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Nonpayments Cycle in Russia Suffocates Economic Growth—Proposal of World Bank Economists

One question preoccupies many scholars and practitioners: How can economic growth in the Russian Federation be reinvigorated? A recent report by three economists in the World Bank's Moscow office, Brian Pinto, Vladimir Drebentsov, and Alexander Morozov, contributes to the current debate. The authors in their paper, "Dismantling Russia's Nonpayments System: Creating Conditions for Growth", explain that the cycle of nonpayments is too ingrained in the economic structure to go away spontaneously. They propose introducing policy measures that can turn the tide and launch Russia on a new path of growth. It is a timely proposal; Prime Minister and acting President Vladimir Putin just recently called "the elimination of barter and other nonpayments" as one of the country's most urgent tasks.

In early 1996 expectations ran high that growth would resume at a sustainable annual rate of 5-7 percent, starting in 1997. Indeed, by mid-1997 foreign exchange reserves rose to unprecedented levels, real interest rates fell, and output registered its first increase since the start of transition. But as a result of persistent shortfalls in the government's cash revenue collection, public debt—from the sale of short-term treasury bills—increased substantially during the 1995–mid-1998 stabilization period. So did the country's vulnerability to market sentiment.

Near the end of 1997, as Southeast Asia's financial crisis flared up, the international finance institutions toughened their stance in the face of the government's inability to meet its cash revenue targets. Investors became wary of the lack of fiscal adjustment and the slow progress in structural reforms. It led eventually to the economic meltdown in August 1998.

After the sharp drop in output in the third quarter of 1998, many observers thought that the recession would deepen in 1999, with GDP falling 7-10 percent. But the collapse of large Russian banks affected enterprises relatively little because of the limited links between the financial and real sectors. As the devaluation of the ruble cut imports and encouraged domestic production, Russia achieved 1.5 percent growth in 1999. This did not mean, however, that Russia steered its economy to a steady growth path.

A common phenomenon characterized both the pre-meltdown phase (during which sustainable growth failed to materialize) and the post-meltdown period (during which the declines were more modest than expected): a large number of enterprises refrained from cash payment-even from payment itself. While nonpayments ensured their subsistence, it impeded their efficient restructuring. As the authors point out in their report, this was a sure recipe for protracted stagnation.

The Deformed Structure

The authors see two layers to the nonpayments structure: overdue payments and all forms of noncash settlement. Overdue payments (arrears) are growing rapidly. At the end of 1998 they reached almost 40 percent of GDP, up from 15 percent at the end of 1994. All forms of noncash settlement increased, including barter, the use of veksels (or promissory notes), and tax offsets in which government spending arrears and overdue tax payments are mutually canceled. Cash collections during the summer of 1998, before the meltdown, were as low as 12-13 percent of domestic sales for both Gazprom and RAO UES (the gas and electric power monopolies), and about 30 percent of sales for the railways. By 1998 the share of noncash settlements in enterprise sales had increased to 50-70 percent. From 1995 until mid-1998 as much as 50 percent of spending by subnational governments was in the form of noncash settlement, with the federal government's share averaging 20 percent.

Nonpayments mushroomed as a result of inconsistencies in the government's policy: while it pursued the macroeconomic goal of getting rid of inflation rapidly, it offered

soft treatment, even subsidization, of non paying companies. The authors recall events of recent years.

Real interest rates abruptly changed from negative to highly positive toward the end of 1994, and they remained positive until early 1997. The high interest rates of treasury bills (GKOs) moved banks to invest in GKOs; result was a working capital shortage for the majority of firms. Anecdotal evidence suggests that enterprise managers diverted liquid funds to GKOs, exacerbating the liquidity problem.

Firms responded to high real interest rates and tightened liquidity by delaying payments and running up arrears to suppliers, workers, and the government. Gazprom, RAO UES, several oil companies, and the railways accumulated especially huge claims within the enterprise sector. Rather than receive nothing at all, and avoid the write-off of these debts, they began accepting payments in kind. Noncash settlements became a way of settling arrears.

Cheap energy supplies were regarded by the government as a crucial part of the life-saving mechanism that keeps companies afloat and prevents increases in unemployment and aggravation of social tensions. Therefore the government curtailed gas and oil exports—major foreign currency earners—in order to free supplies for domestic sales on a price that was only a fraction of the world market price. Attempts of the energy suppliers to raise domestic fuel prices were refuted. Disconnecting clients who do not pay their gas and electricity bills is difficult and could even be illegal under the current civil code, which is ambiguous on this. Some companies, identified on various strategic lists, may not be cut off under any circumstances. Regional governors often interfere to save nonpayers from being cut off the energy lifeline.

The report points out that the government's permissiveness—explained by its social concern and by the collusion of state officials and enterprise managers—enabled enterprises to accumulate arrears with impunity and to pay tax and energy bills with overpriced, noncompetitive goods. Implicit subsidies of the energy monopolies to various companies (though unequal barter and unpaid energy bills) amounted to an estimated $60 billion between 1993 and 1997. The energy monopolies in turn became delinquent on their own tax and social security payments, which aggravated the deficit of the enlarged government (including deficits of the federal, local governments and the extra budgetary funds). Thus, in effect, these subsidies were financed in part by the energy sector and in part by public borrowing from domestic and international capital markets. In addition, enterprises received from the government both direct and hidden subsidies (the latter through tax offsets and arrears).

The Problem that Will Not Go Away

The report tries to explain why this burning issue was not dealt with during the three years preceding the meltdown. Why did most policymakers fail to take the systemic nature of the problem seriously? According to the authors, there was widespread belief that nonpayments would spontaneously disappear as market reforms and stabilization took hold. Tough tax enforcement would solve the problem. This view came from the mistaken belief that tax evasion was the main driving force behind nonpayments.

Today this perception has radically changed. Dismantling the system would require a clean break with the past by hardening enterprise-level budget constraints, eliminating hidden subsidies, and enforcing tax collection. If, however, energy companies and other rich firms are required to bail out the rest of the economy, they will continue to be the major tax delinquents, perpetuating nonpayments and impeding the completion of fiscal reform, and thereby the attainment of low inflation and growth.

Experience between 1995 and 1998 shows that although inflation can be controlled through nonpayments, the economic costs of such a policy are staggering in terms of misallocation of resources and postponed enterprise restructuring, facilitation of corruption, bad investment climate, and stifled growth prospects. Furthermore, under

The term "hard budget constraints" was coined by the Hungarian economist Janos Komai. Essentially, it means financial discipline: firms should pay their bills and taxes on time or bear the consequences, without hope that the government will bail them out. The resumption of growth is linked to enterprise-level hard budget constraints. Growth depends on efficient use of existing assets and efficient reallocation of resources through the exit of bankrupt companies and the entry of start-ups.

Contents

these circumstances, low inflation, which places public debt on an unsustainable course, is not likely to last, so it indicates neither success nor credibility.

The report warns that the revival of economic growth in Russia will demand a hardening of budget constraints—in other words, the dismantling of the nonpayments structure. The process will not reverse itself automatically, even if real interest rates fall and more credit becomes available. Broad political measures are required.

Russia's Fragile Economic Growth

According to government figures, Russia's GDP grew 1.5 percent in 1999—only the second such rate of growth in the post-Soviet era. Industrial output was also up by 8.1 percent. The figures followed declines in 1998, however, when GDP fell 4.6 percent and industrial output dropped 5.2 percent. Relative to 1997, industrial production increased only 3 percent in 1999. Industrial production fell more than 50 percent over the past decade. In 1999 the ruble sank 31 percent. The decline represented an improvement over 1998, when the ruble fell 75 percent, and was a more modest decline than forecasters had predicted.

There was also good news on the fiscal front, where the budget was executed in full "for the first time in the past eight to nine years," according to Finance Minister Mikhail Kasyanov, now First Deputy Prime Minister. Budget revenues will be about 598 billion rubles, or 13.3 percent of GDP; spending will be 666 billion rubles, or 14.8 percent of GDP. Russia will collect about 380 billion rubles in taxes in 1999, 41 percent above the targeted 269 billion rubles, according to Sergei Ignatiyev, a First Deputy Finance Minister.

The driving forces behind the Russian economy in 1999 were booming oil prices and the effects of the 1998 devaluation, which gave formerly noncompetitive domestic industries a shot in the arm. Oil prices recently reached almost $26 a barrel, their highest level in nine years. Russian producers are benefiting from both higher prices and lower production costs as a result of the decline in the ruble. On average, more than four-fifths of Russian oil companies' costs are in rubles, as they use domestic equipment and services.

The consumer price index rose about 35 percent in 1999. The annualized rate of inflation in November was only 15 percent. The balance of payments situation also has positive aspects: the Ministry of the Economy forecasts a merchandise trade surplus of $30 billion for the year, and Russian authorities have managed to honor debt-service payments on post-Soviet debt. Foreign direct investment has made a partial recovery from last year's decline, increasing more than 150 percent to $12.1 billion. The largest contributor is the United States ($4.2 billion), followed by Cyprus ($2.7 billion). Money originating from Russian companies is coming back through Cyprus as Cypriot money.

Despite these favorable indicators, confidence in the Russian economy remains low for a number of reasons:

- Economists say the government did little in 1999 to create the foundations for further growth. Russia remains plagued by corruption, lack of infrastructure, and lack of a firm legal framework.

- The situation of private households drastically deteriorated. Deutsche Bank estimates show that private consumption fell 10 percent in 1999, while government consumption declined 7 percent.

- The IMF continues to withhold the second tranche of its $4.5 billion credit, citing Russia's failure to meet institutional reform requirements.

- Neither banks nor stock markets are channeling significant funds to producers. Bank loans outstanding to the private sector at the end of August were only about 10 percent of expected 1999 GDP. The market capitalization of the 33 large companies that constitute the Russian Trading System index in early December was about 16 percent of GDP. Turnover in shares averaged about 2 percent of GDP.

- The Russian business community continues to place large sums offshore and to undertake little investment in the domestic economy. A recent study by the Finance Ministry estimated capital flight in the third quarter at $2.9 billion a month. Imports of machinery and equipment in the first three quarters of 1999 were two-fifths that of the same period last year.

These concerns notwithstanding, there are some signs of hope. Yegor Gaidar's Institute of the Economy in Transition detected some increase in bank lending to the corporate sector in December 1999 and some increase in investment in food processing, construction materials, engineering, and chemicals.

This material was based on articles by Floriana Fossato, Igor Semenenko, and Andrew McChesney of ***Moscow Times*** *and* ***Oxford Analytica****, the Oxford (U.K)-based international research group.*

How to Break the Cycle

What measures would help the Russian economy break out of the vicious cycle of nonpayments? According to the authors, nonpayments would decline if the government signaled that the rules of the game have changed, that it has corrected its course, and that it will impose hard budget constraints on enterprises and itself. Once net creditors realize that the government will no longer provide hidden subsidies through tax breaks and other concessions, the practice of nonpayments will end spontaneously. The change in the rules would also restore needed integrity to the tax system.

Slashing inflation should be based on genuine fiscal reform, and genuine reduction of the fiscal deficit. Above all, a further buildup of arrears in the pursuit of artificial reduction of inflation should be avoided. Moving to a cash-basis for the budget might result in a temporary increase in inflation, but it is preferable to a quick but unsustainable return to single-digit inflation. At the same time, the much-strengthened federal treasury must be used to control spending commitments, and the govern-

Putin Wants to Combine Strong State with Market Economy

In his first major policy statement, at the end of 1999, Prime Minister and acting President Vladimir Putin said there is no alternative to a market economy, but the state is obliged to support such sectors as science, education, culture, and health. Rejecting both blind adherence to Western market ideas and a return to the Soviet past, he noted that the biggest mistake reformers had made was to try to impose Western patterns on Russian soil. "We can count on a worthy future only if we manage to naturally combine the principles of a market economy and democracy with Russia's realities," he said. "The need for a comprehensive system of state regulation of the economy and social sphere is an important lesson of the 1990s." The time, he said, was not ripe for classical liberalism. "Sometime later we will probably take this recipe, but now the situation demands stronger state influence."

The state, its institutions, and its structures have always played important roles in the life of Russia and its people. For Russians a strong state is the source and guarantor of order, the initiator and main driving force of all change. A strong state can be developed by rationalizing the power structure, raising the professionalism and discipline of officials, intensifying anticorruption efforts, changing personnel policies, increasing the power of the judicial branch, improving federal relations, and effectively combating crime. The public wants greater control over executive power to avoid arbitrariness and abuses. Therefore, attention should be paid to the establishment of a partnership between executive power and civil society.

Putin argued that individualism is far less important for Russians than communal ties. "The collective form of lifestyle has always dominated over individualism. Russian society wants the restoration of a guiding and regulatory role of the state to the extent dictated by national traditions and the state of the country," he added. Putin also ruled out any reforms that would reduce living standards, as poverty is already widespread. He also acknowledged the importance of Russia's raw materials sector, noting that energy and metals account for 15 percent of GDP and more than 70 percent of export revenues. But, he said, a new direction is needed that places more emphasis on consumer goods and services and high technology.

Russia would need to grow by at least 8 percent a year for the next 15 years to reach the level of Spain or Portugal, 10 percent a year to equal Britain or France. In the 1990s Russia's GDP declined to half of its value the previous decade. "According to the overall size of GDP," Putin said, "we are 10 times smaller than the United States and five times less than China."

Putin noted that productivity in the real sector is extremely low, adding that industry was noncompetitive and most Russian machinery and equipment was more than 10 years old. Investment has dwindled: only 4.5 percent of the nation's industrial equipment was less than five years old in 1998, down from nearly 30 percent in 1990. Individual productivity is one quarter that in the United States.

Putin added, "Investments in the real economy sector fell by five times in the 1990s, including 3.5 times into fixed assets. The material foundations of the Russian economy are being undermined. We call for pursuing an investment policy that would combine pure market mechanisms with measures of state guidance."

Russia's economic recovery will be long and difficult without foreign capital. Everything should be done to attract foreign capital and expand the country's participation in international economic organizations. Membership in the World Trade Organization should be a priority, pointed out Putin.

This material was based on news agency reports from Reuters and the Associated Press. The full text of Putin's statement in Russian can be found on the Internet at: www.pravitelstvo.gov.ru/government/minister/article-vvp1_txt.html and at www.pravitelstvo.gov.ru.

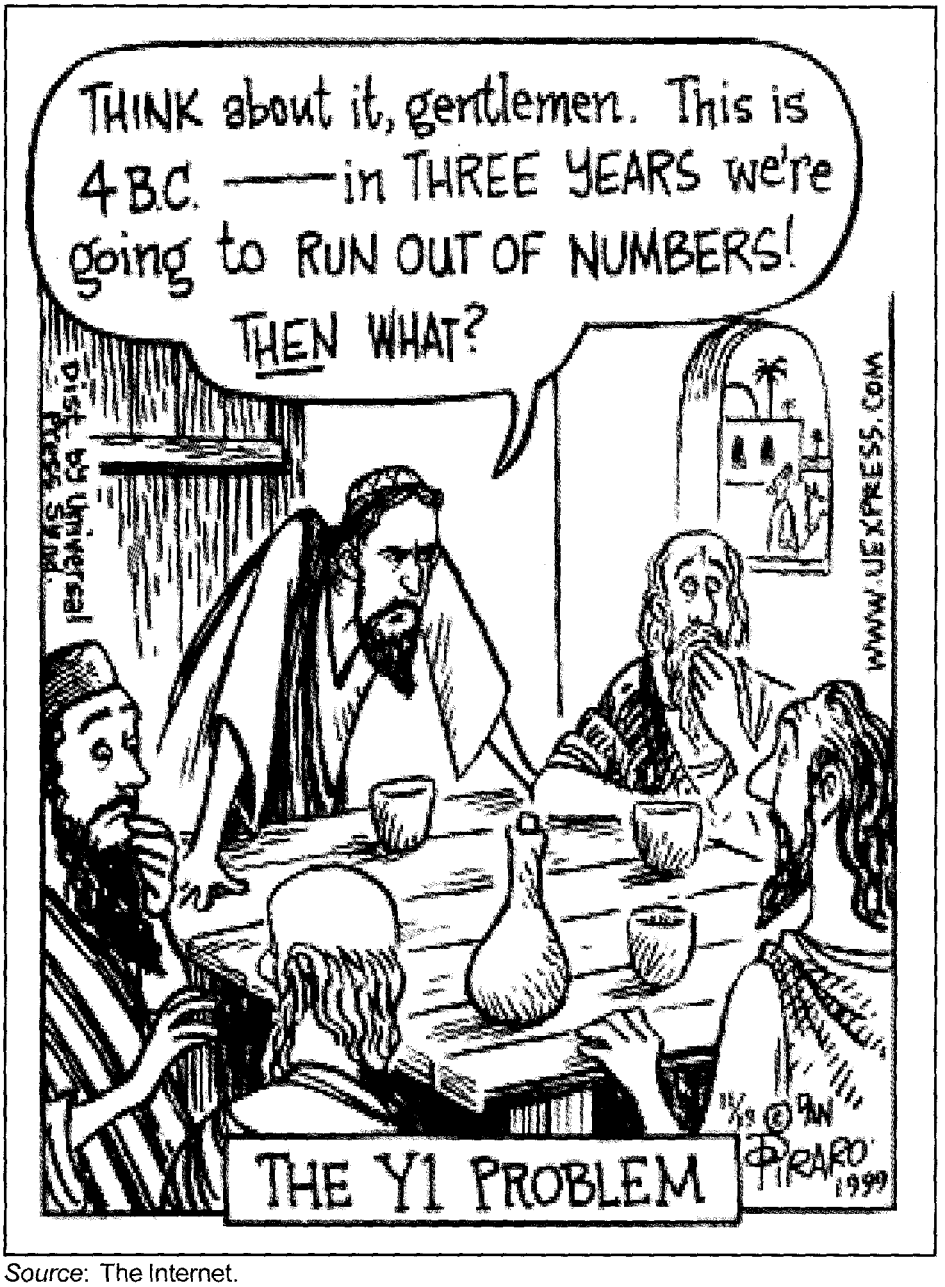
ment at all levels must insist on cash tax payments.

A smooth switch to a transparent, cash-based taxation system means abolishing tax offsets, which are implicit subsidies transmitted through the tax system. Ad hoc tax exemptions and individualized bargaining over tax bills must be removed to provide uniform tax treatment of all companies and sectors. This measure would prepare the ground for a gradual decrease in the statutory tax burden in tandem with increased tax compliance.

Increasing attention should be paid to the deficit of the consolidated (federal and subnational) budget. Budgetary arrears need to be eliminated by improving the general fiscal management. Realistic budgeting must be introduced, in which the Ministry of Finance plays a strong and primary role. Budget procedures need to be streamlined, and the federal treasury should be empowered with the right to register and control spending commitments.

Two conditions need to be fulfilled in order to move the pricing, taxation, and regulation of the energy monopolies to a transparent and efficient basis: the government must pay its bills on time and in cash, and the energy monopolies must be empowered to disconnect nonpayers. Only then will the government's insistence—that energy monopolies themselves pay their taxes in cash, and strive for higher cash collections in their sales— be credible and enforceable.

The likely social impact of hard budgets should be softened. Temporary disruptions are bound to arise, especially with the supply of social services now channeled through enterprises. Such disruptions should be addressed. Given the large size of the hidden subsidies, it is possible that a more effective but less costly targeted social safety net can be designed.



Source: The Internet.

Tackling Social Issues

The standard view is that policymakers in Russia tolerate nonpayments because the social consequences of hard budgets would be difficult to accept. Enterprises are saved because of fears of rising unemployment and disruption in the flow of social services they provide. Data show, however, that delayed transfers to the population and unpaid wages account for a significant part of government arrears at the subnational level.

This is difficult to reconcile with the notion that social concerns are driving the no-exit policy for enterprises. Indeed, social spending was one major casualty of the chronic tax shortfalls between 1995 and 1998. We agree with the authors' final conclusion: sustainable growth, without which gaps in the social safety net will further widen, cannot be resumed under current conditions of nonpayments.

