the Civil society
Keynesian support of aggregate demand	Support of the supply side
Distrust to markets	Markets matter
Bi-polarisation of the world	Bi-polarisation is less important
Low awareness of the environment	Environment matters
Fetish of forced income equality	Equality of chances and indiv. performance
Mass material production	Employment in services
Big business are crucial	Small and medium-sized businesses matter
Elitist state and public administration	Transparent state and public administration
NGOs as partisan interventions	NGOs are crucial for democracy
National economies	Cosmopolitan economy
Physical capital as the main factor	Human capital as the main factor
Material consumption	Quality of life and human development
Gvt. protection and discretionary intervention	Discipline and encouragement by incentives
Authority, traditionalism	Democracy, libertarianism
Traditional family	Female emancipation
“High” politics	Politics for life
Exclusion by formal hierarchies	Inclusion outside of hierarchies
Science and technology elitism	Science and technology openness to public
A-priority rights of State for re-distribution	No rights without duties (responsibilities)
Rising taxes and public administration	Reform of the state and public administration
Negative public social services	Positive public social services
Centralisation	Decentralisation, devolution, subsidiarity
Bureaucracy and corruption	Efficient service to the public
One-time big elections	Permanent direct democracy
Provision of public goods by the State	Mediated public procurement tenders
Closed national state	Cosmopolitan state and nation
Economics of selfish interests	Economics of communitarian coexistence
Formal business entrepreneurship	Informal social entrepreneurship
Traditional hierarchical family	Flexible family ties based on equality
Economic certainties and re-distribution	Promotion of wealth creation
Physical asset investment	Social asset investment
Business ethics are secondary	Business ethics are primary
Formal (positive) law and regulation	Natural law guided by moral norms
Class society	Development of the middle class
Exogenously given inequality	Justice and equality are endogenous
Dependence on external provisions	Self-support, grass-root initiative, soc. capital
Sharing of means via the State	Sharing and prevention of risks via the State
Inflexible and generous pension fund	Flexible, parametric pension funds

¹¹ Giddens is rather confusing by identifying the old and the new politics with social democracy. We think that this is a more general problem that was most visibly recognised by British Labour Party, although the politics of T. Blair goes across the left-wing – right wing orientation.

The “old politics” of industrial capitalism (both conservative and socialist) that developed in the late 19th century were based on an explicit acceptance of a two-pillar system of social organization, which was dominated by the co-existence of markets and hierarchies¹². The role of an individual dissociated from the command of markets or hierarchies was passive. Features that were not a direct functional part of these two pure systems (e.g. morals, solidarity, informal relationships or individual sovereignty) were taken as **exogenous residuals** that were considered constant in time and consensually recognized. As capitalism approached the limits of the welfare state, there was a gradual tendency to transfer these “exogenous residuals” into policy variables. This is clearly visible by comparing column 2 in Table 2 with column 1. The role of an individual was changing from passive “what am I obliged to do?” to more active “what can I do?”

At this moment we can raise again the most basic question of human motivation: “what are the drivers of human behaviour”. As the satisfaction of human needs kept diverging with the maturity of capitalism from markets towards the State provisions¹³, the role of individual activism (responsibility and freedom) was declining. According to the classifications of Maslow (1971) and Aldorfer (1972), the satisfaction of physiobiological needs (intake of energy, water and oxygen; procreation), relatedness (security, affiliation, recognition by others, cooperation and exchange) and competences of self-actualisation (abstract problem-solving, emotional capacities and working skills) got constrained by the traps of bureaucracy. The two channels of provisions (oligopolistic markets and paternalistic State) became too dissociated from the free will of more-and-more individuals. The paramount human need of self-fulfillment has been calling more urgently for a new corrective channel. Such channel can be found in re-installing the individual as a direct and active agent of decision-making and public governance.

We can therefore extend the philosophy of Figure 3 by adding a third fundamental pillar. Table 3 provides a review of principles that characterise the differences in functioning of our three pillars of social governance. We can see that each of the pillars is based on a set of specific principles (objectives and instruments), which allow them to perform specific tasks that an alternative pillar does not cover at all or it is covered only partially. The “logics” or the form of rationalisation of individual pillars are sufficiently different for granting them status of existential autonomy. Therefore the question of substitution, complementarity, specialisation and exclusivity in the functioning of pillars is a crucial problem challenging all alternative structural compositions of social governance.

Since the ways how the society may influence the governance of pillars are rather limited and subject to institutional inertia of embeddedness, the evolution of social systems is not only slow but also highly autocorrelated (embedded). Features of path dependency and embeddedness may therefore interfere with attempts of applying rationality to such designs of human engineering. Politics is a common field for the social governance of pillars. Table 3 shows how complicated its objectives are and how many vested interests act against finding a social consensus.

¹² We will leave it on the judgement of readers to see whether the proposed “new” politics correlates with the principles of our third pillar more than how the “old” politics does. Similarly the readers can judge the validity of our another hypothesis that new politics depart from the dominant reliance on state bureaucracy by replacing it partially by management based on markets.

¹³ This drift can be observed by rising share of the State budget on the GDP in advanced countries – from less than 10% in 19th century to over 50% in 1980s.

Table 3: Characteristics of social governance in post-industrial societies

	Pillar I.	Pillar II.	Pillar III.
Agents:	Firms, businesses	State, government	Individuals, citizens
Channels of interaction:	Markets	Hierarchies	Informal kinships
Origin of gains (social objectives):	Wealth creation, profits	Wealth redistribution, rents	Externalities of justice, equity, solidarity; altruism
Objective of agents:	Profits, money, wealth	Power rents of discretion	Felicity – secure, pleasant and enduring life
Instruments of power:	Money, capital, contracts	Coercive administrative institutions	Human and social capital, civil society network
Media inducing social adjustment :	Prices of goods and factors	Regulation, decrees, legal code	Culture, moral code, natural law, social cohesion
Media of governance (of the pillar):	Competition, economic policy	Political democracy, constitution	Consensus, ethics, meta-culture
Sources of growth:	Capital accumulation	Taxation capture	Education, social wisdom, cooperation, loyalty, trust
Relationship to property:	Private property	Public property	Property sharing, voluntary inter-dependence
Nature of exchanges:	Free trade	Non-equivalent, (enforced) transfers	Satisficing barter, (“reasonable” reciprocity)

Capitalism of free markets was based on an institutional and ideological support of pillar I, while communist “real socialism” did the same with pillar II. Traditional social democracy relied on the combination of both. That is the old origin of the “third way”, going back to 1880, which we think is confusing and incorrect. The key players in traditional political games in industrially advanced countries during 19th and 20th centuries were organised in businesses and in governments. Their real power came from the wealth creation and taxation. The bureaucratic hierarchy of the State is represented at its summit by the Government that exercises its monopoly of coercive power down to businesses and individuals by means of police, army, legislation and judiciary.