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EBRD and World Bank Survey Reveals Intimate State-Enterprise Relationship

The recently published **Transition Report 1999—Ten Years of Transition** *presents the results of a major new survey, conducted by the European Bank for Reconstruction and Development (EBRD) in collaboration with the World Bank, of more than 3,000 firms in 20 transition economies. The Business Environment and Enterprise Performance Survey asked entrepreneurs and managers about the extent and nature of their dealings with the state and the associated obstacles to doing business. The survey included questions on corruption, organized crime, state intervention, and the influence of firms on governments—or "capture of governments."*

Four key findings of the survey:

- Governance is the exercise of economic, political, and administrative authority to manage a country's affairs at all levels.

- Government comprises the mechanisms, processes, and institutions through which citizens and groups articulate their interests, exercise their legal rights, meet their obligations, and mediate their differences.

- Whether governance is "good" or "bad" depends on the degree of legitimacy, representation, popular accountability, and efficiency with which public affairs are conducted.

- In the corporate world, good corporate governance is meant to provide incentives to the board of directors and management to act in the interest of the company and its shareholders.

Grading Governance in Transition Economies

The following results and interpretations have been excerpted from the report.

- **Quality of governance.** The relationship between governance and economic reform (in terms of liberalization and privatization) is not uniform. Firms in the most advanced and least advanced transition economies have more favorable assessments of governance than those in countries that have adopted partial reforms. Countries normally considered among the most advanced transition economies, such as Estonia, Hungary, and Slovenia, are ranked alongside some of the least advanced, such as Azerbaijan and Uzbekistan, in terms of quality of governance (tables 1 and 2). In other countries that have been praised for early reform efforts, such as the Kyrgyz Republic and Moldova, businesses have given low ratings on both governance and the security of property rights.

One explanation for this relationship is that it reflects how the capacity of the state to

Continued on page 8

Table 1. The quality of governance

Country	*Micro-economic governance*	*Macro-economic governance*	*Physical infrastructure*	*Law and order*	*Governance index*
Hungary	0.92	1.72	2.42	2.34	1.98
Slovenia	1.17	1.73	2.26	2.23	1.95
Estonia	1.25	1.74	2.38	2.17	1.95
Uzbekistan	1.4	1.44	2.11	2.16	1.83
Armenia	0.55	1.15	2.21	2.32	1.72
Poland	0.96	1.53	2.37	1.82	1.69
Slovak Rep.	0.88	1.68	2.11	1.7	1.65
Czech Rep.	0.8	1.35	1.57	1.97	1.59
Belarus	0.67	0.77	2.18	2.25	1.57
Lithuania	0.69	31.7	2.19	1.48	1.54
Azerbaijan	1.02	1.59	1.73	1.56	1.53
Croatia	0.67	1.18	2.13	1.62	1.43
Bulgaria	0.9	1.25	1.77	1.49	1.38
Kazakhstan	0.75	0.72	1.85	1.68	1.27
Georgia	0.67	0.93	1.78	1.47	1.24
Ukraine	0.34	0.77	1.76	1.68	1.24
Russia	0.47	0.65	1.91	1.54	1.16
Romania	0.45	0.6	1.49	1.48	1.07
Kyrgyz Rep.	0.46	0.48	1.85	0.98	0.85
Moldova	0.52	0.35	1.42	1.1	0.82

Note: Firms were asked how problematic nine factors were for the operation and growth of their business. Answers were on a scale ranging from: 0 (major obstacle) to 3 (no obstacle). The factors are grouped into four broad subcategories: microeconomic governance—including taxes and regulations; macroeconomic governance—including policy instability, inflation, exchange rate; physical infrastructure—no subcategories; and law and order—including judiciary, corruption, street crime, organized crime. The governance index is constructed as the average of the country scores across all nine factors.
Source: Business Environment and Enterprise Performance Survey.

EBRD: After the Russian Shock, Sound Again

Policy Director Steven M. Fries on New Priorities

What are the latest business results and what are the future plans of the London-based European Bank for Reconstruction and Development (EBRD)? Steven M. Fries, Director of Policy Studies at the EBRD Office of the Chief Economist, sees a bright future for the institute, which will celebrate its 10th birthday in 2001 and will hold its next annual gathering in May 2000 in Riga, the capital of Latvia.

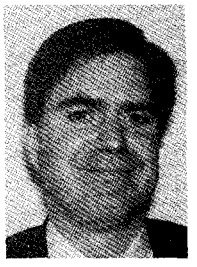
Q: In 1998 the EBRD closed its books with an operating loss of more than $200 million—the first loss in the past six years. Will the result be better in calendar year 1999?

A: Our bank, at the end of 1998, had to significantly increase its level of loan and investment loss provisioning, dictated by the ruble crisis and its chain reaction across the CIS region. [Banks have to put aside loss provisions, or reserves, to guard their liquidity in case of nonpayment; consequently, the provisioning level depends on the risk factor of the loan or equity investment.—The editor] This resulted in a substantial net loss for the year. The lesson we learned was that even sound investment projects can go down if the legal and regulatory framework is not supporting the private sector and, on the macro front, if financial discipline is lacking.

In 1999 the tide has turned. The equity portfolio brought high returns, and we succeeded in keeping our administrative expenses under strict control. As a result, during the first nine months the EBRD recorded an operating profit of Euro (E)130.2 million before provisions. Even after deducting provisions, we registered a net profit of E9.7 million. Our total provisions for the banking portfolio amounted to E1.1 billion, or 16.7 percent of disbursed outstanding loans and equity investments. At the end of September 1999 the EBRD's authorized capital was E20 billion and paid-in capital and reserves equaled E5 billion. You have to compare these figures with the fact that since 1991 we have committed E12 billion for the financing of projects throughout the 26 countries of the region, representing an aggregate value of E42.9 billion. Of these commitments, two-thirds have been in the private sector, one-fifth in equity investments, and about one-third were in the financial sector.

The Bank also made commitments to 102 new investment projects in 1999 worth E2.2 billion. This level of activity was achieved despite challenging economic conditions in Russia, where new commitments amounted to E150 million, down from E541 million in 1998. However, if economic and governance conditions continue to improve as anticipated, EBRD investments commitments in Russia could increase to between E300 – 400 million in the current year.

Q: The EBRD recently published its new medium-term operational strategy. How much will it change the bank's loan and investment policy? The latest operations of the EBRD are quite impressive: $30 million to develop Georgia's electricity sector, $52 million to build a gas-compressor station in Ukraine, $10 million in cofinancing to privatize Macedonia's leading commercial bank, a credit line to support small business in Romania, and the largest equity investment that the EBRD has undertaken: E125 million to purchase a 7.47 percent stake in Ceskoslovenska Obchodni Banka from the National Bank of Slovakia. Is there any new pattern?



A: The basic criteria has not changed; that is, the bank's core business remains the financing of projects that are financially sound, primarily in the private sector, that advance the transition, and complement rather than substitute for the private sector's financing. The strategy, though, has been strengthened in a number of ways, drawing on the Bank's experience as an investor in the region and our understanding of the transition—the forces which advance it and those which hold it back. As our recent enterprise survey on the business environment—conducted jointly with the World Bank and reported in the latest *Transition Report*—has revealed, the environment for businesses varies widely across both countries and different types of firms. New private businesses also face a more challenging business environment than do privatized and state-owned enterprises. At the same time, new private businesses have registered much stronger growth performance than have other types of firms. Recognizing both the importance of the new businesses and the major obstacles they face, the EBRD's new strategy places strong emphasis on the promotion of start-ups and the growth of small and medium–size enterprises (SMEs) through credit lines, microlending, equity and venture funds and through initiatives to improve the investment climate. The new strategy also maintains a strong emphasis on development of the financial sector and on expanding access to financial services, particularly by SMEs. Infrastructure operations will continue, and we will undertake—through a coordinated approach with the World Bank and other institutions—restructuring of potentially viable large enterprises. We take the social dimensions of our activity seriously, primarily by supporting SMEs, which are a major source of job creation, and—as in Bulgaria's case—helping to establish pension funds. To sum up, our portfolio became more diversified, our activities are more balanced, our operations more efficient—I look optimisticly toward the next 10 years of our operations and to the second decade of transition.

govern the economy has changed in different ways within each country. The least advanced transition economies have made the slowest progress in dismantling key aspects of the state's control over the economy and therefore continue to preserve much of the state control inherited from the previous system. Firms in these countries do not see the state as a major obstacle, since it continues to perform many of the functions that it carried out under the old regime in an economy that still bears a strong resemblance to the previous system.

In contrast, countries that have introduced partial reforms have begun the process of dismantling the state's capacity to govern the economy according to the requirements of the command system—this without developing the new institutions on which market-based governance could be established. In this setting, firms might see the state as unable to provide the services it once did and incapable of meeting the demands of the emerging market economy.

- **Governance and state capture.** An important factor in explaining differences across countries in the quality of governance is the extent to which powerful vested interests in the economy "capture" or unduly influence the state by providing private benefits to politicians. High-capture states tend to focus on providing specific advantages to influential firms and lobbies.

Russia's governance problems, for example, are often blamed on the so-called oligarchs, who urge the state to grant them a range of special privileges and exemptions that undermine market-oriented institutions at a high cost to the rest of the economy.

Firms were asked to assess the impact on their business of the sale of parliamentary legislation and presidential decrees to private interests. The capacity of private individuals or firms to pay for government legislation or presidential decrees to suit their own interests is a very strong indication of the degree to which a state is subject to capture. The differences across the transition economies as well as the sheer extent of the problem in particular cases are striking. In Moldova, Russia, and Ukraine more than 40 percent of the firms surveyed feel a significant impact from the sale of government legislation. This share is nearly 60 percent in Azerbaijan. By contrast, fewer than 10 percent of firms in Slovenia and Uzbekistan report a similar impact.

In countries such as Azerbaijan, Bulgaria, Moldova, Russia, and Ukraine there appears a greater concentration of power over the state among key vested interests. In other countries, such as Estonia, a large proportion of firms report that they are able to influence government decisions, while a relatively small proportion claim that state capture significantly affects their business.

The reliance by certain firms on direct ties to individual government officials is likely to encourage bribery and corruption. These ties are less transparent and harder to monitor than institutional ties. They allow the focus to shift from the interests of broad sectors, regions, or groups to individual firms. In high-capture states, it is less likely that businesses will engage in collective action to urge the government to provide public services that could improve overall economic governance. Instead, lobbying is undertaken to address the particular interests of specific firms.

According to the enterprises in transition economies, high-capture states tend to tax and regulate more heavily, extract more bribes, mismanage the macroeconomic environment, and prove less effective at preserving law and order. The survey shows that greater capture of the state by vested interests has a powerfully negative impact on the quality of governance in transition economies.

- **Governance and privatization.** The effects of privatization on the quality of governance differ sharply according to the degree of state capture. Privatization is associated with improved governance in countries where the state has been less subject to undue influence through capture by vested interests. However, privatization in high-capture states is associated with a lower quality of governance.

In countries where the state is prone to undue influence by powerful vested interests, the effectiveness of reforms in improving governance and securing property rights has been diluted. Alternatively, such reforms could be blocked by vested interests—those who profit from the market distortions associated with partial economic reforms—with the capacity to influence government policymaking.

- **The relationship between the state and the firm.** Progress in economic reform has not been synonymous with the elimination of state intervention in enterprise decisionmaking. States and firms continue to be tied together in a web of interactions in which the state provides a wide range of direct and indirect subsidies to firms, while firms provide public officials with some combination of control over company decisions and bribes.

State intervention is most common in pricing, with 36 percent of firms reporting some degree of intervention. In some countries, the level of reported price intervention is extremely high: Belarus (88 percent), the Slovak Republic (64 percent), Moldova (54 percent), and Ukraine (44 percent). On investment, sales, and wages, about 25 percent of all firms report some state intervention.

The small share of firms reporting state intervention in employment—just 16 percent—is rather surprising given the state's commitment to full employment under communism. Although much reduced, state intervention in company decisions is still a prominent feature of transition economies. In Hungary, the Slovak Republic, and Slovenia, for example, there are higher reported levels of intervention in employment and wages than in some of the less advanced economies. States in less ad-

Table 2. The frequency and extent of the bribe tax

Country	*Percentage of firms bribing frequently or more*[a]	*Average bribe tax as a percentage of annual firm revenues*[b]
Azerbaijan	59.3	6.6
Romania	50.9	4.0
Uzbekistan	46.6	5.7
Armenia	40.3	6.8
Georgia	36.8	8.1
Ukraine	35.3	6.5
Slovakia	34.6	3.7
Moldova	33.3	6.1
Poland	32.7	2.5
Hungary	31.3	3.5
Russia	29.2	4.1
Kyrgyz Rep.	26.9	5.5
Czech Rep.	26.3	4.5
Bulgaria	23.9	3.5
Kazakhstan	23.7	4.7
Lithuania	23.2	4.2
Croatia	17.7	2.1
Belarus	14.2	3.1
Estonia	12.9	2.8
Slovenia	7.7	3.4

Source: Business Environment and Enterprise Performancy Survey.

a. Firms were asked to what extent the following statement is true: "It is common for firms in my line of business to pay some irregular 'unofficial payments' to get things done." Response categories comprised: Always, Mostly, Frequently, Sometimes, Seldom, and Never.

b. Firms were asked what percentage of annual revenues "firms like yours" make in irregular 'unofficial payments' to public officials.

vanced countries tend to focus on intervention in prices and sales, with minimal intervention in employment. While the advanced economies appear to intervene to support the workforce, the less advanced countries are more likely to intervene in enterprises' decisions as a tool for macroeconomic management, as they did under central planning.

Time Tax and Bribe Tax

The level of state intervention in company decisions, although vastly reduced from the era of central planning, still places substantial demands on the time of senior managers. In Kazakhstan, Moldova, and Ukraine more than 14 percent of management time is spent with officials, while this figure drops to under 6 percent in Azerbaijan, Bulgaria, Croatia, the Czech Republic, and Slovenia.

In addition to time spent with officials and state intervention in company decisions, firms also pay direct private benefits to public officials in the form of bribes. These may be paid for a variety of purposes, such as to obtain public services, avoid or alter existing regulations and taxes, gain government contracts, obtain subsidies or other state financing, win influence, and appease "predatory" officials. Firms can consider bribes as a cost to be paid for obtaining advantages or preferences from government or as an unofficial tax on their business due to weaknesses in the system of governance.

Firms in the region pay an average bribe tax that ranges from a low of 2 percent of annual revenues in Croatia to a high of 8 percent in Georgia. When added to what is already considered by firms to be an extremely high level of official taxation, the bribe tax imposes a severe burden on enterprises in the region.

The average bribe tax in the CIS countries—5.7 percent of revenues—is almost twice the level reported in Central and Eastern Europe—3.3 percent of revenues. Within the CIS, firms in the Caucasus countries consistently report the highest rate of bribe tax, followed by Moldova and Ukraine. In Central Asia the level of bribe tax is somewhat lower, but the proportion of firms reporting that they pay bribes frequently is considerably higher in Uzbekistan than in other countries. Firms in Belarus and Russia report the lowest level of bribe tax in the CIS, but the frequency of bribe payments differs quite substantially.

In Central and Eastern Europe the bribe tax represents less than 3 percent of annual revenues in a number of countries, such as Croatia, Estonia, and Poland. Fewer than 20 percent of the firms in these countries report paying bribes frequently. Firms in Bulgaria, the Czech Republic, Lithuania, and Romania report a similar rate of bribe tax, but there are sharp differences in the frequency of bribe payments.

Bribery in the transition economies constitutes an extremely regressive tax. While large firms report an average bribe tax of 2.8 percent of annual revenues, the average bribes for small firms are nearly double at 5.4 percent. There is also a major difference in the frequency of bribe payments. While 16 percent of large firms report paying bribes frequently, the proportion for small firms rises to 37 percent.

The regressive nature of the bribe tax is especially pronounced in a number of CIS countries. In Moldova, for example, small firms report paying an average bribe tax of nearly 9 percent of annual revenues, which is more than four times the level for large firms. Similarly, small firms in Armenia, Ukraine, and Uzbekistan report bribe levels nearing or exceeding 8 percent. In addition, the high frequency of bribe payments for small firms in these countries contributes to the extremely high level of senior management time spent dealing with government officials. In Ukrainian small firms, for example, this reaches up to 18 percent of management time. For small firms, in particular, the combination of the bribe tax and the time tax has had a severe impact on the development of new private sector companies, targeting the most dynamic sector in the economy.

Private sector firms pay a larger share of their revenues in bribes than state companies, yet this result is due primarily to the higher bribe tax for new entrants—5.1 percent.

Benefits to the Firm

Do firms receive any specific benefits—that is, beyond the provision of standard public goods? Such benefits could take a number of forms, including direct subsidies, implicit subsidies (for example, tolerance of tax arrears and arrears to state-owned utilities), special exemptions from state regulations, and preferences in the award of state contracts. As many of these benefits are nontransparent by nature, they cannot be easily measured and compared across countries and firms. However, the survey provides an opportunity to examine two types of benefits, namely direct subsidies and implicit subsidies from the state in the form of arrears.

In the large majority of transition economies, fewer than 15 percent of firms report receiving state subsidies. In Armenia, Bulgaria, Georgia, Kazakhstan, the Kyrgyz Republic, and Ukraine firms are primarily supported by means of implicit, rather than direct, subsidies. In Belarus, the Czech Republic, Hungary, and Uzbekistan firms are primarily supported through direct subsidies, while the level of arrears has been contained.

State-owned firms continue to allow the state substantial control over company decisions and pay moderate levels of bribes to state officials, while receiving benefits from the state mainly in the form of direct subsidies. In privatized firms state intervention has been substantially reduced, but the level of bribes remains at least as high as—if not higher than—the level in state-owned firms. The flow of benefits from the state to privatized firms has not ceased, but has changed forms, with a greater reliance on implicit, as opposed to direct, subsidies.

Survey Shows . . .

A decade of transition has transformed the interaction between the state and enterprises in the countries of Central and Eastern Europe and the CIS. The state no longer uses plans and commands to direct firms, but the links between the state and firms remain close. The survey data show that firms both incur costs and receive benefits from this relationship. On the cost side, government officials intervene in a variety of company decisions, extract bribes from firms, and impose significant demands on the time of senior managers. At the same time, firms remain dependent on the state for a range of benefits, including direct investment, tax and utility arrears, and influence over regulation and policymaking.

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Croatia Confronts Vicious Circle of Economic Decline

by Marinko Skare

Soon a new center-left government will take the helm in Croatia, following national elections that brought victory to the opposition parties. Barring any last minute surprises, Croatia's new premier will be Ivica Racan. Racan was leader of the Social Democratic Party (the old Communist Party) that lost the elections in 1990, and then embraced social democratic values. Together with the Social Liberals the new leadership plans to lead Croatia in a new direction—embracing the market economy, bringing the country closer to the European Union, boosting employment, and improving living standards. But first the burdensome legacy of the last decade will need to be cast off.

The Wrong Choice

At the start of the transition some 10 years ago, socialist countries had a choice among several macroeconomic policies, including shock therapy and gradual stabilization. Croatia chose shock therapy. As it turns out, this was the wrong choice. Shock therapy for Croatia did not mean "recession today for the sake of growth tomorrow"; it meant "recession today for the sake of recession tomorrow."

In October 1993 Croatia launched a stabilization program with the primary goal of defeating inflation. This program was based on applying a nominal exchange rate anchor—Croatia's currency, the kuna, was linked to the deutschemark—and wage, price, and interest rate anchors. By January 1994 Croatia's annual inflation rate dropped while the kuna appreciated. In 1995 GDP growth reached 6.8 percent, a rate that continued until 1998. During this period, the annual inflation rate stabilized around 3 percent.

Adverse consequences of the stabilization program soon surfaced, however. Unemployment rose gradually until it reached the present level of 20 percent. Output decline since 1990 has been only partially responsible for this high jobless rate. A more important factor has been the privatization of state enterprises. Not that these enterprises became streamlined and laid off excess workers; rather, the new owners were generally more interested in stripping assets and making quick profits than in engaging in long-term business development. The result has been massive layoffs.

The balance of payments deteriorated, in part as a result of the worsening trade bal-

ance. Croatian enterprises could not make up for huge export losses suffered in the early 1990s. Appreciation of the kuna undermined the competitive position of Croatian exporters. Foreign sales have been on the decline since 1994, with exports dropping 10 percent in 1999, despite the weakening of the kuna since the end of 1998. The Kosovo war also set back tourism—a major currency earner for Croatia.

National savings gradually shrank, and net investments declined. Introduction of the value-added tax in 1998 brought temporary respite, but the tax burden remained excessively high. The heavy tax burden on enterprises leaves no room for private or public investment. The outcome has been declining output and increasing indebtedness. To maintain the value of the kuna, the National Bank stuck to its restrictive monetary policy, keeping real interest rates high. Domestic and foreign debt reached 51 percent of GDP.

Burden of Bad Loans

Because many laws and regulations were not implemented or enforced, a culture of nonpayment prevailed in Croatia. Insolvency of the state spread to enterprises. By 1999 total arrears reached $3 billion. With many borrowers unable to repay debts in time, the volume of bad loans increased. Fiscal discipline was abandoned. Banks, already struggling with bad debt, were forced to aid enterprises. Bad debts reached 11.1 percent of banks' total assets in 1997. In 1999 nine banks, with 8 percent of Croatia's total bank assets, declared bankruptcy. Public investments, after dropping 7.5 percent between 1995 and 1997, were cut another 25 percent in 1999.

Enterprises complained that policies changed frequently, unexpectedly, and sometimes even retroactively. They also complained that uncertainty surrounded official announcements, information was scarce, the business community was excluded from the drafting of rules and regulations affecting business decisions, property rights were uncertain, payments for sales or services were often denied, theft and crime were pervasive, and the judicial system was unreliable.

Economists expect the slowdown of the Croatian economy to continue in 2000, with growth rate estimates ranging from 0.9 percent to a decline of 2.5 percent, similar to the trend in 1999. The $9.2 billion foreign debt will likely increase. Payments of the loans' principal due in 2000 will consume 5 percent of GDP. The exchange rate, now at 7.5 kuna to the dollar, may depreciate further in 2000. Many economists predict that the balance of payments will worsen, foreign exchange reserves may decrease, and, as a result of contraction in the money supply, interest rates may increase in the coming year.

Entering a New Course

More bank failures and higher unemployment, at least in short term, are predicted for the Croatian economy. Cuts in state expenditures, which have reached 75 to 80 percent of GDP, could aggravate already serious social conditions, and the 25 percent poverty rate—mainly among pensioners—is likely to rise further.

The expectation that a stabilization program without consistent structural reforms could lead to economic revival and successful transition to a market economy proved wrong. As long as Croatia postponed consistent structural reforms it also postponed economic growth. In a macroeconomic environment that neglected the growth-driven sectors and discouraged investments and savings, recession was all but inevitable. With the new course being set for Croatia's economic policy, this chain seems at last to be broken.

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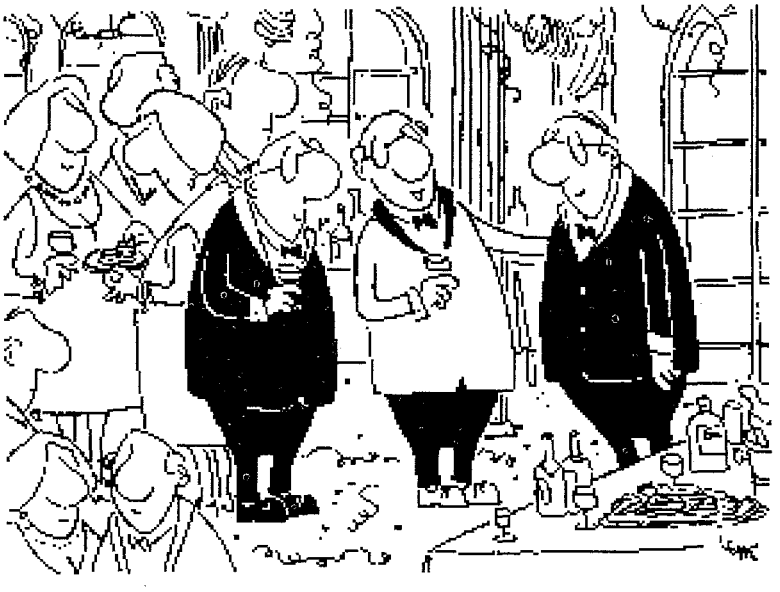
The New Elite



"May I introduce one of the most talented entrepreneurs of our country, he declares a monthly income of three cents!"

From the Hungarian daily *Népszabdság*.

Russian Crisis Hits the Baltics Harder than Expected

by Iikka Korhonen

The Baltic countries—Estonia, Latvia, and Lithuania—have been the most successful among countries of the former Soviet Union in managing their economies. Although the economic slump at the beginning of transition was profound, the Baltic countries swiftly achieved positive growth. They were also fastest in stabilizing their economies. They brought inflation under control following currency reform, and did not allow budget deficits to balloon out of control. They also tackled structural reforms early on. In many respects, the Baltics have already caught up with the more advanced transition economies in Central Europe.

All three Baltic countries have posted impressive growth figures since the mid-1990s. Indeed, in 1997, experts started to worry about economic overheating—especially in Estonia, where GDP growth reached 10.6 percent. The Baltic countries chose fixed exchange rates, so the necessary tightening of economic policy was accomplished solely through fiscal means. As a result, in Estonia growth slowed even before the Russian crisis.

Exposed Banks Suffer

When the Russian crisis erupted in August 1998, many commentators hoped that the effects would be short-lived—at least in the neighboring countries. Although the Baltic countries had extensive trade ties with Russia (see table), there was hope that some exports could be reoriented to other markets fairly quickly. It has since become clear that sidestepping the effects of the Russian crisis was impossible.

The crisis intruded on the Baltics through financial markets and the banking system. While banks in Estonia and Lithuania invested relatively little in Russia and other Commonwealth of Independent States (CIS) markets (with only about 1 percent of their total assets invested in Russia before the crisis), Latvian banks with traditionally close ties to Russian companies became heavily exposed (having invested about 8 percent of their total assets in Russia). Many Latvian banks couldn't resist the high interest rate offered to buyers of Russia's short-term treasury bills (GKOs). Russia's decision to halt debt servicing

BOFIT—Finland's Research Institute Monitors Transition Issues

The Bank of Finland's Institute for Economies in Transition (BOFIT), based in Helsinki, is involved in academic research and the monitoring and analysis of developments in transition economies. Its activities focus on countries geographically close to Finland—Russia and the Baltic states of Estonia, Latvia, and Lithuania. However, given the growing significance of China in the world economy, it recently began monitoring China as well.

During its eight years of operation, BOFIT has established itself as Finland's leading institute of transition studies. Because of its focus on the Russian and Baltic economies, BOFIT has also found a valuable niche in the international research community. The institute has created a wide network of contacts with academic institutions and government bodies in transition economies and in developed countries. Every year specialists from abroad are invited to work at BOFIT under BOFIT's Visiting Researcher Program. Contracts typically cover a fixed period, usually several months to a year.

BOFIT has a permanent staff of 15—10 of whom are economists—and operates under the auspices of the Bank of Finland (Finland's central bank). Functioning as a department of the central bank confers many benefits. Researchers have access to the bank's extensive international connections, a wide range of data sources, and the support of considerable economic expertise.

BOFIT has a range of print and online publications, mostly in English. *Russian and Baltic Economies—The Week in Review* is an online review of recent events. *Russian Economy—The Month in Review* contains monthly analysis of macroeconomic developments, fiscal policy, and financial markets in Russia. *Baltic Economies—The Quarter in Review* analyzes recent economic developments in Estonia, Latvia, and Lithuania.

BOFIT Discussion Papers are academic studies by BOFIT economists and visiting researchers directed toward more specialized audiences such as policymakers. BOFIT Online is an electronic publications series with a focus on more descriptive work on transition economies. All publications can be downloaded free of charge from BOFIT's Web site, or received through email subscriptions. Most publications are also available in hard copy. Series subscriptions are free, including delivery by surface mail.

More information on BOFIT can be found on its Web site at www.bof.fi/bofit/. Mailing address: BOFIT, Bank of Finland, P.O. Box 160, FIN-00101 Helsinki, Finland, tel: 3589-183-2268, fax: 3589-183-2294.

Exports of Baltic Countries in the First Seven Months of 1998 and 1999

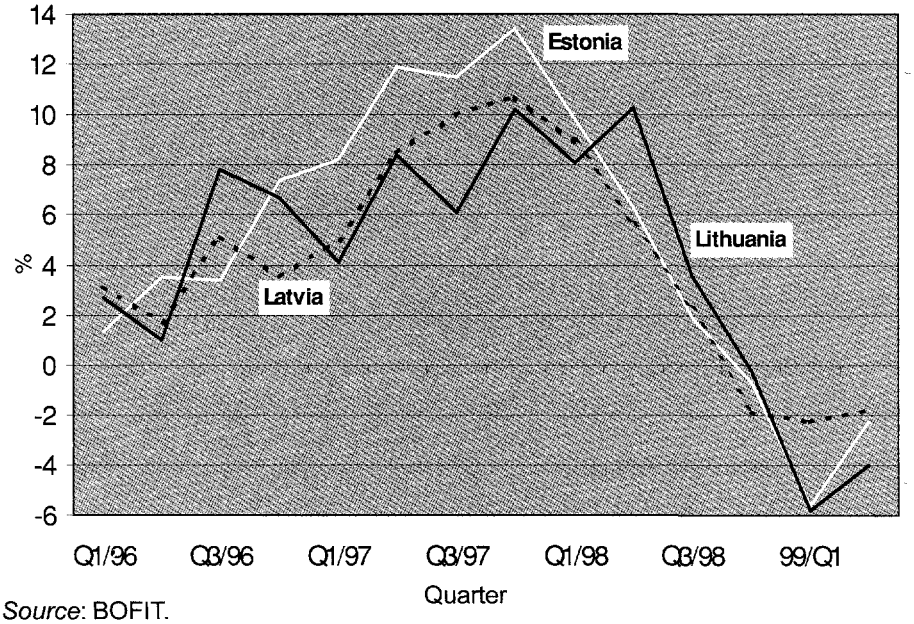
	January–July 1998		January–July 1999		% change in the value of exports (local currency)
	Value (millions of $)	% of all exports	Value (millions of $)	% of all exports	
Estonia					
Exports to Russia	288	15.0	142	9.0	-45.4
Exports to entire CIS	447	23.2	217	13.8	-46.1
Exports to EU	1,000	52.0	973	61.8	8.0
Total exports	1,927	100.0	1,575	100.0	-9.2
Latvia					
Exports to Russia	168	15.3	67	7.0	-60.0
Exports to entire CIS	249	22.6	110	11.3	-55.8
Exports to EU	578	52.7	616	63.6	6.6
Total exports	1,097	100.0	968	100.0	-11.8
Lithuania					
Exports to Russia	419	21.4	121	6.9	-71.1
Exports to entire CIS	850	43.4	324	18.5	-61.9
Exports to EU	661	33.7	873	49.9	32.1
Total exports	1,957	100.0	1,750	100.0	-23.8

Source: BOFIT.

delivered a heavy blow. The Bank of Latvia was forced to close a relatively small commercial bank. Rigas Komercbanka, Latvia's fourth largest bank, experienced a run on its deposits, but managed to keep its doors open; eventually, however, it was shut down, recapitalized, and reopened.

In Baltic interbank markets, interest rates rose after the crisis, but returned fairly quickly to lower levels. In equity markets, the effects were more subdued. The Baltic markets had been on a downward trend for some time—a trend that continued after the crisis.

GDP ups and downs in the Baltics from 1996 to mid-1999



Source: BOFIT.

Sales to CIS Countries Down

Significant depreciation of the ruble had severely damaged the competitive position of the Baltic companies selling on the Russian market. Exports to Russia and other CIS countries, also affected by the crisis, plummeted drastically in the first seven months of 1999 compared with the first seven months of 1998, before the crisis (see table). True, the Baltics have reoriented some of their exports to other markets, especially the European Union. However, reorienting trade has been quite difficult, especially in the food industry, where most major bankruptcy cases associated with the Russian crisis have occurred.

As Baltic exports to CIS markets slumped and interest rates rose, domestic production also suffered. In all three Baltic countries, GDP declined in the last quarter of 1998, and this trend continued in the first half of 1999. Falling production also led to higher unemployment. The registered unemployment rate rose several percentage points in the year following the crisis, and it now stands at about 5 percent in Estonia, 10 percent in Latvia, and 8 percent in Lithuania. These figures, however, tend to underreport actual unemployment.

Recent production statistics suggest that the worst is over in Estonia and Latvia. Both economies appear to have bottomed out and growth returned in the second half of 1999. In the face of widening public sector deficits, both countries successfully cut budget expenditures, seem to have stabilized their economies, and are meeting the expectations of private investors. Interest rates have come down. Public sector deficits, high in 1999, are forecast to fall in 2000.

These prospects have calmed the financial markets. Still, Latvia's current account deficit remains exceptionally high—rising to 9.1 percent of GDP in the first half of 1999. If domestic demand expands, that deficit may widen further. If the external situation deteriorates, authorities should stand ready to tighten fiscal policy.

Lithuania's Disadvantages

Lithuania's situation is less promising. Before the Russian crisis, the CIS market represented a higher share of Lithuania's total exports than for the other Baltic states. Thus Lithuania's manufacturing sector became highly vulnerable. When the crisis occurred, Lithuanian authorities tried to cushion the blow by loosening fiscal policy. Companies relying on CIS export markets received state subsidies. As a consequence, in 1998 the consolidated fiscal deficit had already shot up to 6 percent of GDP.

In 1999 a loose fiscal policy continued. Political uncertainties hampered adoption of a consistent set of policies to counter the effects of the crisis. Speculations about the fate of the litas intensified, and interest rates remained very high. At present, inflation is below 2 percent, and three-month interbank rates are more than 20 percent. These high real interest rates will slow the recovery of the private sector and make public sector borrowing more expensive. The inability to agree on policies has postponed a stand-by agreement with the IMF, but a preliminary understanding has been signed.

Lithuania is now on its third government in less than a year. The new government gives Lithuania another chance to conduct consistent policies. The Bank of Lithuania recently announced that the current exchange rate regime will not last beyond 2001. Its new plan would eliminate the currency board and increase the powers of the central bank, as well as abolish the litas-dollar peg. The litas would instead be pegged to the euro at the rate prevailing for the dollar and the euro on the day of the changeover. So the government's scope for maneuvering could widen. But the public expects clear signals about the government's fiscal policy stance and continuation of the structural reforms. The EU Commission recently raised this issue in its progress report on Lithuania.

Iikka Korhonen is an economist at the Bank of Finland's Institute for Economies in Transition (BOFIT).

Milestones of Transition

OECD

Tough rules for multinationals. Multinational companies face tough new restrictions on their international activities under a draft code of conduct drawn up by the 29-nation Organisation for Economic Co-operation and Development (OECD). In the most far-reaching review of OECD guidelines on multinationals for a quarter of a century, officials are proposing new standards on corporate governance, workplace conditions, environmental safeguards, bribery, and protection for whistleblowers. The rules are not legally binding; however, OECD governments are expected to promote compliance. The guidelines are scheduled to be approved by an OECD ministerial meeting in June.

European Union

Farm subsidies from CAP. The EU's 15 members have made no financial provision for giving direct payments to farmers in accession countries, although budgets have been prepared until 2007. The common agricultural policy (CAP) costs 41 billion euros ($41 billion) a year, taking up about half the EU's budget. Applying the full benefits of the CAP to the six potential new entrants—Cyprus, the Czech Republic, Estonia, Hungary, Poland, and Slovenia, all of which have agricultural sectors larger than the EU average—would add about 6 billion euros to the annual budget, according to Jorge Nunez, agricultural analyst at the Centre for European Policy Studies. Since most of the accession countries would be net beneficiaries of the EU budget, more than 80 percent of the extra cost would need to be borne by existing members.

All six candidate countries submitted position papers rejecting long transition periods and pressing for payment of the full range of subsidies to their farmers. Formal entry for the six front-runners seems feasible in 2004–05. However, the EU must decide how the six, which could soon be joined by members of another group of six mainly East European nations, will fit into the common agricultural policy.

Central and Eastern Europe

Bosnia-Herzegovina

Associated Press reports that total foreign assistance to Bosnia-Herzegovina could be cut to half the current levels. After the 1995 Dayton agreement the United States and other major powers agreed to provide $5.1 billion over four years to rebuild Bosnia-Herzegovina, encourage foreign investment, and set the country on its way to a sustainable market economy. The last installment of $1.05 billion was approved in May at a donors' conference in Brussels. Rampant corruption and communist-style bureaucracies have discouraged foreign investment. Of the roughly $2 billion that flowed into the country between 1996 and 1998, only 2.3 percent was private funds, invested in the manufacturing sector, according to the office of Bosnia's top international overseer, Wolfgang Petritsch. Unemployment in the Muslim and Croat part of the country stands at about 70 percent—and is believed to be even higher in the Serb-ruled area.

Czech Republic

The financial sector suffers from lax legislation, says National Bank Governor Josef Tosovsky. Before the Czech Republic can join the European Union it has to address the acute necessity of changing the legal environment, Tosovsky said at a banking conference in Prague. International institutions, including the European Commission and the World Bank, are correct in criticizing Czech laws that enable debtors to avoid their obligations.

Continued on page 36

Overcoming the Obstacles to China's Infrastructure Development

by Chi Fulin

Investment in public utilities and infrastructure should go hand in hand with accelerated market-oriented reforms to strengthen the efficiency and competitiveness of China's infrastructure development.

Other international experience has shown that well-functioning public utilities and infrastructure enhance productivity, lower production costs, and improve quality of life. A solid infrastructure is critical to China's economic growth. Since the 1980s public utilities and infrastructure worldwide have undergone rapid development, with vertically integrated and state-owned public utilities being privatized and industries such as telecommunications, civil aviation, railways, power generation, and water utilities opened up to the global market. Since these sectors involve mostly technology- and capital-intensive industries, multinational corporations play an important role in their development, and international competition is even more intense than in other industries.

Top Priority Sectors

In China service sectors such as transport, telecommunications, finance, insurance, education, and technology are relatively underdeveloped and their share in GDP remains low. Due to long-standing underinvestment, China's public utilities and infrastructure have become bottlenecks, constraining the sustained and rapid development of the economy and the efficient allocation of resources. The sluggish performance of the transport and telecommunications sectors calls for wide-ranging reforms. In the coming years, service industries must be involved if China wants to continue its high-speed economic development. These industries should be equipped with the necessary technology, hardware, capital, and human resources to advance rapidly. Rapid development of the information infrastructure should be a top priority for the coming knowledge economy.

In 1998 China's government launched a three-year national program to invest several billion dollars in public utilities and infrastructure, mainly from budgetary resources. Using bond issues and bank loans, the government poured about $26.5 billion into the economy—soon to be followed by another $24 billion in bonds for infrastructure projects. But most infrastructure investment clearly should come from enterprises and the public. So far the government has failed to invigorate social investments, and—despite large capacity increases in electricity, transport, and telecommunications—supply has just kept pace with the growing needs of industrial and residential consumers, while water resources and urban infrastructure still fall short of demand.

According to experts, the old-style management and operation of public utilities and infrastructure are not up to the task, partly because of the inefficiency of centrally managed infrastructure investment. Despite strong government control, many investments ended up in duplicate constructions or oversized prestige projects. Investment in public utilities and infrastructure should thus work with accelerated market-oriented reforms to strengthen the efficiency and competitiveness of China's infrastructure development.

China's entry into the World Trade Organization will undoubtedly expose its public utility and infrastructure companies to tough competition from foreign companies. Monopoly holdings should be dissolved and opened up to private capital investment. This requires market-oriented reform of finance, corporate governance, and the regulatory system.

Major Reform Steps

- **Attracting private capital.** Encouraging private capital investment—both domestic and foreign—in public utilities and infrastructure is all the more important because deflation is still present in the Chinese economy. This deflation is demonstrated by smaller returns on investments, increased savings (higher joblessness continues to fuel an already high personal savings rate—equaling 40 percent of income), accumulation of unsold goods, and a steady drop in commodity prices. The economy grew by 7.8 percent in 1998 and by 7.1 percent in 1999, a pace China intends to maintain in 2000.

In the first nine months of 1999, the retail price index fell by 3 percent year-on-year. In 1999 total fixed asset investment dropped to 2,200 billion renminbi ($275 billion), down from 2,845 billion renminbi in 1998. In the first eight months of 1999, actual inflows of foreign direct investment fell by 6.8 percent year-on-year to $29.2 billion. The government's efforts to counter these trends and stimulate economic growth through an expansionary monetary policy and increased budgetary spending will have limited success unless investments are mobilized from diverse sources.