In the ideal case, industrial capitalism could have existed nearly exclusively on the principles of the market alone. However, some exceptions were required since predation was (is and will be) a human feature as natural as production. Markets cannot function without enforcement of property rights and a defence against external invasion. That would require the existence of the Minimal State – thus the introduction of a parallel second pillar to our table was inevitable. So we can see that the State is defined as an unavoidable complement and not as a competing substitute to markets even in the archetype of the neoliberal capitalist system based on free trade.

During early stages of capitalism capital was the politically dominant factor because of its scarcity and its high potential mobility among industries and countries. Its positive marginal yield regulated by competition was the dominant source to GDP growth and wealth. Any taxation above the requirements of minimal state was causing deadweight losses. Therefore it was the capital that dominated political collusions. Also the complementary human capital and social capital were under its natural control. Markets are natural computational entities of an unparalleled power, able to coordinate extremely complicated simultaneous decision-making problems of billions of agents and to calculate dynamic equilibria for millions of (“commodity”) allocations (Hayek, 1944, Mirowski, 2002), provided the markets are free and the commodities are private goods.

According to Adam Smith, 1776, the invisible hands of markets could also function as substitutes for morality, social norms and the intrusion of autocrats. Thus, from an economic point of view, the political role of our third pillar in an industrial stage of social development could be reduced to minimum. The paradox of neoliberal economics is that even though its philosophy is

based on individuals (both as consumers and as producers) defined as the only sovereign agents in its game of *homo economicus*, in reality the power of the capital over-ruled the autonomy of consumers or workers as decisive agents. The authentic role of individuals, morals and justice has again to be re-discovered in the post-industrial world.

The importance of markets in shaping social governance was on a steady decline since the World War I, offering more power to be taken by the State. This process is best represented by the growing share of public spending and taxation on GDP – the so called “state capture”. Unfortunately, as it was evident at least since 1970s, the visible hand of the State had also its constraints to becoming a satisfactory agent for replacing the markets. Government failures became even more omnipresent and dangerous than market failures. The most tragic situation occurred in the centrally planned economies. Nevertheless, the legacy of the past 20th century is such that the growth of economies is dominated by big businesses (acting under imperfect and failing markets), while the global social environment is dominated by all-embracing interventions of governments and their bureaucracy. What is even most difficult to change is that individuals accepted this “exogenous” culture by voluntarily waiving their personal responsibilities and delegating the decision-making to hierarchies and businesses.

The political power associated with the third pillar (described in the fourth column of Table 3) has been on a gradual rise in recent 50 years, as the post-industrial economic development was gaining ground and civil society strengthened. Nevertheless, it should be said that it is still not dominant at the present state of economic development. The dominant playground of “people” in modern post-industrial societies remains in their role as input factors (i.e. as labour challenged by unemployment) and consumers of both the private goods and the public goods (i.e. the recipients of public transfers). But if the value of human and social capital of “labour” is growing (as is growing their marginal productivity), so is rising their political role in the economic sector. Its increasing role in the government sector is also recognized.

The weakness of individuals is that they are atomised and their defence against businesses or governments is generally by passive resistance. A clash between an individual and a big business or an office of the government is asymmetric. The fiction literature of such authors like Kafka, Hasek, Huxley or Orwell illustrates it quite persuasively. However, the evolving paradigm of post-industrial capitalist society raised the social value of individuals as much as never before in the history. As is argued by Thurow (1999), the wealth in the past was associated with the ownership of land, natural resources, plants and equipment. The new trends in creating wealth are associated ever more clearly with the control of knowledge, and with the social organisation and education that encourage creativity and curiosity. At the same time the process of acquiring knowledge in the free open world is ever more biased to personal initiative than to the activities of governments or businesses.

The role of the third pillar in politics was coming to prominence as the nature of industrial capitalism was gradually changing with the rise of service industries, economies to scale, product differentiation and imperfect markets. The demand for the provision of public goods, or for commodities having some aspect of public goods, grew much faster than the demand for private goods. At the same time there were growing supplies of products with negative externalities, like pollution, congestion or crime. On one hand, the markets were crowded out by the interventions of the State. But on the other hand, there rose a tendency to involve civil society more intensively in the social decision-making. That was also instrumental in building the theory of public choice, as an application of economics to the analysis of “non-market” decision-making. Actually the new ideas are to introduce markets, competition and/or auctioning mechanisms to fields dominated by hierarchies, traditions and morals. Thus the decisions in big corporations, governments, bureaucracies and NGOs are supposed to be more exposed to transparency and market-like procedures. The seminal contributions by such economists like Buchanan, Olson and Stiglitz opened with such arguments a new avenue in economic thought on development and economic organization, what was also reflected by new approaches to politics.

The preferences for former market and etatist fundamentalism changed slowly in favour of the present "European approach" ¹⁴ to politics, economic policies and social organization. That system is marked by the idea of "partnership economy" based on social contracts (Meade, 1989), regulation of factor and some commodity markets, heavy public spending and the stress on solidarity and justice (Rowls, 2001). The most idiosyncratic European policies are the policies of cohesion and the Lisbon agenda (Murray, 2004). They are both extending the traditional fiscal macroeconomics into their involvement with enterprise co-financing and the inclusion of civic sector into socio-economic development.

Although the parties, which gained most from applying the principles described in this chapter to their policies were the "new" Social Democrats (Giddens, 1998) or the Greens, the three-dimensional approach to politics, where the dialogue between Market, State and Citizens is balanced, will doubtless influence also the policies on the liberal side.

7. The Integration of Citizens and Civil Society into the Socio-political System

By placing individuals on the same footing with amalgamated social players, such as enterprises and the state, we can re-design the tripod foundations of any industrial societies as it is shown in Figure 4 (modified scheme of Pestoff, 1992, and Abrahamson, 1995).

¹⁴ Taken from this point of view, Europe is a leader in many aspects of the democratic social integration, non-market public choice and policies of human equality, while United States are still standing by the traditional power politics backed by markets. The divide between them became revealed with politics of G. W. Bush and the additional spur it received from 11th September 2001. See Kagan (2002) for the explanation of the policy split.

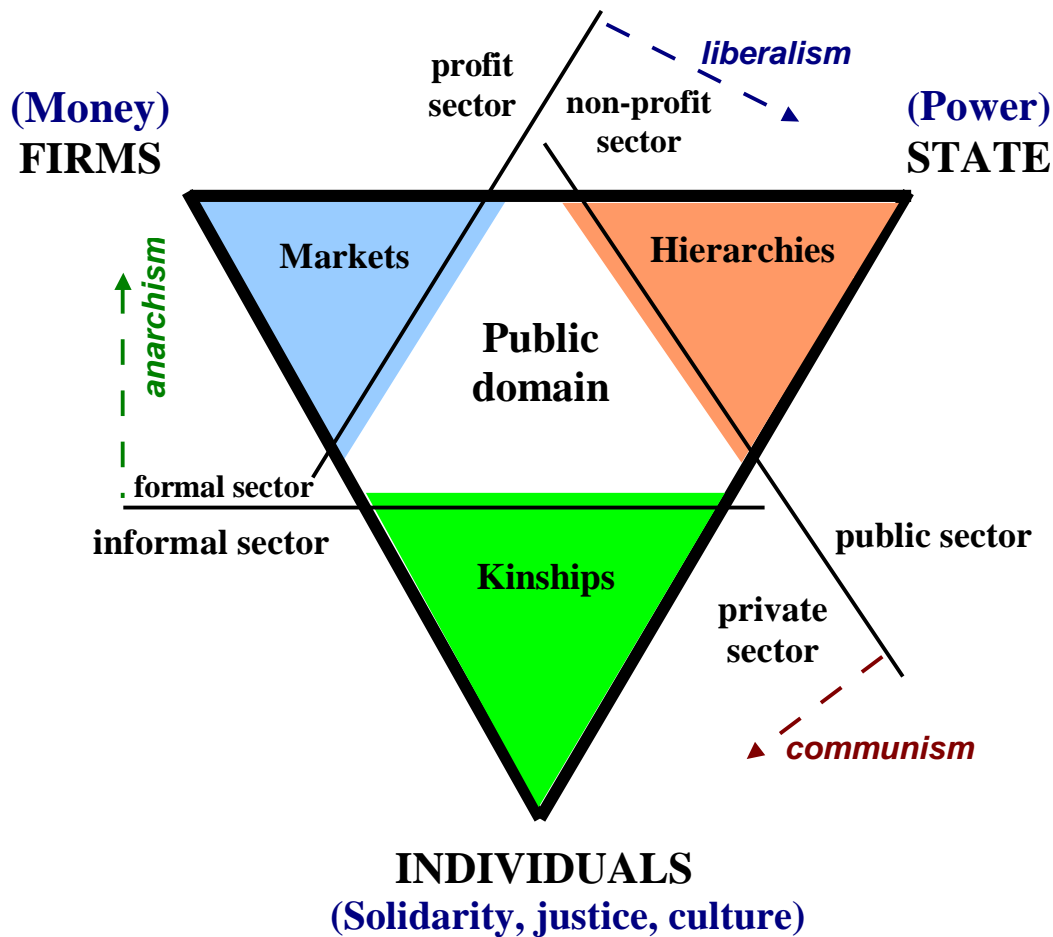


Figure 4: The triangle of socio-political pillars and the forces changing the scope of their dominance

In this figure we see how the three exclusive sources of social organisation, governance and wealth divide among themselves the arena of human consensus, politics and policies. The division of fields is delineated by institutions, the most apparent of which are formal, i.e. legally enforced rules and classifications, like those ones distinguishing between profit versus non-profit organisations, between public versus private sectors and between formal and informal rules of acting. However, the criteria given by formal institutions should be double-checked for its consistency by informal institutions because they need not overlap¹⁵. It is actually the real behaviour and not the official label that matters.

In the middle of the social organisation there is left a large niche for the "public domain" as the cross-boundary for social interaction, which is subject to **formal rules**. Some authors call it the "**civic sector**" (Abrahamson, 1995) because its agents are organised individuals (often forming civic legal bodies) bargaining about objectives (i.e. their inner revealed preferences) that need a support of other social agents (i.e. other individuals, governments or enterprises). Here we touch the

¹⁵ For example, an organisation of the black economy may behave informally as a perfect enterprise, even though officially it does not exist. Similarly, a strong power group (e.g. the communist party in the USSR or Al-Kaida in Afganistan) may have lacked an official entitlement to represent the State but informally they acted so. Building of parallel hierarchies, or the "state in state", is a traditional concept of governance since the first state was established.

central idea of this paper – the hypothesis that the area of “public domain” is the *nervus rerum* (engine) of social governance.

It would be incorrect to infer that the public domain /civic sector/ should be an extended platform of individuals using formal civil initiatives for following their objectives pertaining exclusively to the field of kinships. Our inner niche is the platform for enforcement of interests coming from any of the three pillars. These can be non-profit and non-state civil organisations, churches, trade unions, professional chambers, but most manifestedly political parties and media.

The crucial point here is that the instruments with which the three groups of social players coordinate their activities (i.e. markets, hierarchies and kinships) are omnipresent in the whole social system. Although they have its specific home domain, where their functional principles originate (as depicted by a corner) and where their influence is most visible, their functional principle is universal and can be used in other domains. For example, markets can be used in allocating resources for enterprises, but also in competitions for tasks of public administration, political party competitions, guiding NGO decisions, allocating leisure or finding a partner. Hierarchies are used in most varied fields of public administration, but also in running enterprises and families¹⁶. Social cohesion, culture and its standards are important not only in maintaining individual social contacts, but also in running businesses and hierarchies (trust, loyalty, justice, etc.).

The imposition of new roles to civic sector, together with assigning more substantial role to its exchanges with the “informal community” of individuals, are the special objects of interest of our description of new features in the political economy of social governance. While we can agree with Habermas (1987) that the “system world” of money and bureaucracies in the industrial societies has colonised not only the public domain but also the life of individuals, we can also witness how the cause of individuals, families and voluntary organisations of collective (shared) interest backfires. For this we must rely on the role of culture (including ethics) in the functioning of societies. In its anthropological sense, culture is conceived as the reflection (abstraction) of all capabilities and habits acquired by man as a member of society. In its function it is assigned intrinsically and exclusively to individuals. It is actually a definition of *homo sapiens* as a social and not only a biological entity. The culture assigns man two paramount social properties:

- a) The maxim about the right of an individual to be the own master of his/her creative entity, without being responsible to any higher power. This is the crucial principle of liberal approaches to society (Williams, 1996).
- b) The objective that by developing culture the life will become more secure, rich and enduring.

Both properties thus can serve as criteria for human social activities, their structures of institutions (such as ethics or laws) and the choice among alternatives of interaction. They also serve to distinguish between authentic human activities and the loss of sovereignty due to external manipulation or domination. In that sense, **the objective function of individuals is superior to the objective functions of enterprises or hierarchies.**

Dividing lines between sectors in the triangle of Figure 3 represent the domains of institutional arrangements particular to given society. In the terminology of Hayek (1973) they reflect the status of *taxis*. The dividing lines can be shifted in response to how much the society is willing to accept the ideas of liberal economies, totalitarian organisation or anarchism. Also the division between sectors should not be treated in a strict discrete (binary 0 or 1) logic. Depending

¹⁶ *The penetration of hierarchies into markets was best explained by Coase (1937), as the transaction costs constrain the efficiency of markets. The problem of over-sized firms, their rising bureaucracy and the failures of corporate governance are well-known issues that attack the fundamentals of capitalism (Schumpeter (1947), Boston Consulting Group (2003) or Rajan (2002)). The role of hierarchies and markets in families is discussed in Horwitz (2002).*

on the state of social formal versus informal organisations, the borders should be treated like a shadow (fuzzy) interface, not defined by a legal status but by the actual behaviour.