Private Sector Is Embraced in China

On January 4, 2000 China's State Development Planning Commission announced that private enterprises would be put on equal footing with state-owned enterprises. Commission Chairman Zeng Peiyan acknowledged that China's economy faces problems that need urgent solutions. Zeng said the government would actively guide and encourage private investment and would eliminate all restrictive and discriminatory regulations—relating to taxes, land use, business start-up, and imports and exports—that are unfriendly toward private investment and private economic development. In stock listings private enterprise should enjoy equal opportunity with state-owned enterprises. All areas should be opened to private capital investment except those related to national security and others that must be controlled by the state. In 1999 China's parliament changed the constitution to elevate the private sector to an "important component" of the economy.

Currently, private companies face numerous obstacles that stymie their development. Lack of access to capital—through bank loans or public stock offerings—has long been a major problem. State banks remain wary of lending to nonstate companies. Only a handful of some 950 listed companies in China are privately held. Private businesspeople are often forced to pay bribes to obtain operating licenses.

In China 1.49 million "private firms"—defined as employers with at least eight people—employ 19 million people. Another 31.6 million "individual traders"—firms that employ less than eight people—employ 83.3 million people. Some economists estimate that private firms and collectives account for about two-thirds of China's annual GDP.

In 1999 China's state-owned firms accounted for 70 percent of the new investment and more than 70 percent of state bank lending. State-owned firms employ 56 percent of the labor force, but last year they accounted for less than 40 percent of industrial output. Economic statistics show that by the mid-1990s more than half the economic output came from the nonstate sector.

Fifty million new workers enter China's labor force annually. The state-run sector contracts at least three million workers a year, while private firms absorbed 1.36 million workers that were laid off by state firms in the first 11 months of 1999, as reported by *Economic Daily* on January 5.

- **Making funding transparent.** Infrastructure development should be funded mainly by direct financing rather than by state grants. This practice leaves more resources in the budget, utilizing idle social capital and enhancing investment efficiency. For larger investments, public utilities and infrastructure companies—either individually or as a group—should raise money in capital markets, combining capital, technology, and human resources. Companies can also join forces to become more competitive in global markets through mergers and changes in ownership, or by cooperating with multinationals to adapt technologies and management methods. Foreign capital should continue to play an important role in the development of public utilities and infrastructure.

- **Stimulating competition.** Not all public utilities or infrastructure sectors are sluggish natural monopolies; many have the potential to be competitive and commercial operations. There is increased demand for deregulating some industries previously considered natural monopolies. Open competition can exist, even in sectors that seem to be dominated by natural monopolies. For example, while electric power generation might belong to a single regional, state-owned company, distribution could be up for grabs among competing firms. But public tendering among the competitors should be conducted in an open, fair, and honest manner. The state should gradually withdraw from these competitive sectors to focus on infrastructure development affecting public welfare.

- **Separating state and enterprise.** Reform of the state administration lags behind the economy's progress toward a market orientation. Changing the government's role and separating the state from enterprises should be the core reform of China's public utilities and infrastructure. Only the enterprises that are free from state control are real players in a competitive market in which property rights are clearly defined. Most public utility companies and other state-owned firms in the infrastructure sector should be transformed into joint stock companies. The potential profits in transport, telecommunications, and energy should accelerate this transformation. The state can rid itself of shares through auctions, mergers, or leasing.

- **Regulating power.** In those infrastructure sectors where market mechanisms are at play, the government should promote competition and ensure that small enterprises are on equal footing with large enterprises. In sectors still dominated by natural monopolies, the government should negotiate with enterprises and consumers to draft rules regulating market entry, prices, and services. This process would prevent the abuse of monopolistic power for unduly high profits, thus protecting the rights and interests of the consumers.

Chi Fulin is executive director of the Haikou-based China Institute for Reform and Development (CIRD) in Hainan Province. This article is based on his presentation at a recent international conference, organized by CIRD, on infrastructure and public utilities.

How Gradual Was China's Agricultural Reform?

Initial Conditions, Reform Policies, and Performance

by Karen Macours and Johan F. M. Swinnen

The debate on the comparative virtues of gradual and radical reforms has once again heated up. In the newest debate, China is usually held up as an example of gradual reforms that resulted in few disruptions and in extraordinary economic growth.

We have analyzed the relative importance for transition performance of initial conditions and reform policies, focusing on output and productivity change in agriculture only. This approach reduces the danger of "comparing apples to oranges." At the start of the reforms, agriculture accounted for 70 percent of total employment in China, but less than 15 percent in Russia and several Central and Eastern European countries. Obviously this huge difference may affect the outcome, especially if the specific characteristics of (socialist) agriculture affect the sector's response. For example, the shift from large-scale collective production organizations to individual, small-scale production typically has been stronger in agriculture than in other sectors.

While the transition economies showed a variety of adjustments during transition, we can distinguish three "extreme" patterns in the first five years of transition in agriculture. The three patterns are summarized in figure 1.

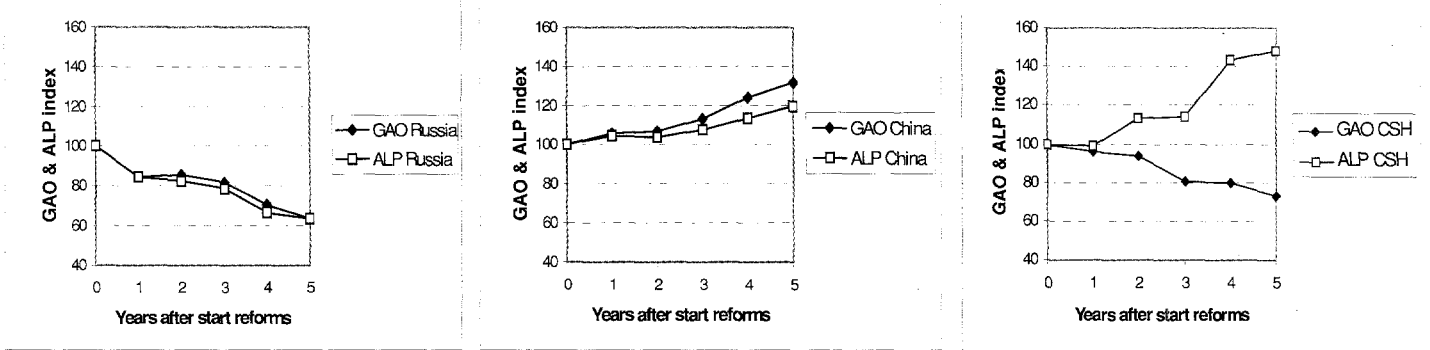
- **Pattern 1, Russia.** A strong decline in gross agricultural output coincides with a similarly strong decline in labor productivity. Russia, Belarus, and the Ukraine are typical examples of pattern I, but Azerbaijan, Kazakhstan, the Kyrgyz Republic, Moldova, and Tajikistan also fit this pattern.
- **Pattern 2, Central Europe.** A strong decline in gross agricultural output coincides with a strong increase in labor productivity. This is the pattern followed by the Czech Republic, Hungary, and the Slovak Republic.
- **Pattern 3, China.** A strong increase in gross agricultural output coincides with a slower increase in labor productivity. Examples of this pattern are China and Vietnam. Interestingly, Albania also fits into this pattern.

Comparing Transitions in Russia and Central Europe

Both Russia and Central Europe were characterized by pre-reform subsidies to agriculture, relatively low labor intensity on farms, and a small share of agriculture in the economy. But they differ in pre-reform land ownership and duration of central planning. In agriculture terms of trade show the relationship between prices for inputs (fertilizers and seeds, for instance) and output (product). Deterioration of terms of trade means that output prices cannot compensate for cost increases. In both Russia and Central Europe terms of trade declined in agriculture following price and trade liberalization, inducing a fall in output. In fact, during the first five years of transition, gross agricultural output increased only in those countries where relative prices increased (see figure 2). This is consistent with our earlier findings that 40 to 50 percent of the average decline in crop output in countries of Central and Eastern Europe was due to changes in terms of trade.

The choice and implementation of privatization, land reform, and overall liberalization policies differed substantially between Russia and Central Europe. In Central Europe strong individual land property rights were enforced, often through restitution to former owners. In contrast, in Russia and the Ukraine land ownership rights had been allocated as shares in the former collective and state farms. As a consequence, individual property rights and incentives for improvements in resource allocation and effective reorganization of the farms remained weak and limited.

Figure 1. Three patterns of transition



ALP: Agricultural labour productivity; GAO: Gross agricultural output; CSH: Czech Rep., Slovakia, and Hungary
Source: Macours and Swinnen 1999.

Further, the more extensive and radical liberalization of the general economy in Central Europe reduced obstacles to intersectoral labor mobility. In contrast, in Russia the low overall liberalization and lack of entrepreneurial skills after several generations of communist rule constrained labor mobility. Thus surplus labor has not left agriculture and is trapped in large-scale farms that continue to be dominated by old management styles. These differences are reinforced by a social security system that is weaker in Russia than in Central Europe, keeping labor in agriculture and on the former collective farms because of food and social security benefits.

As a result, the decline in agricultural output in Russia has been similar to that in the Czech Republic, Hungary, and the Slovak Republic under worsening terms of trade. But while productivity has fallen in Russia to the same extent as agricultural output, the three Central European countries have seen increases in productivity.

Comparing These Patterns to China's Agricultural Reform

The third pattern, followed by China and Vietnam, was characterized by growth in both labor productivity and gross agricultural output during transition. These countries started from a very labor-intensive agriculture, which was taxed. This explains why price and trade liberalization caused an improvement in the terms of trade.

Institutional reforms in China included the distribution of clear and strong land use rights to farm workers and rural households and a complete break-up of collective and state farms into individual farms. With high labor intensity, the shift to individual farming implied important efficiency gains from improved labor incentives and low costs of fragmentation. The shift to individual farming was also stimulated by the low income levels in these countries, where food security concerns played an important role. Radical and widespread decollectivization emerged—to some extent spontaneous following the crisis. The combination of these factors contributed to increases in both agricultural output and labor productivity. However, the food security concerns and the link between social benefits (such as housing) and economic sectors increased intersectoral (and rural-urban) mobility costs, contributing to the slower growth in labor productivity than in agricultural output.

It has been argued that institutional and organizational disruptions—inducing investment and output declines—have been more serious in Central Europe and Russia than in China, which applied a more gradual approach to market liberalization. While this seems true for some aspects, China's reform of property rights and its measures to restructure farm organizations were more radical than elsewhere, contributing to more, rather than fewer, disruptions. Our analysis suggests that key determinants of agricultural growth during the first years of transition have been initial conditions, radical land reform, and farm restructuring.

In conclusion, using the "Chinese miracle" as an argument for advocating gradual reforms in other transition economies may not be a good argument. China's reforms in agriculture, its dominant economic sector at the outset of the reforms, were more radical than in Russia, for example, in many aspects. Furthermore, we show that initial output growth in Chinese agriculture was strongly affected by price liberalization, which caused opposite effects in China compared to Russia and Central Europe, due to different initial conditions.

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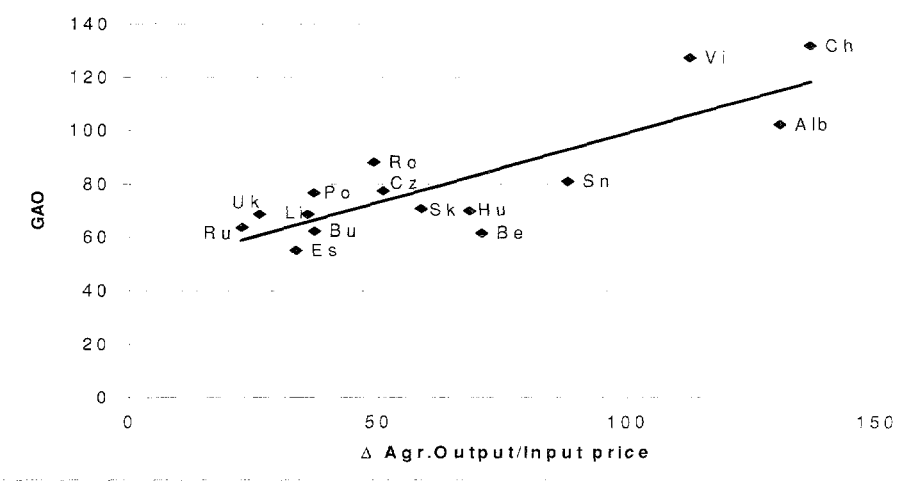
This article is based on the authors' paper, "Patterns of Agrarian Transition: A Comparison of Output and Labor Productivity Changes in East Asia, the Former Soviet Union, and Central and Eastern Europe," *PRG Working Paper, Katholieke Universiteit Leuven, 1999, http://www.agr.kuleuven.ac.be/aee/clo/prgwp.htm.*

Figure 2. Output and price changes after five years of reform in 15 transition Economies



Ru=Russia, Uk=Ukraine, Li=Lithuania, Po=Poland, Cz=Czech Rep., Ro=Romania, Vi=Vietnam, Ch=China, Es=Estonia, Bu=Bulgaria, Sk=Slovakia, Hu=Hungary, Be=Belarus, Sn=Slovenia, Alb=Albania. GAO=Gross agricultural output.
Source: Macours and Swinnen 1999.

The (Not So) Mysterious Resilience of Russia's Agricultural Collectives

by Maria Amelina

Anyone who examines Russian agricultural reform has to wonder at the institutional resilience of collective farms. Indeed, kolkhozi (collectives) and sovkhozi (state farms) of Soviet times—awkwardly renamed joint stock companies—continue to be the dominant agricultural producers. Now that they are owned largely by their employees, their profitability and efficiency are decreasing. Yet the number of collective farms still stood at 27,000 in 1997, the same as in 1994. They produce half the country's agricultural output, own more than 80 percent of agricultural land, and refuse to disappear (see table 1 and 2).

At the same time, the number of individual farms has remained surprisingly low. Eight years after the enactment of the first presidential decrees legalizing individual farming, the number of individual farms had actually decreased—from a peak of 280,000 in 1996 to 274,000 at the end of 1997. Individual farms produce just 2 percent of recorded agricultural output on 6 percent of agricultural land. The remaining 48 percent is produced on tiny private plots—averaging one-third of a hectare—by rural and urban workers for whom this is a part-time occupation or by pensioners for whom it supplements retirement benefits.

Ideological Remnants

To explain the puzzle of the longevity of collective farms, it is important to evaluate both the political and the economic benefits that different groups of stakeholders derive from the preservation of this institutional structure. The structure seems particularly appropriate for a post-Soviet setting. In Soviet times institutions were created to serve political and economic goals simultaneously: the role of collective farms was not only to produce agricultural output, but also to serve as an ideological showcase for the superiority of large-scale collective agriculture. Local governments not only provided the environment for the operation of economic entities and coordinated the distribution of agricultural inputs and outputs, they also oversaw the timely fulfillment of plans.

A close alliance between local governments and collective farm managers evolved because of their shared responsibilities. The goal of this informal association was to guarantee that collective farms within the jurisdiction of a particular administrator gained preferential access to scarce inputs—such as fuel, fertilizers, and seeds. The timely acquisition of these inputs from centralized sources and the fulfillment of output plans shaped the rules in the "battles for harvest," a term for harvesting and sowing under socialism.

Islands of the Command Economy

In the post-Soviet era, during which federal agricultural policies have been weakly implemented, the role of regional (oblast-level) government in fostering—or blocking—agricultural reform has become critical. Research in two Russian provinces reveals fundamental differences in the way oblast governments have influenced agricultural producers and, consequently, enterprise restructuring. In the Saratov oblast the regional government has pursued a more interventionist agricultural policy, while in the Leningrad oblast the administration has shifted to a more laissez-faire regulatory stance.

What made these two administrations act differently? More interesting, what allowed the interventionist government to succeed in the environment of liberalized prices and curtailed federal support?

The Saratov oblast is following the post-Soviet path. Politically, the oblast government depends heavily on rural votes and on personal and professional rural ties. All the key positions in the oblast administration, including the mayor of the city of Saratov, are held by former Soviet agricultural managers and administrators. The local administration, despite nationally liberalized prices, adheres to the earlier practice of central distribution of resources with the help of the commodity credits system. For example, the oblast government instructs oil refineries to deliver fuel to collective farms during the sowing period, in return for tax forgiveness. The collective enterprises are required to repay commodity credits to budgetary organizations after harvesting, either with food deliveries or in cash.

The oblast government is able to define the conditions of commodity credit repayment, besides deciding at what price the commodities should be delivered by the farms. The firmness of the repayment conditions depends on the priorities of the oblast administration for a particular year. If political imperatives of courting the village vote dominate the agenda, the repayments are not enforced. If, however, the government needs to generate more revenue, it forbids all other sales before the commodity credits are repaid.

Table 1. Collective enterprises: Main indicators

	1991	1994	1997
Number of collective producers (thousands)	26.9	26.9	27.0
Number of unprofitable collective enterprises (percentage of the total number of farms)	5	5	82
Share of agricultural production (percentage of national agricultural production)	68.8	54.5	49.9
Agricultural land use (percentage of total agricultural land)	91.2	82.8	80.4
Average size of land holdings per collective producer (hectares)	4,200	3,300	2,900

Source: Goskomstat, *Statistical Bulletin*, 8 (37), October 1997; Moscow. Sel'skoe Hoziaistvo v Rossii 1998, Moscow.

This elasticity of budget constraint is nothing new for collective farm managers. Familiar with the economic mood swings of their Soviet superiors, post-Soviet collective farm managers know how to adjust their behavior to these fluctuations. They do not have to adjust their skill in distribution to the new market realities, where success depends on generating profits. In other words, most collective farm managers can only perform their traditional social, political, and economic roles in an interventionist setting.

Interviews with collective farm managers in the Saratov oblast indicated that these farms serve as "guarantors of stability" in the countryside, as a safety net of last resort, and as input providers for the small private household plots of their employees. Collective farm managers also have to make sure that the farms produce enough to exchange for the inputs that will be needed to resume the production cycle the next season. Obviously, these goals are very different from the market imperative of profit maximization.

Shedding Light on Motivations

The employees of collective farms are also interested in the preservation of this association for a number of reasons. A household-level survey of the employee-shareholders of the collective farms in the Saratov oblast showed that their income is derived primarily from household plots and livestock production and, to a much lesser extent, from direct wage payments by the collective farm. Inputs for private agricultural production, however, as well as agricultural services, come predominantly in the form of official and unofficial payments derived from the collective farm. The low cost of inputs compared with their market price makes the employees prefer the limited and egalitarian access to resources from the ex-kolkhoz to the risk of independent farming.

The other side of the coin is that growth of private farming—facilitated by the supply of inputs from the collective farm—is severely constrained by the egalitarian nature of input distribution and low—close to subsistence—levels of inputs available from the system.

There is a different dynamic in the Leningrad oblast. This oblast is more industrial, with a larger share of GDP coming from nonagricultural production and a larger population living in urban areas. The local administrative elites of this oblast also come primarily from urban backgrounds, and consequently do not have the skills required for Soviet-style distribution of resources.

Further, in this oblast the budget constraint of the enterprises appears to be hardening much faster than in the Saratov oblast. Employees of collective farms derive their incomes primarily from cash wages paid in a direct and transparent manner. To be able to compensate their employees in cash rather than in kind, the collective enterprises sell their output in the market and generate the necessary revenue. This is in sharp contrast to the continuous operation of the barter circle observed in the Saratov oblast.

These divergent developments in oblast-level policies and their effect on the institutional evolution of collective farms have far-reaching implications:

- Post-Soviet hierarchical structures crowd out other potential players from the agricultural market. In the Saratov oblast, for example, the number of individual farmers is decreasing despite the favorable natural endowments (such as rich black soil) and a good legal framework for land transactions, while in the agriculturally poorly endowed Leningrad oblast the number of individual farmers is growing.
- Shedding light on economic and political motivations within this hierarchical structure helps clear up some misunderstanding. For example, to explain the en-

Table 2: Individual farms and private plots: Main indicators

	1991	1994	1996	1997
Share of agricultural production (percentage of total)	—	1.7	1.9	2.2
Agricultural land use (percentage of total)	0.6	4.8	5.2	5.7
Average size of land plots (hectares)	—	42	43	44
Number of producers (thousands)	4.4	270	280	274

Source: Goskomstat, *Statistical Bulletin*, (37), October 1997; Sel'skoe Hoziaistvo v Rossii 1998, Moscow.
Note: In 1993 some privately held plots were reclassified as plots for individual construction, which led to the decrease in the total number of plots in this category.

durance of the kolkhoz system and the slow change in the Russian countryside, some students of Russian agricultural reform argue that the rural population is old and aging, unable to embrace reform. This sort of interpretation seems to liberate policymakers from the burden of seeking new approaches to reform: even in the medium term there is very little one can do about demographic trends.