The area of the social triangle allows us to depict different locations of economic agents in our sectors. For example, a large private enterprise A (production of car components) is dependent in its performance nearly exclusively on markets, both for products, capital and labour, meanwhile another large private firm B (provision of energy) is highly dependent on public regulation and/or public contracts. In contrast, public enterprise C (theatre) competes for both private contracts and for public competitive tenders under regulated prices.

On the other hand, small business D (gallery and art shop) is highly dependent on the loyalty of local community, being on the margin between profit and non-profit (family employment) sector. Activity E is a self-provided repair of one's own house, which cannot disregard some market signals. Activity F is the care of a family for an emotional maturity of their children, while in activity G the family corrects the educational failures of the public primary school J and in activity H a similar attempt is done by the scout organisation.

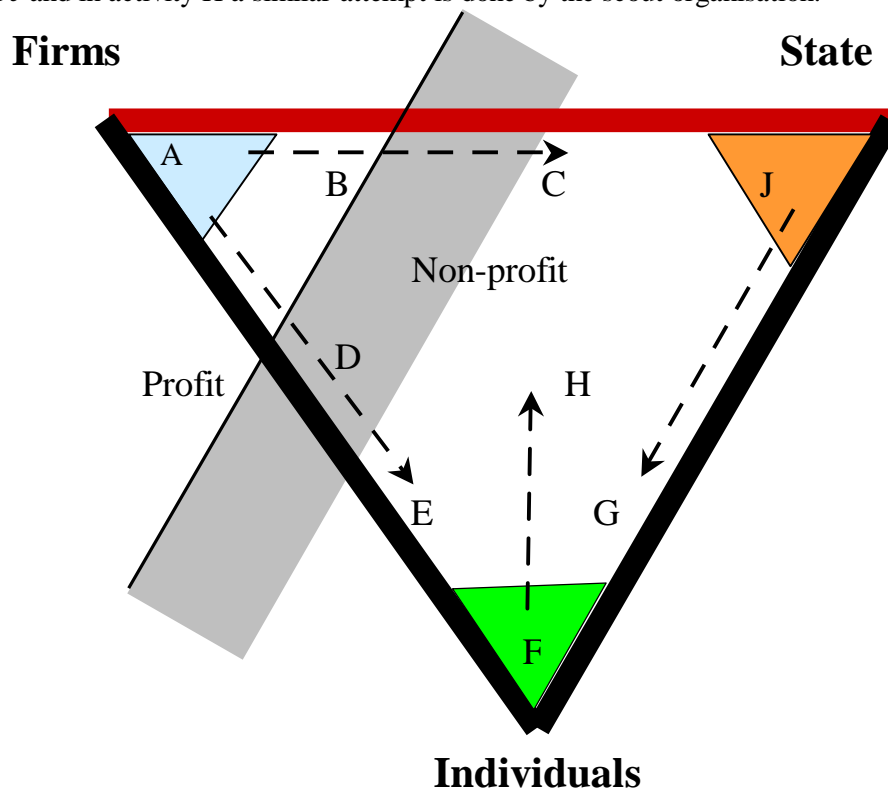


Figure 5: The location of agents or activities in the triangle of socio-political classification

The inclusion of individuals and their informal and formal organisations into the mix of agents of social governance widens substantially the processes of coordination. We have three basic **instruments** at our disposal (markets, hierarchies and culture) that can be exercised by three basic types of **agents** (firms, governments and individuals) in order to follow their three specific **objectives** (profits, power and felicity). It is not difficult to understand that none of them has among its objectives a concern for a globally balanced social optimum. This could be ascribed only to God. The global social optimum is an outcome of interactive processes (*"tâtonnement"*) in the whole system – their negotiations, concessions and re-justments based on free exchange of information. We have also identified the core of the social system (the public domain) that included also the civic sector and where the alternative forces driving the society are conciliated. The only part that is

missing in Figure 3 are external linkages to similar structures of other nations and external shocks coming from the nature.

It is only the interaction of all our players and their instruments that brings the society into a movement that is called “development”. Naturally, the development can be evaluated by historians by adjectives such as: balanced, harmonious, progressive, peaceful or constructive, including (more often) their antonyms. In any given moment we can only see a result of the equilibrium or disequilibrium of powers. There are no a-priory given “social” objectives. All is subject to an interplay of social powers.

A social coordination and governance subject to a wide combination of different objectives and instruments implies automatically a **choice** and a **specialisation**. The principles of comparative advantage in the usage of instruments, based on differences in local endowments and productivity, come again to prominence. Each instrument has its own domain of efficiency, even though its usage is potentially universal. Social optimum can be achieved only if all instruments are in balance in their marginal positive effects and any potential improvement is not compensated by a decrease in felicity by any other individual. Generally it is a black box ¹⁷, whose unique property is that it is hardly predictable ex-ante or empirically verifiable ex-post. Nevertheless, its message is not void: its existence helps in creating social equilibria that otherwise, if judged logically by means of comparative statics of isolated criteria ¹⁸, would imply that social reality evolves only within the range of seemingly suboptimal levels. If the mechanism of consolidating public and private choices gets stalled, the myriad of potential trade-offs for any social development will expose the social governance to a risk of indeterminacy.

There is an analogy here. As was explained by Hayek (1944), market mechanism is a huge and complicated optimisation engine that can easily break down by government interference. But as Greenwald and Stiglitz (1986) argued, markets can fail due to many other interferences, such as externalities or information distortions. Social governance is an even more complicated optimisation engine than simple commodity markets because it extends over additional agents (stakeholders) following much more varied and conflicting optimisation criteria. The demands on its procedural complexity rise exponentially once it is agreed that each of the three pillars has its equal footing in the decision-making. If the bargaining mechanism of social governance is constrained, the outcome must be logically inefficient.