The intuitive approach—and the one likely to yield the largest return—is to support agricultural reform in those regions that are agriculturally better endowed. However, it appears to be more effective to concentrate the restructuring effort on those regions where the reform process has taken better root—where local governments have disengaged themselves from agricultural production and where agricultural producers operate under uniform rules. Foreign assistance to agricultural reform in Russia has to take into account the diverse patterns of restructuring as well as the intricate and, in part, hidden web of benefits that secures the longevity of the kolkhoz system.

Maria Amelina is an economist in the Development Economics Research Group at the World Bank. Her findings are based on a survey conducted between January and March of 1999, in **181 Households of the Leningrad and Saratov Oblasts**. *This article is based on her paper "Why Is the Russian Peasant a Kolkhoznik Still?" The author can be reached by email: Ma melina@WorldBank.org.*

Oxford Analytica: Economic Slowdown Expected in Cambodia, Laos, and Vietnam

In the aftermath of the East Asian crisis and in the absence of bold structural reforms, economic growth in Cambodia, Lao PDR (Laos), and Vietnam is likely to remain below the levels achieved in the first half of the 1990s. With population growth still rapid, overcoming poverty will be a slow process, predicts Oxford Analytica, an international research group based in Oxford.

Since embarking on market-oriented economic reforms some 15 years ago, Cambodia, Laos, and Vietnam have undergone substantial change. In the mid-1980s the political influence of the former Soviet Union in the region was still strong, and the region's three economies were firmly oriented toward the eastern bloc. All three countries are now members of the Association of Southeast Asian Nations (ASEAN), and their trade and investment ties are predominately with other parts of Asia and the European Union.

Overseas, investments from China play an important role in the economies of Cambodia and Vietnam; in Laos, Thailand has emerged as the leading trade and investment partner, supporting far-reaching economic and social change. Until the advent of the East Asian crisis in 1997, Cambodia, Laos, and Vietnam were experiencing unprecedented economic growth, which offered the prospect of sustained rises in average per capita incomes.

Laos and Vietnam have conducted their experiment with market reforms in a climate of relative political stability. In both countries the Communist Party has maintained its monopoly on power. By contrast, Cambodia has experienced a transition from one-party rule to a multiparty, constitutional democracy.

Despite these changes, major questions hang over the future of the three countries, for the following reasons:

- **Low incomes.** All three countries are very poor. Average annual per capita incomes stand at around $300. Even Vietnam, which is more attractive to international investors owing to its large population of 76 million, is a small market in terms of consumer purchasing power. As economic expansion has slowed in the wake of the East Asian crisis against a backdrop of still rapid population growth (albeit at a slower rate in Vietnam), the prospect of a swift improvement in average income levels in any of the three countries is remote. With key urban centers saturated with quality consumer durables, the most successful companies in this environment are those that have targeted the low-cost, nonluxury market.

- **Agricultural drag.** While the contribution of agriculture to GDP is lower in Vietnam than in Cambodia and Laos, all three countries remain essentially agricultural economies. The process of industrialization is just beginning. Devising and implementing viable industrialization strategies remains a continuing challenge, as does managing the social problems inherent in the large movement of labor from rural to urban areas now under way.

- **Difficult business environment.** Low labor costs alone do not compensate for a difficult business environment. Nonlabor costs are high, reflecting excessive bureaucracy and corruption. The post-crisis decline in costs in the more developed Asian economies has reinforced the relative unattractiveness of Southeast Asia to investors.

in 2000–01, GDP growth in Cambodia, Laos, and Vietnam is unlikely to return to the levels recorded in the first half of the 1990s. This reflects a loss of international business confidence, exacerbated by the East Asian crisis and the fact that earlier growth was achieved on the back of one-off gains that cannot be repeated. Assuming political stability and a reasonable harvest, Cambodia is likely to record the fastest economic growth of the three countries, averaging around 6 percent, as the resumption of international donor lending kicks in. Laos and Vietnam can expect average GDP growth of around 5.5 percent in 2000–01. This compares with 4.0 percent for Cambodia in 1999, 4.6 percent for Vietnam, and and 4.0 percent for Laos.

The challenge for Laos is to bring inflation below the current triple-digit levels. In the third quarter of 1999, there were some signs that inflation may have peaked. Laos's satisfactory late-1999 harvest should lead to lower food prices. Inflation is unlikely to be a major problem in Vietnam and Cambodia this year.

The outlook for all three countries depends on the ability of their governments to push through difficult structural changes to shift from a planned to a market economy. Despite the frustrations voiced by multilateral institutions and investors, the international donor community is likely to remain engaged in all three countries in 2000.

Are Asian Economies Different?

Sanjay Kalra and Torsten Slok

China avoided the large output de-clines suffered by the transition economies of Central and Eastern Europe and Central Asia. The country's economic performance over the past two decades has been impressive. In China, the Lao People's Democratic Republic, and Vietnam the relatively large agricultural sectors and the availability of large rural labor surpluses helped accelerate growth without the large-scale dismantling of the "overindustrialized" state-owned sector that happened in Eastern Europe and the former Soviet Union.

In broad terms, the reform process in China can be characterized by the following:

- The "easy-to-hard" reform sequence started with those sectors with the easiest and greatest gains.
- The reform process took a "dual track" approach with the aim of having the old gradually give way to the new.
- The cyclical pattern of implementation assured that periods of advance would be followed by periods of consolidation.
- Reforms have been carried out with considerable pragmatism and flexibility, enabling different norms to coexist and compete.

The transition process in China, Cambodia, Lao PDR, and Vietnam has been marked by a number of common factors:

- The choices on the speed and scope of the transition were heavily influenced by initial conditions, political acceptance of the market mechanism, and the availability of external financial assistance and foreign direct investment. The initial conditions were characterized by low per capita income, extreme poverty, rudimentary infrastructure, weak administrative capacity, and, in China, a large state industrial sector.
- The responses to impending instability have been unpredictable. At times, macroeconomic instability spurred liberalization and reform (as in Vietnam in the mid-1980s); at other times (most recently in Lao PDR and Vietnam in the wake of the Asian crisis) there has been some backtracking and recourse to old methods of command and control.
- Partial reforms inevitably generated tensions and macroeconomic imbalances, suggesting the need for continuation of—and often providing spurs for—the reform process. The dual track pricing and exchange rate systems provided market signals on the margin, but also produced macroeconomic imbalances and generated considerable scope for corruption and rent seeking. Similarly, continuing weaknesses in the financial system, governance problems, and the absence of controls over enterprise access to bank credit generated inflationary pressures. Such factors provoked crisis conditions in Vietnam in the late 1980s and price and exchange rate instability in Lao PDR in late 1994.

Has gradualism succeeded in China? The fastest growth took place in the sectors with the most comprehensive reforms. China's initial conditions—including a large rural labor surplus and a large agricultural sector—permitted rapid growth without requiring politically difficult reforms of the state enterprises. Starting from a position of near autarky, China also derived significant gains from trade.

China's and Vietnam's selective and gradualist strategy appears to have provided rich dividends, but cannot be seen as unambiguously validating gradualism. Indeed, high growth occurred in agriculture and other sectors in which reforms were fastest. Reform is slow in state-owned enterprises, and the financial sector is still weak. Recurring losses have accumulated in large portfolios of nonperforming loans. It is becoming evident that vigorous reform in the industrial and financial sectors is the key to future sustained growth.

Sanjay Kalra and Torsten Slok are economists at the International Monetary Fund. This article is based on their recent paper, "Inflation and Growth in Transition: Are the Asian Economies Different?" IMF Working Paper Series, No. WP/99/118.

THE WILLIAM DAVIDSON INSTITUTE
AT THE UNIVERSITY OF MICHIGAN BUSINESS SCHOOL

Corporate Governance: Lessons from Transition Economy Reforms

by Merritt Fox and Michael Heller, William Davidson Institute and University of Michigan Law School

To date, most theoretical work on corporate governance has focused on advanced market economies. In post-socialist countries, corporate finance and institutional economics scholars have often done little more than convey the received theory to transition policymakers. A recent conference on "Corporate Governance Lessons from Transition Economy Reforms" focused, for the first time, on the reverse concern: what, if anything, do the reform experiences of transition countries teach about corporate governance theory more generally?

Sponsored by the William Davidson Institute and the University of Michigan Law School, the September 1999 conference brought together leading corporate governance theorists to present the principal papers. The conference highlighted four areas for policy-oriented research in corporate governance: (1) definitions, (2) measurement, (3) linkages to the real economy, and (4) linkages between research and practice.

Defining Good Corporate Governance

Scholars have not, to date, given sufficient attention to providing a precise and policy-oriented definition of what constitutes "good corporate governance." The existing literature focuses on developed market economies, with debate breaking down between "Anglo-American" and "Continental" perspectives. But this debate misses insights that can be gained from transition countries undergoing fundamental structural reform.

Three of the conference papers focused on basic definition questions: Henry Hansmann (Yale Law School) and Reinier Kraakman (Harvard Law School), "An Asset Partitioning Theory of Organizational Law", Lucian Bebchuk (Harvard Law School), "A Rent Protection Theory of Corporate Ownership and Control," and Merritt Fox (Michigan Law School) and Michael Heller (Michigan Law School), "Lessons from Fiascos in Russian Corporate Governance."

The conference also addressed the issue of whether "good corporate governance" for developed economies is identical to that for transition economies. Should policymakers in transition strive to develop a corporate governance structure sufficient to support viable public markets for equity finance? Or should they focus instead on factors that promote bank-centered finance and mediate among inside stakeholders? Developing these issues, Jack Coffee (Columbia Law School) presented "The Lessons of Securities Market Failure: Privatization, Minority Protection, and Investor Confidence."

Measuring Good Corporate Governance

Implementing well-functioning corporate governance regimes requires developing and testing policy-sensitive indicators, improving the amount and quality of national corporate sector data, and collecting and disseminating best practices. A coherent set of policy-sensitive indicators for the corporate sector needs to be developed, one that would include financial, institutional, and performance indicators.

To give one example, a financial indicator could be developed from the average premium paid for a control block of shares in a country's companies. If the premium is relatively small, then the corporate law system is performing well in terms of promoting residual maximization and pro rata distributions. (The residual is defined as the difference between what a firm pays at contractually pre-determined prices to obtain its inputs, and what it receives for its output.) In such a system, portfolio investors would be willing to pay enough for noncontrol shares to make public equity finance commonly practical.

Several papers presented empirical work exploring these difficult measurement issues, including Mark Ramseyer (Harvard Law School), "Lessons from Japanese Transition, 1870–1910," Andrzej Rapaczynski (Columbia Law School), "Why Ownership Matters: Entrepreneurship and Restructuring in Central Europe" and Randall Morck (University of Alberta) and Bernard Yeung (New York University), "The Information Content of Stock Markets: Why Do Emerging Markets Have Synchronous Stock Price Movement?"

Proving the Link between Good Corporate Governance and Wealth Creation

The link between improved corporate governance and wealth creation must be better established, not just on an empirical level, but also in terms of corporate governance theory. On this topic, Paul Mahoney (University of Virginia Law School) presented "The Common Law and Economic Growth: Hayek Might be Right" and Katharina Pistor (Harvard Kennedy School of Government) presented results from "Economic Development, Legality, and the Transplant Effect."

Practical Steps to Improve Corporate Governance

There are immediate practical steps that transition countries can undertake to promote improved corporate governance. For example, many of the needed corporate governance reforms coincide with, and would be subsumed under, "rule of law" work that countries are already pursuing. Also, efforts to improve sectoral data collection will both lay the groundwork for necessary empirical research and be immediately useful to current market participants and governmental regulators.

In a sobering account of early efforts to link theoretical work with practical reforms, Bernard Black (Stanford Law School), Reinier Kraakman (Harvard Law School), and Anna Tarasova (University of Maryland-IRIS) presented "Russian Privatization and Corporate Governance: What Went Wrong?"

Professors Merrit Fox and Michael Heller are preparing the proceedings of this conference for publication in an edited volume. Excerpts from four of the papers are printed below. All the conference papers are available by contacting Sharon Nakpairat at sharonch@umich.edu.

Lessons from Fiascos in Russian Corporate Governance

by Merritt B. Fox and Michael A. Heller, William Davidson Institute and the University of Michigan Law School

Russian industry has performed poorly since privatization. The voluminous literature on transition economies explains this poor performance primarily in terms of continued bureaucratic meddling, poor macroeconomic and tax policy, and low human capital. Problems in corporate governance are often mentioned as well, but little analyzed. The goal of this paper is to open the black box of "poor corporate governance" by detailing its consequences for the Russian economy and by tracing its causes to the initial structure of Russian privatization. Understanding what went wrong in Russia teaches lessons not only for transition policy, but also for corporate governance theory generally.

After the fall of Russian communism, state enterprises were rapidly privatized, stock markets created, and a corporate legal code adopted. However, even at its peak before the 1998 collapse, the total stock market capitalization of all Russian industry only reached about $130 billion—less than Intel Corporation. These numbers represent a trivial fraction of the apparent value of the underlying corporate assets controlled by Russian corporations. The low prices reflect severe corporate governance problems, including the high probability that the firms' underlying assets will be grossly mismanaged and that whatever cash flow is produced will be diverted to benefit insiders or reinvested in unproductive projects. In this paper, we focus on two questions: What are the consequences of these corporate governance problems for the real economy in Russia? Why are these problems so widespread and persistent?

To answer the first question, we define corporate governance in a way that looks to the economic functions of the firm rather than to any particular set of national corporate laws. Firms exhibit good corporate governance when they both maximize residuals and, in the case of investor-owned firms, make pro rata distributions to shareholders. Whether managers operate their firms in ways that meet these ideals depends on the structure of constraints and incentives in which they operate, a structure that depends in part, but only in part, on the prevailing legal system. Defective corporate governance means that a firm does not meet one or both elements of our definition.

Most attention in reports on transition economies has focused on problems relating to non-pro rata distributions: for example, when insiders dilute shares of outsiders, loot companies, fail to pay dividends, and engage in many other tactics that deprive outside shareholders of their pro rata share of the wealth generated by the firm. Non-pro rata distributions do indeed help explain low stock prices and the poor performance of the corporate sector. But failure to maximize residuals has the same effect, indeed even more directly. The vast transition literature never makes clear which failure dominates in any particular enterprise fiasco. Instead, bad corporate governance becomes a catch-all for problems that should be understood as being quite distinct.

In this paper, we give more precision to the idea of "bad" corporate governance by developing a typology of the kinds of dam-

age to the real economy that loosely constrained, poorly incentivized managers can inflict. We identify, with examples, why this damage has been particularly severe in Russia. This typology is summarized in the following table.

Nonmaximization of Profit

Pathology 1: Unreformable value-destroying firms fail to close. Arises when an unreformable, value-destroying firm can dissipate cash reserves or salvageable assets. Corporate governance is not the key issue when the firm has no reserves or salvageable assets, or when subsidies or unsuitable credits are present.

Pathology 2: Viable firms fail to use existing capacity efficiently. Arises when continued firm operation, if undertaken as efficiently as possible and without new investment, would be a positive net present value (NPV) decision; but costs are not minimized, the best price is not obtained for given output, or a non profit-maximizing output level is chosen

Pathology 3: Firms misinvest internally generated cash flows. Arises when a firm uses internally generated cash flow to invest in new negative NPV projects instead of paying out this cash flow to shareholders who could invest the funds better elsewhere in the economy.

Pathology 4: Firms fail to implement positive NPV projects. Arises when a firm identifies but then fails to act on positive NPV projects. Managers tend to be risk averse because they cannot diversify away unsystematic risk of a firm's project. If others do not pick up the opportunity, the firm's failure also reduces social welfare.

Pathology 5: Firms fail to identify positive NPV projects. Arises when a firm's managers fail to identify positive NPV projects that the firm is particularly well positioned to find. The possibility of venture financing and spinoffs can reduce the prevalence and social costs of this pathology.

Non-Pro Rata Distributions

Pathology 6: Firms fail to prevent diversion of claims. Arises when some residual owners of a firm manipulate corporate, bankruptcy, and other laws to shift ownership away from other residual owners—often by diluting shares held by outside minority shareholders.

Pathology 7: Firms fail to prevent diversion of assets. Arises when some residual owners privately appropriate assets and opportunities belonging to the firm, but leave the firm's formal ownership structure intact.

As for the second question—why corporate governance problems are so widespread in Russia—we go beyond standard causal explanations of poor corporate governance, which include the low level of corporate transparency, lack of effective adjudication of corporate law violations, weak enforcement of judgments, and the absence of a network of trust among Russian businesspeople—factors that are common to all post-socialist corporate economies. We expand this inquiry by focusing on the role of initial conditions at the time of privatization—specifically, the initial boundaries of privatized firms and the initial allocation of firm shares primarily to insiders—and the bargaining dynamics that have followed. Our focus helps explain why Russian corporate performance remains so much worse than in other transition countries. These initial conditions are unique to Russia (and the other republics of the former Soviet Union). They result from a privatization program that followed the course of least resistance. The domestic Russian architects of privatization and their foreign advisers believed it politically necessary to move quickly. As with real estate privatization, the initial path in corporate privatization represents not only political expediency, but also the primacy of pure economists over those more sensitive to the bargaining implications of packaging rights. The reformers hoped, naively as it turned out, that resources would naturally flow to their highest value users after markets were established. But they underestimated the roadblocks that the initial conditions would continue to impose for resource reallocation.

Conclusion

A typology of Russian corporate governance can offer useful lessons for corporate governance theory. The rich array of deviant behavior we canvass in Russia helps flesh out a framework of pathologies that, in a comprehensive way, links corporate governance failures to real economy effects. How is this analytic tool useful? It helps give more precision to the often vague notion of corporate governance failures. Scholars write about the costs of poor corporate governance without telling us the mechanisms by which loosely constrained and poorly incentivized managers are causing social welfare losses. We suggest that in every economy, those losses may be inflicted in differing degrees through five distinct pathologies of nonmaximization of profit and two versions of non-pro rata distributions. Identifying which pathology predominates may help point to more appropriate corporate governance reforms.

The second focus of the paper—explaining what has caused the flowering of Russian corporate pathologies—may also prove useful for corporate governance theory. Not surprisingly, the existing scholarly literature on comparative corporate governance mostly reflects the experience of the United States, Western Europe, and Japan. In the United States it is unusual for a corporation to maintain a share ownership pattern over the long term that involves a majority of shares owned by insiders and a minority owned by outsiders who trade their shares publicly. Our understanding of the mechanisms that constrain management to act in relatively share-value–maximizing ways—one share, one vote, the

hostile takeover threat, share price–based management compensation schemes, board elections, shareholder approval of certain interested and extraordinary transactions, ex post court review, the managerial labor market and other reputational incentives—is built primarily against the U.S. backdrop because the typical American corporation forms the paradigm for theorizing.

We suggest that looking at Russia introduces an analytic focus not immediately obvious from studying such long-established systems. Among other things, we see concretely that initial conditions matter for subsequent corporate governance development. The Russian experience suggests two salient initial conditions—uneconomic firm boundaries and competing groups of insider owners—that offer avenues for further research. At a minimum, the bargaining failures that followed privatization provide evidence that counsels skepticism toward the periodic claims of some scholars and activists for including "stakeholders"—such as labor, the local community, and the local government itself—in corporate governance. The Russian experience reminds us, also quite starkly, of the tradeoff between the agency costs of management in a publicly held corporation and the disadvantages of lack of access to public equity finance. This tradeoff appears in the leveraged buyouts of the late 1980s and the "going private" trend of the early 1970s: firms involved in both movements have tended to go public again at some later point.

More generally, the Russian experience suggests we rethink how close corporations operate. While there is a well-developed jurisprudence of close corporations in the United States, there is only a modest literature on the economics of such legal relations. Governance of the close corporation has traditionally been viewed by lawyer-economists as a contracting problem among well-informed, well-represented, motivated individuals, where the best policy advice that can be given is to have the law not obstruct the deals these individuals might reach.

The bargaining failures that followed privatization in Russia could shed light on our own system by focusing attention on the understudied area of losses from fragmented ownership in close corporations and other special corporate governance arrangements such as those associated with start-up companies backed by venture capital. When insiders exercise their rights so that each blocks the others, corporate assets may be wasted in a "tragedy of the anticommons." If competing blocks of insiders have incentives each to veto share-value–maximizing decisions, or if the costs of aggregating and negotiating insider interests to reach such decisions are sufficiently high, then corporate assets may be wasted in low value uses. In short, the Russian experience counters recent theoretical and empirical research, which argues that control by multiple large shareholders actually improves firm performance.

Privatization and Corporate Governance: Lessons from Securities Market Failure

by John C. Coffee, Jr., Columbia University Law School

Recent research on corporate governance has found systematic differences among nations in ownership concentration, capital market development, the value of voting rights, and the use of external finance. In particular, the size, depth, and liquidity of securities markets has clearly been found to correlate directly with the quality of the legal protections given shareholders, and in turn, encourages capital market growth and ownership dispersion. Because the nature and quality of these legal protections differs widely across nations, the corporate world today subdivides into rival systems of dispersed ownership and concentrated ownership, with different structures of corporate governance characterizing each.

This point has important implications for a policy debate that has begun among scholars who have studied the transitional process: should privatization be "fast" or "slow"? Should policymakers adopt a "damn-the-torpedoes, full-speed-ahead" approach that accepts the inevitability of some overreaching by controlling shareholders, but justifies this cost as necessary to realize and expedite the efficiency gains incident to privatization? Or should privatization proceed more cautiously because of the risks of market failure and political corruption that may result when control seekers are tempted to bribe and seduce the judicial and regulatory systems to achieve the private benefit of control? These tempting private benefits arise, of course, precisely to the extent that privatization preceded the creation of an adequate legal foundation. The cases examined in this article illustrate this tension and favor a prudential course of phased privatization.

What Really Distinguishes the Czech and Polish Experiences?

To this point, the Czech and Polish experiences have been differentiated in terms of the highly spontaneous character of Czech privatization versus the carefully planned—indeed, constrained—

character of Polish privatization. But both nations share one common fact that is troubling for the new scholarship that emphasizes the importance of differences in substantive corporate law: they each had a corporation law heavily based on the German civil law structure. Put simply, their experiences were very different, but their corporate laws were largely the same. As a result, because the corporate laws of Poland and the Czech Republic each provide only weak protection for minority shareholders, their different experiences cannot be used to corroborate the claim that differences in substantive corporate law are the key causal factors that determine the success or failure of privatization.

Yet, if Poland and the Czech Republic had similar corporate laws, their approaches to securities regulation were entirely different. Not only did Poland impose high disclosure standards from the outset (including quarterly reporting), it also created an SEC-like agency to enforce its laws from the beginning of its privatization experience. In addition, Poland adopted provisions requiring ownership transparency that are similar to parallel provisions in the United States. These provisions require disclosure by a potential acquirer of ownership of specified thresholds of a company's shares. Finally, Poland (but not the Czech Republic) followed the British model of takeover regulation by requiring any shareholder who acquired more than a specified level of stock to make a mandatory bid for the remaining shares. In sum, as Katharina Pistor has shown, Poland had "weak" corporate law, but "strong" securities law.

In overview, these restrictions may have been responsible for some of the differences in the Czech and Polish experiences. At the least, these restrictions helped to stop (or at least slow) the frantic scramble for control that occurred in the Czech Republic. Accordingly, the Polish experience may suggest the need for refinements in the model developed by those scholars of corporate governance who have focused, somewhat single-mindedly, on differences in substantive corporate law. In comparing systems of corporate governance, many of the most important differences may lie at the level of securities regulation. Here, rules prohibiting insider trading, requiring ownership transparency, and restricting coercive takeover bids may do more to protect minority shareholders from expropriation than do corporate law rules. Indeed, as earlier suggested, the most important common denominator between the "protective" legal regimes in the United States and the United Kingdom may be their highly similar securities laws, not their common law origins.

Another hypothesis, however, must also be noted: more important than these legal differences may have been the creation of the Polish National Investment Funds (NIFs). By holding controlling stakes, these state-created financial intermediaries blocked the path of entrepreneurs who otherwise might have competed to seize control of newly privatized companies. A critical, if possibly unintended, role of the NIFs was to provide an assurance to smaller shareholders that they need not fear the potential expropriation of their investment in a privatized company, at least because of its vulnerability to a predatory control seeker. Indeed, much of the scramble for control in the Czech Republic seems to have been defensively motivated: each large shareholder essentially realized that if they did not acquire control, someone else would, with resulting injury to them. In short, the fear of loss may have provided a greater incentive to compete for control than the expectation of any synergistic or opportunistic gain.

In this light, the inefficient exposure to loss that the Czech system imposed on minority shareholders may also explain the earlier noted absence of equity offerings for cash in the Czech Republic, in contrast to their frequency in Poland. Because an offering of equity securities inherently dilutes large shareholders, it exposes them to an increased risk of exploitation; correspondingly, it also disturbs and potentially upsets any equilibrium that may have been achieved among large shareholders. Having acquired a majority position, a controlling shareholder might prefer to rely on high-cost bank financings than to utilize equity financing where use of the latter could interfere with its ability to realize the private benefits of control. But this fear was not a danger in Poland, where the NIFs gave greater assurance of continuity at least for an interim period. Thus one implication of the Czech experience may be that unregulated control contests and the rapid transition from dispersed to concentrated ownership can give rise to externalities—both political and economic.

Correspondingly, the sharp decline in the stock prices of Polish NIFs once shareholders were permitted to take control of them from the government also reinforces the interpretation that unregulated control contests expose minority investors to the risk of expropriation and result in reduced share prices. Had the Polish government instead placed some maximum ceiling on the percentage that any investor (or group of investors) could own in an NIF, this decline might have been reduced.

The Common Law and Economic Growth: Hayek Might be Right

by Paul G. Mahoney, University of Virginia School of Law

"The ideal of individual liberty seems to have flourished chiefly among people where, at least for long periods, judge-made law predominated" (Hayek 1973, 94).

Recently, financial economists have produced evidence that financial markets contribute to economic growth and legal institutions contribute to the growth of financial markets. King and Levine (1993) demonstrate that countries with more developed financial markets experience faster per capita GDP growth. La Porta and othersl. (1998; 1997) find evidence that the extent to which a country's corporate laws protect the interests of minority investors is an important determinant of the cost of external capital. They also, interestingly, find that countries whose legal systems are derived from the common law tradition provide superior investor protections on average. Levine (1999) finds that better investor protections are associated both with more developed financial markets and faster economic growth.

While the causal link between investor protection and financial market development seems obvious enough, the apparent link between the common law tradition and investor protection is more surprising. Corporate law seems an unlikely place to find a systematic difference between common and civil law countries. Compared to other areas of commercial law, such as contracts or commercial paper, corporate law has been largely code-like in the common law countries from a very early date. This raises the question of whether the tendency toward more efficient rules of corporate law in common law countries is a coincidence that might disappear or reverse in other areas of commercial law.

On the other hand, it may be that the common law provides superior property rights protections across the board, leading to faster economic growth not merely through its impact on financial markets but on all commercial activities. There is, after all, a substantial difference in the ideas motivating the common and civil law traditions. The judges who played a leading role in shaping English common law were deeply concerned with protecting property and contract rights. By contrast, the scholars who shaped the civil law, especially the *Code Napoléon*, were concerned principally with creating a strong, centralized executive to pursue collective goals. Thus Hayek (1960; 1973) argued forcefully for the superiority of the English to the French legal tradition.

It is not obvious that this difference in intellectual history translates into practical differences today. Many legal scholars have noted that the differences between the common law and civil law loom larger in theory than in reality. In the United States, for example, much of commercial law has become fairly code-like over the course of this century because of the adoption of the Uniform Commercial Code and the federal bankruptcy code. In civil law countries judges and scholars have come to appreciate that no civil code can be sufficiently complete and unambiguous as to remove all discretion from the judges who apply it. Thus, while in theory civil law judges follow only the code and not the precedent, in practice they pay attention to prior decisions of appellate tribunals (Merryman 1985).

This paper therefore attempts a preliminary analysis of whether the differences between the common law and civil law traditions are sufficient to produce differential economic outcomes.* I first provide cross-country evidence that the common law is associated with higher per capita economic growth compared to the civil law. I then survey possible explanations and suggest that the most promising one lies in the common law's stronger protections of property and contract rights against administrative action. The common law has a strong tradition of judicial review of administrative decisions and the civil law has an equally strong tradition of keeping ordinary judges out of the way of administrators. The comparative freedom of common-law courts to overturn administrative decisions makes rent-seeking more costly (because its outcome is more uncertain) in a common-law system, leading to a reduction in rent-seeking. I present evidence that governments in common law countries, on average, interfere less than their civil law counterparts with private economic activity.

Conclusion

During 1980–97—an era when it seems plausible that government policies had an especially large effect on economic growth by influencing the extent of participation in the expanding international economy—common law countries experienced dramatically larger real per capita GDP growth, on average, than did civil law countries. The difference remains when we control for initial GDP and secondary school enrollment, for foreign trade or proxies for trade, or for geographical region.

A plausible explanation is that the common law countries were more apt to structure their economic systems around property and contract, and less around government economic activity and

redistribution, than the civil law countries. A concrete mechanism through which that effect may occur is the two traditions' different treatment of administrative action. Common law countries give judges more authority to overturn administrative decisions alleged to violate individual rights than do civil law countries. This may reduce the amount of rent-seeking and increase the relative importance of markets.

That is not to say, however, that differences in administrative law fully explain the more market-oriented policies in the common law countries. Differences in the intellectual and ideological background of the common law and civil law systems may also make a difference. Merryman (1985) defines a legal tradition as including "a set of deeply rooted, historically conditioned attitudes about the nature of law, [and] about the role of law in the society and the polity." In many, if not most, countries, lawyers are important participants in government. Differences in the way common and civilian lawyers think about law—particularly differences in the way they think about individual economic freedoms versus collective political freedoms—may influence their approaches to government policy. Hayek, in other words, may have been right.

It is also important to recognize that legal systems are endowments but not straightjackets. Over the past decade, governments in Latin America—uniformly civil law countries—have made a dramatic shift to more market-oriented policies. For developed countries, in which legal systems are deeply rooted, market-oriented policies will not arise from changes in legal tradition, but from changing political leadership and public attitudes. The results reported in this paper, however, may be of more interest for transition countries still in the process of creating legal institutions. The common law and its associated attitudes toward property and contract may be more attractive than the civil law tradition that has dominated legal development in the post-communist world to date.

Transition* editor's footnote: **Common law has been referred to as the "common sense of the community, crystallized and formulated by our ancestors." It exists and applies to a group on the basis of historical legal precedents developed over hundreds of years. Because it is not written by elected politicians, but rather by judges, it is also referred to as "unwritten" law. Judges seek these principles out when trying a case and apply the precedents to the facts to come up with a judgment. Common law is often contrasted with **civil law** systems, which require all laws to be written in a code or written collection. Civil law deals with rights and duties between individuals. It is inspired by Roman law, the primary feature of which was that laws were written into a collection; codified, and not determined, as is common law, by judges. The principle of civil law is to provide all citizens with an accessible and written collection of the laws that apply to them and that judges must follow.

Russian Privatization and Corporate Governance: What Went Wrong?

by Bernard Black, Stanford Law School, Reinier Kraakman, Harvard Law School, and Anna Tarassova, University of Maryland-IRIS

Rapid mass privatization of state-owned enterprises in formerly centrally planned economies has not turned out nearly as well as its creators hoped, in Russia or elsewhere. When Russian mass privatization began in 1992–93, its proponents (including ourselves) hoped that the Russian economy would soon bottom out and then turn upward, as the efficiency incentives unleashed by privatization took hold. That did not happen. Instead, the Russian economy stumbled along through mid-1998, continuing to shrink slowly by official indicators, then collapsed again, as it had in 1991–92 prior to privatization. Russia's mass privatization "voucher auctions" were moderately honest, but gave control to managers. This permitted insiders (managers and controlling shareholders) to engage in extensive "self" or "inside" dealing (transactions by the company, not on arms-length terms, in which the insiders profit directly or indirectly at the company's expense), which the government did nothing to control. Later privatization "auctions" were a massive giveaway of Russia's most important companies at bargain prices to a handful of well-connected "kleptocrats," who continued to behave in the ways that earned them this nickname. Medium-term prospects are grim; the Russian ruble has plunged—the Russian government has defaulted on both its dollar-denominated and ruble-denominated debt, most banks are bankrupt, corruption is rampant, tax revenues have collapsed, capital flight is pervasive, and the government seems clueless about what to do next.

The Russian disappointment with mass privatization is mirrored by similar problems in other former Soviet Union countries and also, though less severely, by problems with Czech mass privatization, which in its early stages seemed to be a model of the transition from central planning to a market economy. This suggests that the failure of mass privatization to jumpstart the

Russian economy may reflect structural flaws in mass privatization as a transitional mechanism, not just Russia's specific circumstances.

This paper joins an emerging literature that criticizes the prevailing wisdom that rapid privatization of large firms is an important element of the transition from central planning to a market economy. We develop below a case study of what went wrong with large-firm privatization in Russia, using the Czech Republic as a comparison case study to assess the extent to which Russia's problems can be generalized. We bring to this task a reasonable mix of insiders' knowledge and outsiders' skepticism, gained through experience with privatization and capital markets reform in Russia and other countries.

We leave to others the analysis of the macroeconomic steps that Russia might have taken and focus here on microeconomic steps related to privatization and capital markets development. But the two are related—Russia's macro effort to balance the budget, control inflation, and attract new investment was defeated, in large measure, by micro failures to rationalize the tax system, control corruption and organized crime, control insider self-dealing at privatized enterprises, and establish a tolerably friendly business climate.

We see three main failures in the Russian privatization effort. First, rapid, mass privatization of large enterprises is likely to lead to massive insider self-dealing unless (implausible in the initial transition from central planning to markets) a country has a good infrastructure for controlling self-dealing. If control is given to the current managers (which was the political deal that underlay Russian mass privatization), they often will not know how to run a company in a market economy. Unless stopped (Russia made no effort to stop them), some managers will steal whatever assets the company still has, perhaps killing an otherwise viable company. If outsiders can acquire control in the stock market (as in the Czech Republic), they will often be worse owners than the managers that they replace. Indeed, bad owners will tend to drive out good ones. A controlling stake is worth more to a dishonest owner who will extract all of a firm's value than to an honest owner who will share the firm's value with minority shareholders.

To prevent this outcome, a decent legal and enforcement infrastructure capacity must precede or at least accompany privatization of large firms. If privatization comes first, massive theft is likely to occur before the infrastructure to control it can develop. Moreover, as a practical matter, important parts of this infrastructure can be built only on a base of existing private firms. For example, to develop skill in prosecuting fraud and self-dealing, regulators need some fraud and self-dealing to practice on. Thus privatization must to some extent be staged, lest the crooks simply outrun the regulators.

The Russian government accelerated the process of bad owners driving out good ones by selling control of major enterprises (cheaply) to crooks, who got the funds to buy them by skimming from the government. In most cases, these new owners transferred their skimming talents to the enterprises they had acquired, without improving the businesses and sometimes by starving them for funds.

In a mythical thick market for corporate control, honest entrepreneurs could buy companies from crooks if the company was worth more if run honestly than if run to maximize short-run skimming. But in fact, such entrepreneurs do not exist in Russia in significant numbers or with significant capital. If they existed, they would not pay anything close to fair value when buying a company from a crook because they could not verify what shape the enterprise was in. Moreover, the business might be worth more to the crook, who has a comparative advantage in the important tasks of self-dealing, evading taxes, obtaining favors from the government, not paying workers, enforcing contracts in effective albeit unofficial ways (instead of ineffective enforcement through the courts), and using these same unofficial means to enforce price-fixing or market division agreements or scare off competitors. In contrast, an honest owner risks having long-term investments expropriated by the government.

Second, the profit incentives to restructure privatized enterprises and create new ones can be swamped by a generally hostile business environment created by (among other factors) a punitive tax system, official corruption, organized crime, an unfriendly bureaucracy, failure to privatize the urban land that businesses need to grow, and a business culture in which skirting the law was seen as normal, even necessary, behavior.

A hostile business environment makes asset-stripping more attractive to insiders, compared to the alternative of improving the business. And fewer new businesses meant weaker market competition, which can create pressure on firms to restructure wholly apart from profit motives.

Third, too-rapid privatization of large firms can compromise future reform efforts. Inside dealing would occur to some degree even if large enterprises were not privatized, but the reduced state control that accompanies privatization can make inside dealing easier. In a vicious circle, dirty privatization also reinforces corruption and organized crime, as the new owners (some already with Mafia ties) turn their new wealth to the task of bribing judges and government officials. Corruption and organized crime then reinforce a culture in which inside dealing is the norm. Corrupt officials and company insiders then join forces to resist future reforms, while the public comes to see privatization (and, by inference, other market reforms) as connected with inside dealing, corruption, and the growth of organized crime.

Our concerns here are with privatization of large enterprises, not with the other elements of the "shock therapy" prescription dispensed by Western advisors. There is much to be said, in the transition to a market economy, for the government rapidly selling or giving away small shops and businesses to the people who work there, and apartments and land to the people who live there. These steps do not entail the separation of ownership and control that makes self-dealing attractive for those who control large enterprises. But the Russian and Czech experience leads us to believe that a concerted effort to develop the infrastructure needed to control inside dealing is central to successful privatization of large firms—as important, and in the early stages, perhaps more important than privatization itself.

To be sure, Russia's problems could have arisen without privatization. Ukraine offers a sobering example: it has not privatized large firms, is as corrupt as Russia, and has done even worse economically. But the Ukrainian example only tells us that doing nothing is not a viable strategy for the transition from Marx to markets either. A piece of the overall puzzle that seem important to us: The largest Russian companies were privatized in massively corrupt fashion, and ended up controlled by none-too-clean entrepreneurs, soon dubbed "kleptocrats" by the Russian press—a handful of well-connected men who made their first millions—and sometimes billions—through sweetheart deals with or outright theft from the government, and then leveraged that initial wealth by buying major companies from the government for astonishingly low prices. The "reformers" who promoted privatization regretted the corrupt sales of major companies, but claimed that any private owner was better than continued state ownership. Even if the new owners got their ownership in regrettable ways, they would thereafter have incentives to increase company value. The extent to which the reformers believed this story themselves, or had been given financial inducements to put a good spin on a dirty process, remains unknown. But many foreign advisors bought this story. The "Washington consensus" supported dirty privatization as better than no privatization, and supported Russia's privatization czar, Anatoli Chubais, as he pursued privatization by any available means.

Left unnoticed was that the new owners had two ways to make money—increase the company's value, or steal what value already existed. The first was difficult, perhaps beyond their ability, and uncertain in outcome. The second was easy, they were expert at it, and it was sure to produce a handsome profit that could be tucked away overseas, beyond the reach of a future Russian government. Most of the kleptocrats chose the second, easy approach.

As an example, a major Russian oil holding company was acquired in 1995 by a major Russian bank (itself controlled by a powerful director) as part of the corrupt "loans-for-shares" privatization process. For 1996 the oil company's published financial statements showed a revenue of $8.60 per barrel of oil—about $4 per barrel less than it should have been. One surmises that most of the missing revenue ended up in offshore bank accounts controlled by the controlling investor and accomplices. This one powerful director skimmed over 30 cents per dollar of revenue, while stiffing workers on wages, defaulting on tax payments by claiming that the oil company could not afford them, destroying the value of minority shares in both the oil company and its majority-owned production subsidiaries, and not reinvesting in the company's oil fields, which badly needed new investment.