8. Distortions and Bias in Social Governance

¹⁷ *Black box is a processing mechanism whose inputs and outputs are known, but its functions remain hidden. The most famous regulatory black box is the “invisible hand” of economic systems. It is obvious that societies are challenged by a similar problem of general equilibrium in many other activities than producing commodities for market sales. Any human act of choice that requires time is subject to scarcities and externalities. Its allocation requires a process of communication and negotiation similar to auctioning.*

¹⁸ *This is a difference between partial and global equilibria. Therefore societies are presumed to be underperforming if only pure market criteria are considered (e.g. low consumption per capita). Hierarchic commands are judged ineffective if evaluated mechanically by regulatory criteria (e.g. troops are not ready for an attack). Similarly a pursuance of individual felicity may be deemed a failure if it is assessed separately against the individual's potential (e.g. Mr. X lost his job). But actually Mr. X sabotaged the army, resigned from his job and worked hidden in the shadow economy – so the society is at its optimum. As it is with the maximisation calculus where the number of exogenous and target variables is greater than one, the social optima may have many partial optima. On top of it, the alternative optima can be only rarely mutually compared and ranked, as the constraints on Pareto optimum explains.*

The fuzzy approach to dividing lines is most useful in explaining one of the most important reasons why the communist system was finally dissolved and why, contrary to all historical experience, its demise (“velvet revolution”) was peaceful. As we discussed it at the end of chapter 3, the cause was in the diffusion of power from the informal sector. The system of central command tried to control even those areas, which normally belonged to private informal sector, private business activities or to the civic sector. That obviously resulted in enormous formal constraints to development, smothering the initiative and the willingness to cooperate. But, as Baumol (1990) explained, entrepreneurship is a firm part of human nature and it is virtually impossible to smother it completely. Once it is not possible to practice it in the formal business sector or in the official hierarchy of public administration – it finds its ways into the informal sector. If the constraints were too high in the black economy as well, the entrepreneurship had to locate its activities into the informal world of inter-personal networks. It was not only in the ways how to spend holidays or how to organise sports, but also how to extend the personal networks to enterprises, public administration and even to the communist party.

This process of informal “subversion” of formal hierarchies by informal social networks is depicted in Figure 6. The communist formal structure of governance, that looked monolithic and unscathed to an outsider, was actually deeply eroded, holding together only by the opportunistic informal collaboration within its myriad of social networks. This opportunism was often parasitic and counteractive to the objectives of the central command, built intuitively on the principles of decentralisation and subsidiarity¹⁹. The hierarchy of principals and agents lost its pyramidal dominance and in some linkages it was actually reversed (Mlcoch, 1983 and 1995).

The erosion progressed even further after the intuitively correct interventions of Andropov and Gorbachov – offering more powers to civil society and individual initiatives. The weakness was fully revealed at a moment when, after an even mild constant external shock, hardly anyone was willing to stand by such corrupt formal structure. All peaceful alternatives to continuing with the communist rule were found more promising from the individual point of view. The communist regimes were not defeated by the hardware of capitalist power but by the “software” of capitalist opportunism for gains.

¹⁹ *Even though there were some exceptions, such as Polish Solidarity, which was built as a parallel competition to the State hierarchy.*

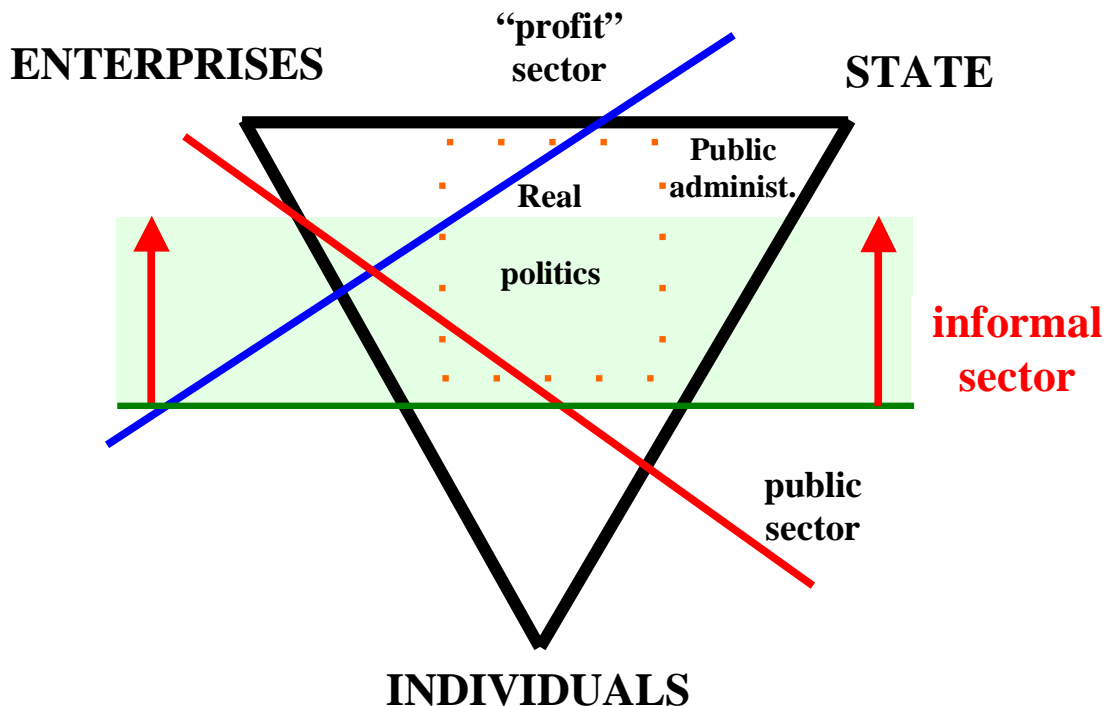


Figure 6: Erosion of the communist system: an informal opportunistic infiltration

We can reverse this argument and ask a question in what position the communist command system would be if the formal hierarchy would be supported (and not undermined) by the informal backing. By using an analogy with the World War II, when the Stalinist upper command received a nation-wide informal support, we could presume that the collapse of the communism would be much delayed and it would be more difficult to bring its economic and military power to such an evident indifference so easily. According to this logic, the proliferation of informality should have been thwarted by building a wall of inequity between the ruling and the ruled. A coactive collusion between the despotic Party, the State security and the wealthier enterprise bureaucrats would generate sufficient synergy for defending their privileges from any disruptive shocks. That would happen even though it would be evident that its economic system must be lagging behind the market system due to disregarding the market information for its allocation of resources²⁰.

Indeed, individual initiative and informal cooperative behaviour, induced in the sector of kinships, were able to compensate partially for such losses and avoid the most striking misallocations. This could be depicted in Figure 2 by widening the shaded U-shaped shaded envelope and pushing the actual performance closer to its upper right-hand corner. Although the information about shortages, stocks and other non-price signals (see Kornai, 1980) is more rudimentary than information contained in market prices, it still offers rational guidelines for correcting the allocation of resources, at least partially. In that sense, it was more the ambiguity of operating in the shadow zone of C-T' (Fig. 2) and the smell of enticing closeness of consumerism expected from coming closer to the zone B-T'' that overthrew the communism, than the lag in efficiency of central planning.