It is doubtful that running the oil company honestly could have earned the bank director a fraction of what he earned by skimming revenue, let alone offshore and tax-free. He made a rational, privately value-maximizing choice. Even if running the oil company honestly was the best long-run strategy, the bank director might have preferred a quickly skimmed bird in the hand to two long-run birds in the bush. Besides, skimming was a business that the director knew and was good at, while running an oil company was a tough business that the director did not know and might fail in.

This example illustrates a general point: Privatization is not enough. It matters who the owners are. If it is not politically feasible to import foreign owners, who are more likely to run privatized businesses honestly (though hardly certain, as the Czechs learned), and to reinvest if profit opportunities exist, the second-best choice for large-firm privatization may be for the government to begin with case-by-case privatization of selected firms with strong profits and reputations for honest management, watch these firms carefully once they are privatized, and work hard to develop the legal and institutional infrastructure needed to limit insiders' ability to self-deal.

Even without immediate privatization, the promise of running a to-be-privatized company (with privatization conditioned on future performance), plus the need to compete in a world market, can motivate its managers to undertake some restructuring. If the company generates cash, the government will have a better chance of retaining enough revenues to maintain basic services. The government's ability to detect and control theft will be higher if the enterprise is still state-owned. And the enterprise's long-run sale price will be far higher if it is sold in a stronger legal environment, in a fairer auction, and perhaps with more foreign participation than was politically acceptable in the near term. Ironically, Russia and other former Soviet Union countries had such a "staged privatization" program in place in the early 1990s, through a program called "enterprise leasing." The privatizers killed enterprise leasing because they thought it was not fast enough and gave too much power to enterprise managers.

Proponents of fast privatization of large firms may respond that there is no assurance that the infrastructure to control self-dealing

will develop on any relevant timeframe. This is indeed a risk. But the right response may be staged privatization plus working hard to improve the business climate and develop the infrastructure to control self-dealing, rather than privatizing large firms anyway and hoping that the outcome will somehow be acceptable.

Several countries on the fringes of the former Soviet Union created a reasonably friendly climate for new businesses, and achieved corresponding economic success—including Estonia, Hungary, Latvia, Poland, and the Czech Republic (which, in hindsight, may have succeeded despite, rather than because of, rapid privatization of its major firms). Poland offers a nice contrast to Russia. It was slow to privatize either major businesses or the banks that were needed to finance new investment. It succeeded economically nonetheless because it quickly privatized small businesses and land, and it created a climate in which new businesses could thrive and employ the workers that large enterprises needed to shed.

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World Bank/IMF Agenda

Wolfensohn Visits Russia

World Bank President James Wolfensohn will visit Moscow at the beginning of February, at the invitation of Prime Minister and acting President Vladimir Putin, the Itar-Tass news agency reported, quoting Deputy Prime Minister Viktor Khristenko. In another development, the World Bank on December 22, 1999, approved a $30 million loan to support the fiscal performance of local governments in Russia. Since Russia joined the Bank in 1992, commitments to the country have totaled $11 billion for 44 operations.

World Bank–IFC Reorganize for Better Coordination

The World Bank Group will restructure to better align and expand its work related to the private sector, Peter Woicke, executive vice president of the International Finance Corporation (IFC) and managing director of the World Bank, announced on December 21. The announcement followed Board approval of the reforms, which will take effect January 1, 2000.

The reorganization will tighten the link between the World Bank Group's public sector work and its private sector transactions in the developing world, which are made through the IFC. The World Bank helps governments to formulate policy frameworks that encourage a favorable business environment. The IFC, the private sector arm of the Group, provides advice and makes loans and equity investments in companies.

- A new combined Small and Medium Enterprise Unit, under Director Ira Lieberman, has a mandate to coordinate Bank Group activities in support of small and medium-size businesses. It includes dissemination of knowledge that will encourage creation of local financial institutions for financing of small and medium-size enterprises.
- Three new joint World Bank–IFC industry groups will be set up, for industries where there is a strong interface between public policy and private sector transactions. The newly appointed director of the telecommunications and informatics group is Mohsen Khalil, that of the oil, gas, and petrochemicals group is Rashad Kaldany, and the director of the mining group is James Bond.
- The Private Sector Advisory Services will coordinate the principal advisory services focused on the private sector in both the World Bank and the IFC. The director is Michael Klein. The advisory services include support for privatization, infrastructure, corporate restructuring, corporate governance, and advice on policies and regulations to encourage foreign investment.

Larry Summers Urges IMF to Restructure

The IMF should limit itself to short-term lending for financial emergencies and the World Bank should take more of a lead in long-term development and poverty reduction, remarked U.S. Treasury Secretary Lawrence Summers on December 14 in a London speech timed to the Berlin meetings of the Group of 20. The new G-20 includes the G-7 industrial countries—Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States—plus Argentina, Australia, Brazil, China, India, Indonesia, the Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, and Turkey. The representatives of the European Union, including the European Central Bank, bring the tally to 20. The G-20 finance ministers and central bankers are to meet again next autumn in Canada.

In his remarks ("The Right Kind of IMF for a Stable Global Financial System," http://www.ustreas.gov/press/releases/ps294.htm) Summers urged the IMF to recognize the dominance and preferability of private sector capital flows over government lending. Nearly $1.3 trillion in private capital flowed to emerging markets in the 1990s, compared with about $170 billion in the 1980s. Twenty emerging market economies issued sovereign Eurobonds in 1998, compared with one in 1990.

"Going forward the IMF needs to be more limited in its financial involvement with countries, lending selectively and on short maturities," he said. "The IMF must be a last, and not first, resort." The IMF must do more to provide the private sector with information from emerging-market economies: promoting standard accounting methods and encouraging data reporting on reserves, external debt, and indicators of financial soundness.

The IMF should rely on three core instruments for its short-term lending: a new contingent credit line to help countries ward off financial contagion; short-term stand-by arrangements for countries with nonsystemic balance of payments problems; and the Supplementary Reserve Facility for countries suffering systemic capital account crises, for very short-term loans at prices to encourage rapid repayment.

The IMF should deepen the commitment to transparency that is built into its own operations, making its financial workings clearer and more comprehensible to the public. "There is no reason why there should not be a regular publication of the IMF's operational budget." The IMF should become more attuned, not just to markets but to the broad range of interests and institutions with a stake in the IMF's work, maintaining a vigorous ongoing dialogue with civil society groups and others, Summers pointed out. He remarked, "It will be important for its shareholders to consider

not just the role of the IMF, but the World Bank and other development institutions and also how these institutions relate to each other."

World Bank's New Country Director Hails Ukraine's New Government

The World Bank welcomed Ukraine's new government, expressing hope for a fresh start on reforms and promising a new strategy for lending to the former Soviet republic. The World Bank's newly appointed director for Ukraine and Belarus, Luca Barbone, said the Bank will work out a three-year plan for Ukraine. Barbone praised the first reform steps of the newly appointed government. "Everyone considers that the present governmental team is the best since Ukraine's independence. The only problem for Ukraine is that it lost its masterful central banker," said Barbone, commenting on the fact that former National Bank chief Viktor Yushchenko, a reformer, was promoted to prime minister in the new government.

In January IMF Managing Director Michel Camdessus is expected in Kiev to consult about releasing frozen loans to Ukraine. The IMF has delivered some $965 million from its $2.6 billion loan package to Ukraine since 1998 but froze the aid program in September. Ukrainian officials say that without IMF and related World Bank help, the country will have difficulties meeting its 2000 foreign debt obligations of more than $3 billion.

World Bank Launches Global Network: http://www.gdnet.org/

The Global Development Network (GDN), a new worldwide institution devoted to enhancing democratic governance at local, national, regional, and international levels, was launched in Bonn, Germany, during a conference in December. The launch was attended by more than 500 acclaimed thinkers and policy leaders. More than two dozen donor organizations endorsed the GDN, initiated by the World Bank. Creating a forum of researchers, decisionmakers, and donors, the network will link policy thinktanks in developing and transition economies with their counterparts in the industrial world. The global network will help raise the quality of policy research and increase its impact on policy design and implementation.

IMF: Capital Flow Controls Can Be Useful—Sometimes

Capital controls have helped some countries insulate themselves—at least temporarily—from financial crises. Rapid capital market liberalization, when badly handled, can increase vulnerability to financial crises. These are some remarkable elements in a new IMF report published on January 11. The report—**Country Experiences with the Use and Liberalization of Capital Controls,** by Akira Ariyoshi, Karl Habermeier, Bernard Laurens, Inci Otker-Robe, Jorge Iván Canales-Kriljenko, and Andrei Kirilenko—warns, however, that none of the countries applying controls succeeded in maintaining separation between domestic and foreign interest rates and reducing the appreciation of real exchange rates. Such controls may lose their effectiveness as markets exploit potential loopholes and circumvent controls.

Stiglitz Says Vietnam Needs Liberal Trade Policy for Growth

Liberal international trade policies are essential for growth in relatively small developing countries such as Vietnam, said the World Bank's outgoing Chief Economist Joe Stiglitz in a Hanoi conference of local and foreign business executives. Stiglitz said the financial damage suffered by Vietnam's neighbors during Asia's financial crisis was the result of lax short-term capital flow controls, not open trade policies. The transition from a socialist to a market economy "poses challenges as well as opportunities" for Vietnam's leaders, Stiglitz said. Hanoi "must learn to manage the risks associated with a more open economy."

Donors Pledge $2.8 Billion to Vietnam

Under the chairmanship of Andrew Steer, the World Bank's director for Vietnam, foreign donors at their annual meeting in mid-December pledged a total of $2.8 billion in fresh aid to Vietnam, but said $700 million of that amount was linked to accelerated reform of the country's economy. Major donors include the Asian Development Bank, the IMF, the United Nations Development Programme, the World Bank, and Australia, France, Japan, and Sweden. Donors commended Vietnam for reducing poverty in the 1990s—a World Bank report said that the proportion of Vietnamese living in poverty dropped from 58 percent in 1993 to 37 percent in 1998 thanks to strong economic growth and agricultural reforms launched in 1986. But they expressed concern about the slow pace of economic reform.

Participants urged Vietnam to open its economy, embrace competition, and improve the business climate. Deputy Prime Minister Nguyen Manh Cam told donors that Vietnam was committed to speeding economic reforms and advancing its integration into the global economy. Cam, who is also foreign minister, said the *doi moi* process of economic liberalization launched in the late 1980s would gather pace in the next millennium. In 1998 donors pledged $2.7 billion in aid to Vietnam. Of that, $500 million was conditional on accelerated reform, although none of this money has been disbursed.

Andrew Steer noted that attempts by the government to improve the investment climate for the private sector, especially foreign businesses, were not yet sufficient to reverse the trends of the past 30 months, which saw investment levels plunge from 29 percent of GDP to 19 percent—although a number of recent measures, such as the new Enterprise Law, were important positive steps towards creating a level paying field between private and state enterprises (see page 37). In a major report the World Bank said that if

Vietnam was slow to reform—to liberalize the trade regime, boost the private sector, and restructure state-owned enterprises and the country's banks—growth could slip from 4 percent in 1999 to 3.5 percent in 2000 and to 3 percent thereafter, rates not seen since the late 1980s. Hanoi has targeted GDP growth of 5.5 to 6 percent in 2000. In the spirit of the Comprehensive Development Framework, donors agreed to assist the authorities to draft policy strategies in fields such as education, health, forestry, infrastructure, environment, governance and enterprise reform.

Donors Offer Another $1 Billion for Kosovo

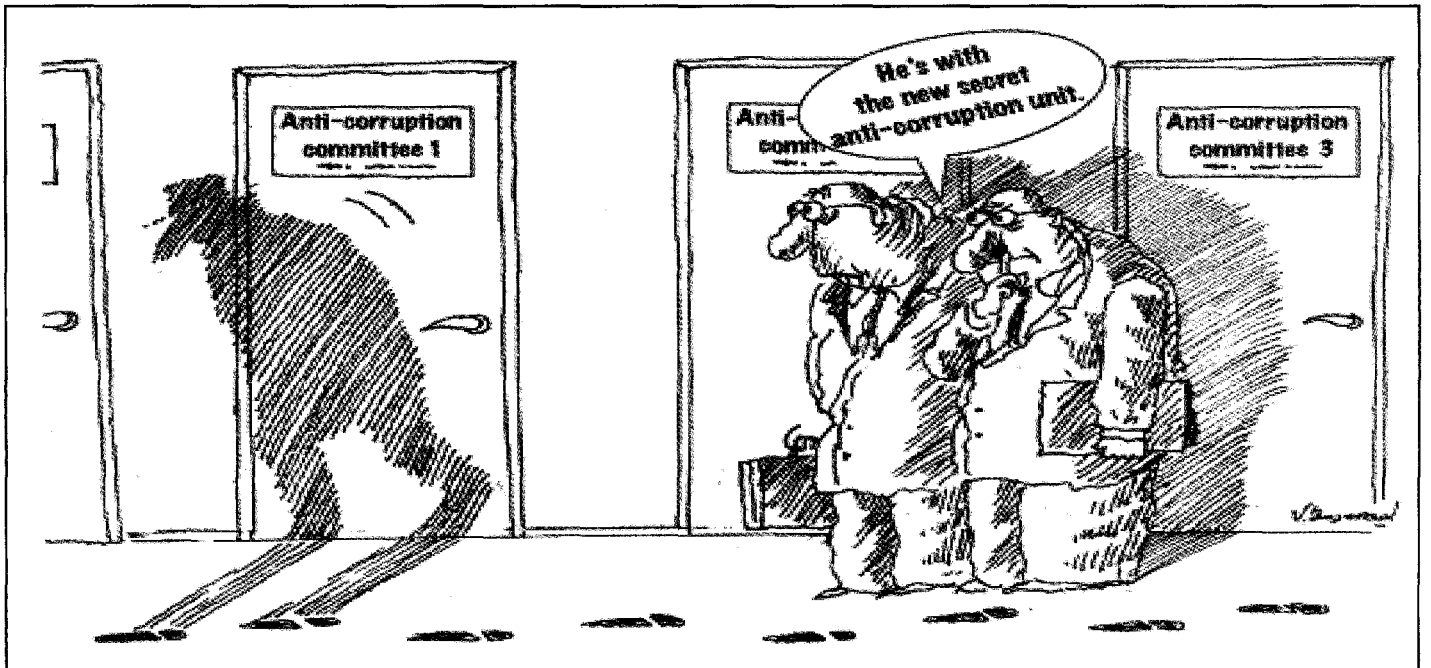
During a November 17 meeting in Brussels, representatives of 47 countries and 34 international organizations pledged about $1 billion of new financial assistance in support of Kosovo's medium-term reconstruction program. Participants in the meeting—cochaired by European Commission Director Fabrizio Barbaso and World Bank Director Christiaan Poortman—agreed that organizing a reliable local administration, making provision for essential public services, stabilizing macroeconomic conditions, and setting the stage for private sectorled recovery and long-term growth are the priorities. In the next four to five years another $2.3 billion in donor assistance will be necessary. At the First Donors' Conference on July 28, 1999, $2.1 billion had already been pledged.

For more information on the economic reconstruction and development in Southeast Europe, visit the joint World Bank–European Commission website at http://www.seerecon.org/.

Poor Need "Lifeline" Rates as Transition Economies Privatize Energy

Transition economies must develop plans to maintain energy service for poor customers as state utilities are sold off, World Bank lead energy specialist for Europe and Central Asia Laszlo Lovei said at a conference on energy regulation in transition economies. "In most of these countries the bulk of energy production and distribution is still in state hands. For privatization to succeed, you need fairly broad support, and that includes not just the large industrial customers, but also households."

Selling off state utilities is a politically charged issue because customers—accustomed to receiving power at state-subsidized rates—are worried that private companies will raise prices and cut them off. Privatization was inevitable because of the need to upgrade equipment and introduce more efficient and competitive distribution as countries in Central and Eastern Europe and Central Asia become more closely allied with the European Union. But regulators must adopt schemes to reassure poor users that they will not be left in the dark while not discouraging payment by those who can afford it. A World Bank study has shown that schemes that guaranteed no disconnection of service caused distortion of prices and a huge burden on the utility companies. By contrast, Lovei pointed out, special electricity tariff schedules that provide limited amounts of power at low prices and greater amounts at higher cost—so-called lifeline rates—seemed to have the best cost-benefit results.



Feeling the presence of the new, classified anti-corruption squal.

From the *Moscow Times*.

Milestones of Transition *continued*

Continued from page 14

Czech laws and the judicial system do not protect the interests of creditors and minority shareholders and allow loss-making companies to survive. "There has not been a single sentence for banking criminality so far," Tosovsky said.

Hungary

Is Hungary Central Europe's fastest growing economy? The Hungarian economy expanded by 4.4 percent (on an annual basis) in the third quarter of 1999, up from 3.6 percent growth in the first half. Analysts feel that the full-year GDP growth could top 4 percent. This improvement was driven by a strong export performance—up 13.2 percent on the same period in 1998—while import growth slowed from 10.2 percent in the second quarter to 9 percent. SG Securities Limited, a London-based financial advisory firm, reported that Hungary may become the fastest growing economy in Central and Eastern Europe in the next two years, overtaking Poland. Its overall economic growth is expected to accelerate to 4.5 to 5 percent in 2000, after an expected 4 percent GDP growth in 1999, and should remain at 5 percent in 2001.

Romania

Priorities for 2000. Romania's priorities for 2000 are to meet an inflation target of 25 to 30 percent, achieve GDP growth of at least 1.3 percent, and reduce the 38 percent corporate tax to 25 percent. The government's program sees its main challenge as fighting unemployment, currently around 11 percent. The current account deficit for 1999 has been halved to around $1.2 billion, or 4 percent of estimated GDP. The country's international liquidity position, however, remains fragile: current reserves represent about one-third of the annual external financing need. Since 1996 consumption has fallen by one-quarter and business is suffering from a depressed domestic market. Foreign direct investment in the first nine months of 1999 was only $145 million. Political instability, legal uncertainties relating to the status of property, problems with the banking system, bureaucratic obstacles, and slow efforts to adopt international accounting standards have deterred investors.

CIS

Moldova

Economic indicators for 1999 are worse than those for 1998. Moldova's new prime minister, Dumitru Barghis, an engineer by training, told Parliament that economic indicators slipped in 1999. Preliminary data show a 4 percent drop in GDP and a budget deficit of more than 5 percent. Inflation is expected to be around 40 percent. Stressing that these are "the worst indicators over the last years," the prime minister warned that the 2000 budget, to be presented in February, will allow for no other expenditure than the servicing of the country's external and internal debt.

Russia

At present, deaths exceed births by about 700,000 annually. Some experts say Russia's population could drop from today's 150 million to 80 million in 50 years. "If demography is said to be destiny, the destiny of Russia for the next 50 years or more is appalling," says Murray Feshbach, a research professor at Georgetown University's School of Foreign Service in Washington. Feshbach sees a rapid spread of drug-resistant tuberculosis, AIDS, and sexually transmitted disease in Russia. One study predicts that some 13 million Russians will be infected by HIV by 2005. Alcohol- and smoking-related illness in Russia is also a problem. The World Bank is considering a $150 million loan for a program to deal with AIDS and tuberculosis, while the World Health Organization, other UN organizations, the Soros Foundations, and the United States and other nations are trying to help in modest ways.

What makes life harder? The Russian National Public Opinion Center (VTSIOM) conducted a survey in the last two weeks of December 1999. The 1,600 respondents, representing an adult urban popu-

Quality of life issues cited by urban survey respondents in Russia, 1994, 1998, and 1999 *(percentage of respondents)*

Issue	*1994*	*1998*	*1999*
Low income	68	75	71
Health problems, poor availability of health care	27	31	29
Frustration, gloomy prospects	22	27	29
Everyday life problems	21	25	24
Fear of losing job	24	19	22
Impossibility of ensuring good education for children	9	12	19
Bad housing	15	13	14
Lack of spare time	11	9	10
Lack of accord in the family	4	4	4
A family member's drinking	6	4	3
Don't know	6	2	4

Source: VTSIOM.

lation, were allowed to list several issues that represented for them the largest problems of quality of life in Russia (see table).

The survey results for 1999 suggest that no serious improvement has occurred in the lives of Russians over the past five years. As in previous years, more than two-thirds of the population considered poor income to be the number-one problem. Number two was health problems and poor availability of medical services. Many low-income families cannot afford expensive medication. The share of the population experiencing frustration, and seeing no prospects worth living for, has grown steadily, reaching 29 percent at the end of 1999.