Another interesting problem, concerning the ill-performance of the three-pronged systems of social governance, is the analysis of distortions that were caused by the transition of former

²⁰ This would explain why only the most autocratic regimes of North Korea and Cuba survived and why the only token of resistance was in Romania.

communist countries. Such changes were marked by shifts of dividing lines away from the corner of their origin, while the fuzziness of their actual formal position also increased. The problem is shown in Figure 6. The dramatic weakening of the legal system reflected only the existing social power that the informal sector gained before the demise of communism. The distrust of all kinds of central regulations backfired by giving *carte blanche* to hyper-libertarianism (“*laissez passer*”) ²¹ in running businesses and by opening most varied schemes of formal and informal privatisation that did not help much in increasing the efficiency (Benacek, 2001). At the same time the large State was retained and the number of public servants actually increased ²².

The existence of large developmental asymmetries in an open society is an enormous incentive to entrepreneurship. For example, the number of registered firms (including self-employment) in Czechia increased from a couple of thousand in 1989 to 1,119 thousand in 1993 and the number of registered entrepreneurs represented unparalleled 27% of total employment in 1998. Unfortunately the structure of incentives at that time was such that the rise of new entrepreneurs with productive motivation was accompanied by a rise of entrepreneurship that was redistributive (rent-seeking in bureaucracy), speculative (tax evasion) and even destructive (banking and privatisation frauds) – see Benacek, 2001. It resulted in the creation of niches for the collusion between businesses and the government (area I.), for the rising power of mafia and the black economy (area II.) and for the encroachment of unfettered bureaucracy into matters that in traditional capitalist societies would be treated informally (area III.). The expansion of informal networks, businesses and bureaucracy in transition was to a large extent at the expense of the civil society and NGOs (areas IVa, IVb and IVc).

The lack of contract transparency, failing markets, failing governments and failing ethics during early stages of transition resulted in the rise of debts, social uncertainty, inequality and problems with economic growth. For many agents the basic law of capitalism – that of the hard budget constraint – did not exist in the first stages of transition (Maskin, Xu, 2001). The power of the centralised hierarchy was shattered but its army of executive bureaucrats was retained together with their extensive rights in disposing with the public property.

²¹ *The most interesting was the Czech “miracle” (negligible unemployment and high growth until 1995) ascribed to a conservative fiscal stance. Unfortunately the effect of budget surplus was more than neutralised by skyrocketing hidden debts in the banking and enterprise sectors and the current account deficit. A prudent banking of the only privatised bank was taken even by the prime minister for a national shame and an excuse for leaving the banks state-owned (Respekt, 4.12.2000).*

²² *For example, the number of public servants in Czechia doubled during 1990-2001 and the number of clerks in both the central and the regional governments increased in 1998 by a quarter relative to the already increased number of clerks in 1993. Similar trends can be observed in other central European transition countries.*

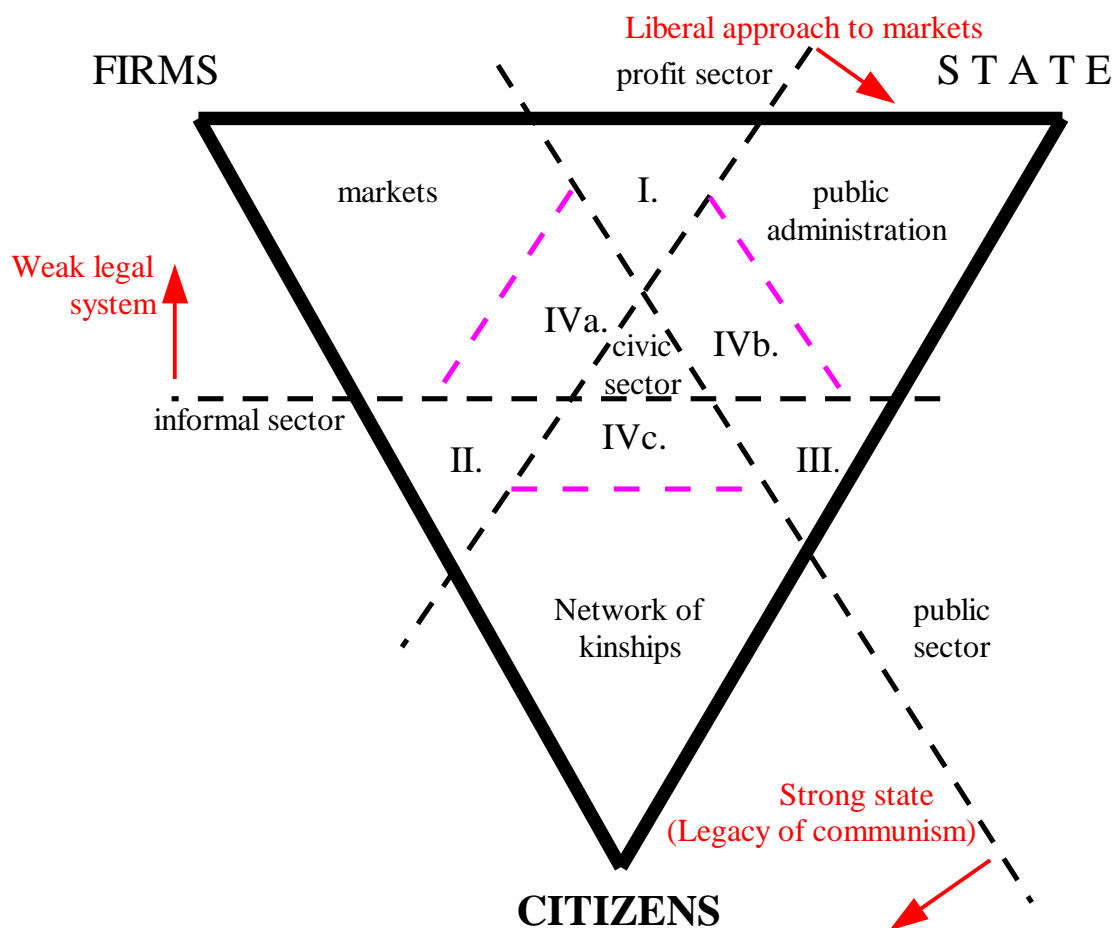


Figure 7: Maladies of the squeezed civic sector during transition

The first five to 10 years of transition were not only a unique experiment in economics ²³, they were also a grand experiment in the whole social organisation and human collective behaviour. People with a social network, organisational skills and minimal capital could mastermind schemes of dominance that involved creative activities of generations to build. The environment of non-enforceability of law and prevailing informality of contracts allowed the agents to “endogenise” the functioning of markets, hierarchies, institutions and even ethics. Differing by countries, regions or social circles, the opaque nature of transition influenced fundamentally the social conduct in all of our three pillars. As is common in situations of social uncertainty and intransparency, the rearrangement of the social organisation was marked by adverse selection where the recruitment of the new elite reflected the moral hazard and by-ways of becoming rich quickly.

Looking at the situation during 1991-97 from hindsight, it is generally agreed now that the ideas of Washington consensus ²⁴ were not able to address all the functional distortions in the

²³ Let us mention that the official label of “transition” was “an economic transition from centrally-planned to market economy”. It reveals how the ideologically biased expectations of changes fed the one-dimensional (macro)economic vision of the social governance. Paradoxically at the same time the laissez passer approach to transition was interpreted by many as a technical change in the corner of “markets” only, while the rest of the society would remain still.

²⁴ Washington consensus was a set of policy measures propagated by the World Bank and IBM for the transition of post-communist countries. It included macroeconomic stabilisation accompanied

economy and they even further destabilised the social situation. The discussion of a more complex approach to transition that commenced in the mid 90s (Stiglitz, 1994) was officially accepted by the World Bank only much later. Although there were experiences from Latin American and Asian countries that privatisation and economic reforms were clearly associated with improved governance of both the states and the enterprises, this was not so evident in European post-communist countries. It was found that the mixture of a high degree of state capture and an intensive reform (such as a mass formal privatisation) did not improve the governance (Hellman, Schankerman, 2000). To the contrary, the collusion between bureaucracy, banks and enterprise agents decreased the quality of governance and increased the degree of state intervention and general corruption.

9. Alternatives and New Features in Contemporary Social Governance

The last problem we will discuss concerns the alternatives to the “three-pronged social governance” in our interpretation. Once the role of kinships, culture, solidarity and social cohesion is gaining in the socio-economic fields, because of the objective changes in the society, it should be reflected first in the civic sector and transformed into new politics. Politics are supposed to change the respective social institutions that mirrored the past status quo. It is the nature of three-pronged systems that a systemic change needs an extra-party coalition. Fight for the third pillar (the citizen support) is a crucial coalition. Giddens (1998) presumed that it is natural for the left-wing (social-democratic) parties only to adopt the principals of the third pillar into its system. It would sound rational if we considered only the values of justice and equity as the core of the third pillar or if the social inclusion concerned people without capital. Right-wing (liberal) politics would have much lower degrees of freedom for making these social “parameters” a part of the policy objectives. In their system they are considered exogenously given outcomes.

However, the coalition between the first and the third pillars, and their implementation into the new politics of the traditional conservative/liberal parties are easier to consolidate if some different aspects of ethics and culture are considered. For example, one of the strongest properties of markets is that they are intrinsically about the equivalence of exchanges. Actually **all social intercourse is about exchanges**. Thus “markets” are phenomena with much wider scope than what is contained in the pillar I. The problem is that the usage of markets outside pillar I. is based generally on **barters**. And barters are constrained by the weak enforcement of contracts and transaction costs. The result is a risk of **inequitable exchanges**. Equitable but legally non-enforceable exchanges outside of pillar I. can be sustained either by consensus of parties (pillar III.) or by unilateral force (pillar II.) only. In this respect the interaction between markets and human consensus is a more efficient coalition than a coalition between the redistributive force (governments) and individuals. The former boosts the market productivity that helps to all, while the latter offers only a redistributive (i.e. non-productive) motivation that is often challenged by political opposition and higher transaction costs. Therefore many contracts and exchanges outside of the pillar I. cannot take place if the third pillar is not active in their support. This is very much in line with the empathy and the encompassing interests of enlightened autocrats (or kleptocrats) described in Olson and Kahkonen (2000) that voluntarily waive their redistributive power in support of environment promoting market exchanges.

The political parties stressing the importance of markets and the need of their transparency and ethics can thus strengthen their argument by activating the interaction between individuals, civil society, ethics and enterprises. The gains are widespread: higher efficiency of markets and higher

by liberalisation of prices, international trade and massive (formal) privatisation, which changed only a part of the market pillar. The institutional issues, such as the transformation of legislation, contract enforcement, property rights, public sector, civil society or social governance were practically disregarded.

income of all participants. As was argued by Dahlman (1980), informal sanctions based on ethics can to a large extent substitute the business regulations of the bureaucrats.

Our third pillar bears the key to decisive factors of modern production: the accumulation of human capital, the development of relational /social/ capital (Bezemer, Dulleck, Frijters, 2003) or social capabilities in general (Temple and Johnson, 1998). The majority of advances in economic growth in modern economies is associated with these factors. Without doubt is in the interest of all entrepreneurs to avoid the rising costs by having scarce supply on this side of inputs. The opportunity cost of building an enterprise competing internationally with a lack of human capital is high. Therefore it is in the interest of businesses (and their parties) to persuade the labour (pillar III.) that the buildup of human capital pays and force the public finance (pillar II.) to provide the education efficiently. Pillar III. also deals with social cohesion. If the society accepts that cooperation, solidarity, transparency and finding consensus in conflict resolution are crucially important for the social development²⁵, so it benefits the competitiveness of enterprises and lowers the unemployment rate. These are not politics that would be alien to the interests of capital owners.

Our last point offering new visions to conservative/liberal parties deals with the battle about the family. The recent accelerating disruption of the traditional family in rich countries could become one of the most important social shocks in human history. Pillar III thus could become not only a source of new positive externalities but also a source of opposite tendencies. In addition to causing economic slowdown, geo-political instability and undermining the legitimacy of the market system in some areas, it may undermine its own foundations. According to Horwitz (2002), family still remains an important provider of economic and felicity “production” based on economies to scale. In addition, it provides a fundamental mechanism for transmitting and learning of human values, skills, ethical sentiments and instincts of sovereign cooperative behaviour. As such, the family fulfils an irreplaceable educational task that could be on a par with the whole formal system of primary schools. A collapse of the family system may result in a downgrading of the build-up of human capital, at least in widening its unequal endowments by individuals.

The present policies aimed at market revival²⁶ are not possible without finding a role for the non-State public domain and a solution to the collapsing functions of the family and the inter-human culture. The pushing of frontiers has been so far gradual and modest, but the direction of such attempts is apparent, as is depicted in Figure 8.

²⁵ *It is not trivial to find out that countries with the highest rate of economic competitiveness are those where these social values are sanctioned – Finland, Denmark, Ireland or Sweden.*

²⁶ *One of the most powerful policies in the European Commission are the competition and trade policies, including the still not accomplished single market in services and the free labour movement.*

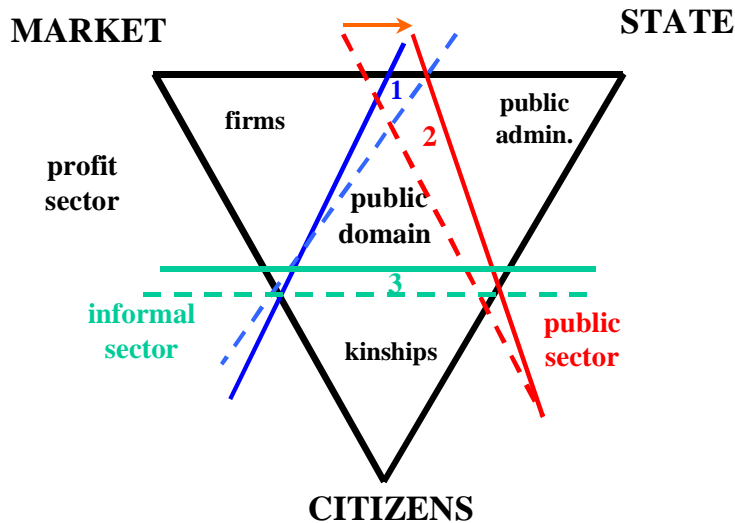


Figure 8: Enlargement of the space for civic activities in social governance

The original boundaries between sectors are depicted by intermittent lines. The civic crowding-in [1] and [2] means gaining more control by the civil society over the dangers of redistributive coalition between business corporations, political parties and the state bureaucracy (state capture). For example, it may concern the surveillance over public procurement, monopoly regulation and industrial pollution; or the higher involvement of civil society in the policies of pensions, social security, health or education. The crowding-out [3] represents more liberal approaches to informal relationships of individuals, such as families or kinships.

We can describe these tendencies as a revival of the Schumpeterian capitalist spirit of entrepreneurship. It is not a re-inventing the wheel. Family, informal kinships and personal accountability were traditional links between the markets and the incentives to produce or to accumulate wealth. The protestant ethic of industrial revolution stressed this link and found a natural opposition in the collusion of businesses with the pillar of hierarchies. Politics based on the general principles of the three-pronged governance cross over the antagonism between political left-wing and right-wing. The common modern political objectives of all parties about fostering education, social inclusion, cohesion, fairness and self-responsibility could be differentiated in their means, stressing alternative links of the first two pillars with the third pillar.

10. Conclusions

The concept of three pillars in social governance can be derived from objective developments in the capitalist societies during the first 70 years of the 20th century and their transition to post-industrial societies in the last 30 years. The collapse of the command economies based on the state and party hierarchies was an important catalyst of these fundamental changes that had an impact on the world economy, the role of the state, the conditions for social interactions and the position of individuals (networks of “kinships”) in such a dynamic world. That had an intensive impact on the selection of new policies and attitudes to politics throughout the world.

The rational idea about dismantling the power of hierarchies in the post-communist countries and the crowding-in of market principles into socio-economic functioning was soon challenged by the reality of both failing markets and failing governments. The contagion got widespread: rising pessimism about the credibility of the existing political system, governments and media is present even in countries with uninterrupted democratic capitalist traditions. Such tendencies resulted in ideas about the need of strengthening the role of individuals, families and civil societies in coping with the challenges of the globalised post-industrial society.

The most important phenomenon that strengthens the role of individuals in modern world is the fundamental importance of knowledge and education in economic growth and governance. The design of environment favourable to the functioning of education, science, research and development, to the development of small businesses and entrepreneurship, and the widening of responsibilities that could be borne by the civil society – these are the crucial topics for shaping the present policy-making.

The following statements can be associated with the politics of three-pronged systems of social governance based on the interaction between businesses, governments and individuals:

- a) The recent state of evolution of economically advanced societies, their organisation, growth and the stress on choices are becoming more dependent on the inclusion of individuals and civic activities in the decision-making.
- b) Markets, hierarchies and social culture are the indispensable channels for the bargaining among the varied and contradictory objectives (needs) of individuals.
- c) Though these three channels are rivals because they represent domains of disparate interests, they should aim at finding a consensus. Their nature is a **competition** subject to transparency.
- d) Achieving a general social equilibrium requires the availability of **accommodating institutions** of public domain (democracy). Their efficiency is vitally dependent on an unhampered information flow and the non-existence of impediments to entry. It is therefore crucial that each social agent (individual) has both a voice and a choice in the game²⁷.
- e) The **specialisation** of three basic pillars (instruments) of social governance is another necessary prerequisite for their efficiency that makes the search for social equilibrium a stage game. This stresses again the importance of undistorted information for avoiding of lock-ins in their interplay.
- f) The inclusion of the third pillar into the social co-existence increases its efficiency by bringing in the benefits of direct **barter of inter-human exchanges**, altruism and ethics. Unfortunately, it has its pathogeny in the rising risks of malevolence (e.g. terrorism).
- g) The paramount role of the **government** rests in the principle of *primum non nocere*²⁸, that is in refraining from building constraints to the economic and political (democratic) markets, to the openness of social contracts and to the initiative of the players in the social game. For example, it is often enough to guarantee the enforcement of the rules of the game, as the built-in mechanisms.
- h) Even though the agendas of enterprises and governments have their **globalised aspects** (e.g. concerning competitiveness, environment, human diversity and solidarity) that requires a world-wide coordination, the same agendas are at the same time subject to devolution and **subsidiarity**. Their solution is not optimal without the inclusion of information from civil society and citizens.
- i) The impacts on GDP, as the provision of public goods by the government (e.g. the support of education, science, health, equity, justice or small entrepreneurship) has its trade-off by reducing other productive activities via taxation, should be re-considered.
- j) Three-pronged approach to social governance reveals the shortcoming of pure economics (build on the assumptions of perfect markets and value-free principles), deemed as a hard social science. New advances in economics require its further “endogenising” and further integration of behavioural determinants at the level of individuals as the authentic economic agents.

²⁷ *The analogy of social (political) bargaining with markets in allocating the production, inputs and consumption is not a coincidence. Auction (free entry), voice (free information), price (costs and benefits) and competition (choice) are universal concepts for finding a solution to any social situations where there are conflicts of interests and scarcities.*

²⁸ *From the Latin “foremost not impairing”, applied originally to medicine.*

- k) The politics of the “new third way” is best known from the initiatives of the social democratic parties. We can find many similarities between their proposals and the principles postulated in this paper.
- l) However, three-pronged politics need not be limited exclusively to the politics of social democrats, because there is a choice among alternative aims, values or instruments for their achievement. For example, instead of the “justice and equity” by means of transfers, similar objectives can be followed by involving the civil society and ethics in raising the efficiency of market systems.
- m) The support of families and informal networks is another policy that can be compatible with more conservative approaches to politics. That would allow expanding the principles of markets into areas of exchanges that are at present in the domain of state administration, civil or informal societies.
- n) The inclusion of citizens and civil society into the performance of markets is at least as important move as the inclusion of citizens and civil society into the improvement of the state hierarchies.

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