Vietnam

The Vietnamese government enacts a new Enterprise Law. The new Enterprise Law in Vietnam facilitates more private business and ensures equal treatment for state and privately owned companies. It will also loosen collateral requirements on bank loans, which will help small companies borrow money.

Le Kha Phieu, general secretary of Vietnam's Communist Party, praised a gathering of young entrepreneurs from the state and private sectors for their efforts in promoting business in Vietnam. "All enterprises are equal in terms of rights and duties under the Vietnamese law," he said. Private businesses often complain that they aren't given the same access to capital as state-owned firms, and that they are subject to complex registration, hiring, and other requirements. Business executives called for "a more favorable business environment" for private businesses, the Vietnam News Agency reported. Formal private businesses—not including family-run businesses—now employ around 1 million of Vietnam's 40 million working people.

We appreciate the contributions from Radio Free Europe/Radio Liberty.

Conference Diary

Forthcoming Conferences

2nd Kiel Workshop in Economics—Integration of Financial Markets in Europe
February 11-12, 2000, Kiel Institute of World Economics, Germany

Information: Claudia M. Buch, Stefan M. Golder, Ralph P. Heinrich, Kiel Institute of World Economics, Duesternbrooker Weg 120, 24105 Kiel, Germany, tel.: 49 431 88141, fax.: 49 431 85853, email: kiel-workshop@ifw.uni-kiel.de

The Institutional Foundations of a Market Economy, WDR 2001-2002
February 23–25, 2000, Villa Borsig, Berlin

Sponsors: Development Policy Forum/DSE, World Bank, and German Ministry for Economic Cooperation and Development (BMZ)

The welcoming address will be given by Heinz Buehler, director general of the DSE, and opening addresses by Roumeen Islam, World Bank, and Gudrun Kochendoerfer-Lucius, DPF/DSE. Sessions will include "Defining Institutions and Moving toward Institutional Change," Masaoki Aoki, Pranab Bardhan, and Kenneth Sokoloff; "Competition Policy and Regulation," Jean Jacques Laffont; "Governance and Political Institutions," Robert Bates and Robert Wade; "Financial Institutions," Thomas F. Hellmann and Colin Mayer; "Enforcement of Contracts: The Judicial System," Avner Greif and Katharina Pistor; "Corporate Governance," Erik Berglof, Alexander Dyck, Simon Johnson, and Luigi Zingales; and "Social Structure and Social Capital," Francois Bourguignon and Jean Philippe Platteau. The closing remarks will be made by Roumeen Islam, World Bank. Participation is by invitation only.

Information: Boris Pleskovic, Research Advisory Staff, Development Economics Vice Presidency, Room MC4-385, World Bank, 1818 H Street, NW, Washington, DC 20433, tel.: 202-473-1062, fax: 202-522-0304, email: bpleskovic@worldbank.org.

Twelfth Annual Bank Conference on Development Economics (ABCDE) 2000
April 18–20, 2000, Washington, DC

The welcoming address will be given by James D. Wolfensohn, president, World Bank, and keynote addresses by Joseph E. Stiglitz, World Bank; Jeffrey Sachs, Harvard University; and Janos Kornai, Harvard University/Collegium Budapest. Sessions will include "New Development Thinking" (Paul Collier, Ravi Kanbur and Nora Lustig, Jan W. Gunning, and Karla Hoff), "Crises and Recovery" (William Easterly, Roumeen Islam, and Joseph E. Stiglitz; Ricardo Caballero and Mohamad Hammour; Eisuke Sakakibara; and Guillermo Perry), "Corporate Governance and Restructuring" (Alexander Dyck, and Gerard Roland), and "Social Security, Public and Private Savings" (Peter Orszag and Michael Orszag, and Orazio Attanasio and Miguel Szekely). The first two afternoons will each have four parallel workshop sessions. Participation by non-Bank and non-IMF staff by invitation only.

Information: Boris Pleskovic, Research Advisory Staff, Development Economics Vice Presidency, Room MC4-385, World Bank, 1818 H Street, NW, Washington, DC 20433, tel.: 202-473-1062, fax: 202-522-0304, email: bpleskovic@worldbank.org.

International Experience: Developing the Civil Society in Russia
June 23-24, 2000, Omsk, Russia

Organizers: Omsk State Pedagogical University, in cooperation with the Russian-American Academic Exchanges Alumni Association "Professionals for Cooperation."

Topics: Protecting human rights: Role of the society and the state; economic factor in developing the civil society; interaction of mass media and the authorities; internationalization of universities and improvement of the educational process; development of international cooperation in the conditions of civil society; training professionals for foreign countries; civic education programs; and teaching civic education.

Information: International Affairs Office, email: common@omsk.edu, tel./fax.: +7 3812 243795.

2000 International Conference—Emerging Economies
July 10-12, 2000, Prague, Czech Republic

Organizer: Academy of Business and Administrative Sciences.

Information: Dr. A. R. Korukonda, Program Chair, 2000 ABAS International Conference in Prague, P.O. Box 88, Room 226 Murphy Professional Building, St. Bonaventure, University St. Bonaventure, New York 14778, tel.: 716-375-2076; 716-375-2089; or 716-372-8094, fax.: 716-373-2270 or 716-375-7859.

Sixth ICCEES World Congress Secretariat, Finnish Institute for Russian and East European Studies
July 29 - August 3, 2000, Tampere, Finland

Information: Annankatu 44, Helsinki 00100 Finland. tel.: 358-9-2285 4434; fax: 358-9-2285 4431; email: iccees@rusin.fi; Internet: http://www.rusin.fi/iccees.

Sixth EACES Conference: Globalization and European Integration
September 7–9, 2000, University of Barcelona, Spain

Information: Department Politica Economica, Universidad. Avda. Diagonal, 640, 08034 Barcelona, Spain, tel.: 3493-402-1949, fax: 3493-402-4573, email: gate 2000@eco.ub.es.

New Books and Working Papers

The Macroeconomics and Growth Group regrets that it is unable to provide the publications listed.

World Bank Publications

To receive ordering and price information for World Bank publications, contact the World Bank, P.O. Box 7247-8619, Philadelphia, PA 19170, United States, tel: 202-473-1155, fax: 202-676-0581, email: books@worldbank.org, Internet: http://www.world bank.org or http://www.world bank.org/html/dec/Publications/Work papers/tranecon.htm, or visit the World Bank bookstore in the United States, at 701 18th Street, NW, Washington, DC, or France, at 66 avenue d'Iena, 75116 Paris.

Global Economic Prospects and the Developing Countries 2000, December 1999, http://www.worldbank.org/prospects/.

In 1999 developing countries were expected to grow by 2.7 percent, accelerating to 4.2 percent growth in 2000. For developing countries, excluding those in transition, growth is significantly less than the rate of the precrisis 1990s. Despite a faster than expected global recovery, the lingering effects of the global financial crisis continue to depress output and hamper efforts to reduce poverty worldwide, this report concludes.

The appendix to the report shows regional prospects for the transition economies of Europe and Central Asia (ECA). Accelerating world trade and stabilizing commodity prices should contribute to a stronger recovery in the region in 2000, and real GDP is expected to increase by 2.5 percent. Economic output decreased by 0.2 percent in 1998 for the region, reflecting Russia's liquidity crisis and subsequent regional contagion. For 1999 the growth estimate is 0.3 percent. In 2000 average growth for the Central and Eastern European (CEE) countries is forecasted at 3.2 percent, underpinned by high investment growth but boosted by strong inflows of foreign direct investment. The economic situation in both Romania and Ukraine is tenuous, reflecting high debt service payments. Output in most Commonwealth of Independent States countries is projected to recover more gradually, owing to expected slow growth in Russia. The long-term growth forecast for the ECA region has been reduced from 5 percent a year to 4 percent over the period from 2002 to 2008.

Susan Stout and Timothy A Johnston, **Investing in Health: Development Effectiveness in the Health, Nutrition, and Population Sectors**, Operations Evaluation Studies, 1999, 92 pp.

World Bank lending for health, nutrition, and population activities is accelerating. The Bank is now the major source of external finance for the sector in the developing world. Its emphasis has evolved from expanding service delivery capacity to encouraging systemic reform.

Frank Sader, **Attracting Foreign Direct Investment into Infrastructure—Why Is It So Difficult?** FIAS Occasional Papers No. 12, 1999, 192 pp.

During the early 1990s the Foreign Investment Advisory Service (FIAS), a joint facility of the World Bank and the IFC, found that governments and foreign investors alike were concerned about and frustrated with difficulties in successfully implementing private infrastructure projects. So FIAS has been advising many governments in the developing world on the best way to establish a policy framework attractive to foreign investors. This study synthesizes these experiences and derives lessons for facilitating and encouraging foreign direct investment in infrastructure.

Verdon S. Staines, **A Health Sector Strategy for the Europe and Central Asia Region**, September 1999, 96 pp.

The health systems inherited by the transition economies of ECA are changing in response to fundamental and unprecedented challenges. The massive social and economic transformation unleashed by the Soviet system's collapse was highly disruptive and placed great pressure on the health sectors. Although the desired shape of future health systems in many ECA countries is discernible, the process for getting there must be invented along the way. This volume summarizes the World Bank's experience in this arena and the lessons it suggests. It outlines both an external strategy that the Bank's ECA health staff could use in assisting countries to restructure their health systems and an internal strategy that the staff could use to organize their activities to achieve this result.

Martin Ravallion, **Poverty Comparisons: A Guide to Concepts and Methods**, Russian language edition, Living Standards Measurement Study No. 88R, 1999, 144 pp.

Timothy Heleniak, **Migration from the Russian North during the Transition Period**, Social Protection Discussion Paper No. 9925, September 1999, 61 pp.

To order: SP Advisory Service, tel: 202-458-5267, fax: 202-614-0471, email: socialprotection@worldbank.org, Internet: http://www.worldbank.org/sp.

William Jack, **Principles of Health Economics for Developing Countries**, World Bank Institute Development Studies Series, January 2000, 305 pp.

This book explains the allocation of health care resources, broadly defined, and is aimed at aiding the design and analysis of policies that affect health care outcomes. It provides a modern treatment of health economics for developing, transition, and industrial countries. It addresses both positive and normative issues in the economics of health care and health insurance. Drawing on agency theory, welfare economics, econometrics, and development economics, this book is a reference and textbook for health policy professionals, policymakers, researchers, and students of economics and international development.

Country Studies

Moldova—Poverty Assessment, November 1999, 85 pp.

Hungary: On the Road to the European Union, November 1999, 249 pp.

Hungary is one of the top economic performers among CEE countries in transition, and one of the strongest candidates for accession to the European Union. Its financial sector is among the most robust and efficient in Central Europe, with rapidly emerging capital markets. This study, which analyzes economic developments in Hungary in recent years, points out that the enterprise sector is efficient and now mostly private, with substantially increasing labor productivity and expanding commercial ties with the EU and other international markets.

Czech Republic: Toward EU Accession, 1999, 344 pp.

Until 1996 the Czech Republic was perceived as the most successful transition economy in the CEE region. However, the Czech miracle came to a halt in May 1997. The country's future economic development and successful integration into the EU depends on whether it can reach sustainable growth again. This report analyzes economic developments in the Czech Republic since 1997. The report is composed of two volumes: a summary report and the main report. The latter assesses economic performance, fiscal problems, intergovernment and local finance, foreign trade, finance and banking, enterprise reform, agriculture, environment, public administration, social conditions, health care, and the infrastructure. The EU accession process dominates the sector analyses.

Technical Papers

Privatization of the Power and Natural Gas Industries in Hungary and Kazakhstan, TP No. 451, 1999, 152 pp.

Hungary and Kazakhstan have privatized a large portion of their electric power and natural gas industries—but following different strategies. In contrast, the other formerly socialist countries in the CEE have privatized almost none of these industries. Hungary and Kazakhstan began their reforms from different starting points. The Hungarian power and gas sectors had a long history of being relatively well managed. In contrast, Kazakhstan inherited pieces of the old systems that were designed to serve the needs of the Soviet Union and had to develop new organizations to manage the system.

Lev Freinkman, Daniel Treisman, and Stepan Titov, **Subnational Budgeting in Russia: Preempting a Potential Crisis,** TP No. 452, November 1999, 141 pp.

Reforms of Russia's budgetary system at the subnational level are vital to preserving macroeconomic stability, improving the efficiency and accountability of government, and enhancing incentives for local and regional governments to support economic growth.

Julia Bucknall, **Poland: Complying with EU Environmental Legislation**, TP No. 454, November 1999, 65 pp.

The EU Commission acknowledges the severity of the environmental problems in Poland, especially in areas of wastewater treatment and air pollution. Compliance with the EU standard in areas such as drinking water and waste management will require high levels of public and private investment and considerable administrative effort.

Dale F. Gray, **Assessment of Corporate Sector Value and Vulnerability: Links to Exchange Rate and Financial Crises,** TP No. 455, November 1999, 53 pp.

Recent crises have demonstrated the importance of improving our understanding of the links between the corporate sector, the financial sector, and the macroeconomy in a world of volatile capital flows. Assessing the vulnerability of the corporate sector and its links to financial and exchange rate crisis is important for both improved surveillance and in the design of policies in crisis countries.

Mary Canning, Peter Moock, and Timothy Heleniak, **Reforming Education in the Regions of Russia,** TP No. 457, December 1999, 112 pp.

Russia's education system, with broad access and high levels of scholarly achievement, has long been a source of strength. The Soviet system, however, was grossly overcentralized, inefficient, and lacking in accountability. In the past decade attempted rapid decentralization has not been well designed: there has been no corresponding transfer of resources, and levels of responsibility have remained unclear. Unless these problems are corrected soon, their harmful impact on the quality and equity of education could be serious. This report analyzes the nature of the current problems and discusses policy options open to the Russian government in its efforts to improve educational efficiency and preserve and even improve equitable access without sacrificing the traditions of academic excellence.

Among other proposals the authors offer, efficiency could be increased by giving schools increased financial autonomy, using a per capita financing formula, and beginning to rationalize the teaching force and improve its quality. A national system of student assessment might help to both raise quality and improve the equity of access to highly selective institutions. Reforms are required for improving the market responsiveness of first-level vocational education, and especially to avoid excessive and premature specialization.

Working Papers

To order: Internet: http://www.worldbank.org/research/workingpapers

Wlodzimierz Okrasa, **Who Avoids and Who Escapes from Poverty during the Transition? Evidence from Polish Panel Data, 1993–96,** WPS 2218, November 1999, 52 pp., and **The Dynamics of Poverty and the Effectiveness of Poland's Safety Net (1993–96)**, WPS 2221, November 1999.

There is a chronic, long-term poverty problem in Poland. Those from larger households, farm households, and households dependent on social welfare are most at risk. Okrasa uses four-year panel data from Poland's household budget survey to explore the distinction between transitory and long-term poverty.

To order: Sheila Fallon, Room MC3-558, tel: 202-473-8009, fax 202-522-1153, email: sfallon@worldbank.org. The author may be contacted at wokrasa@worldbank.org.

Emiko Fukase and Will Martin, **The Effect of the United States' Granting Most Favored Nation Status to Vietnam**, WPS 2219, November 1999, 26 pp., and **A Quantitative Evaluation of Vietnam's Accession to the ASEAN Free Trade Area**, WPS 2220, November 1999, 61 pp.

The general tariff rates that the United States imposes on goods from Vietnam average 35 percent, compared with 4.9 percent for the most favored nation (MFN) rate. If the United States grants Vietnam MFN status, Vietnamese exports to the United States would more than double.

To order: Lili Tabada, Room MC3-333, tel: 202-473-6896, fax: 202-522-1159, email: ltabada@worldbank.org. The authors may be contacted at efukase@worldbank.org.

Maurice Schiff, **Labor Market Integration in the Presence of Social Capital**, WPS 2222, November 1999, 26 pp.

Social capital raises productivity and falls with labor mobility. [The notion of "social capital" was first introduced by the sociologist James Coleman in 1988. He defined it as "the ability of people to work together for common purposes in groups and organizations." It is argued that a group with members who trust each other can accomplish more economic growth than a similar group without trust. Coleman has suggested that social capital is a new production factor that must be added to the conventional concepts of human and physical capital.—*The editor*]. Labor market integration generates a negative externality: it results in "too much" mobility, too low a level of social capital, and an ambiguous effect on welfare. Trade liberalization is superior to labor market integration because it reduces mobility and the negative externality associated with it.

To order: Lili Tabada, Room MC3-333, tel: 202-473-6896, fax: 202-522-1159, email: ltabada@worldbank.org. The author may be contacted at mschiff@worldbank.org.

Michael Klein, **Money, Politics, and a Future for the International Financial System**, WPS 2226, November 1999, 22 pp.

In developing the architecture for a financial system, the challenge is to combine deregulation and safety nets against systemic failure with effective prudential regulation and oversight. In the author's scenario the world moves toward a monetary system in which fixed exchange rate systems, or de facto currency competition, limit the power of central banks. This limits options for discretionary and open-ended liquidity support to help deal with systemic financial crises. Mistrust in monetary authorities and the emergence of private settlement systems lead to a return of asset-backed money as the means of payment.

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Hua Wang and Somik Lall, **Valuing Water for Chinese Industries: A Marginal Productivity Assessment**, WPS 2236, November 1999, 23 pp.

The marginal productivity of water used for industry varies among sectors in China, but there is great potential for the Chinese government to encourage water conservation by raising water prices to industry.

To order: Roula Yazigi, Room MC2-533, tel: 202-473-7176, fax: 202-522-3230, email: ryazigi@worldbank.org. The authors may be contacted at hwang1@worldbank.org or slall1@worldbank.org.

Luca Barbone, Arindam Das-Gupta, Luc De Wulf, and Anna Hansson, **Reforming Tax Systems: The World Bank Record in the 1990s,** WPS 2237, November 1999, 35 pp.

The main constraint on World Bank operations in tax and customs administration is the Bank's inadequate institutional framework for accumulating knowledge from loan operations. The Bank's theoretical basis is still rudimentary. Too little attention has been paid to improving accountability, administrative cost-effectiveness, and anticorruption institution-building. Projects have made inadequate use of various performance indicators. Institutional components of project design have been biased toward organization, manpower upgrading, and procedures related to information technology. Better and more uniform methods should be used to evaluate project outcomes. The Bank must substantially improve pre-project diagnosis, project design, execution, and effectiveness.

To order: Luca Barbone, Room J7-119, tel: 202-473-2556, fax: 202-473-8466, email: lbarbone@worldbank.org. Other authors may be contacted at oldmonk87@yahoo.com, ldewulf@worldbank.org, or ahansson1@worldbank.org.

Dorsati Madani, **A Review of the Role and Impact of Export Processing Zones**, WPS 2238, November 1999, 107 pp.

As instruments for encouraging economic development, export processing zones have only limited usefulness. A better policy choice is general liberalization of a country's economy. The World Bank should be cautious about supporting export processing zone projects.

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Bartlomiej Kaminski, **The EU Factor in the Trade Policies of Central European Countries**, WPS 2239, November 1999, 31 pp.

Despite strong protectionist sentiments, trade regimes have remained open in the Central European countries that had been invited to negotiate their accession to the European Union. Regional disciplines (the EU factor), combined with the legacy of low tariffs under GATT commitments, appear to have offset domestic protectionist impulses.

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Branko Milanovic, **True World Income Distribution, 1988 and 1993: First Calculations, Based on Household Surveys Alone**, WPS 2244, November 1999, 65 pp.

World inequality increased between 1988 and 1993 as per capita income increased more slowly in rural, populous Asian countries (Bangladesh, China, and India) than in large, rich OECD countries. Income differences widened within the countries—for example, between the urban and rural populations of China. This is the first paper that calculates world income distribution for individuals based entirely on data from household surveys.

To order: Patricia Sader, Room MC3-556, tel: 202-473-3902, fax: 202-522-1153, email: psader@worldbank.org. The author may be contacted at bmilanovic@worldbank.org.

Daniel Kaufmann and Shang-Jin Wei, **Does "Grease Money" Speed Up the Wheels of Commerce?** WPS 2254, December 1999, 17 pp.

Can corruption improve economic efficiency and can bribery be productive? Not according to this study. According to the "efficient grease" hypothesis, corruption can improve economic efficiency and fighting bribery can be counterproductive.

This need not be the case. The authors examine the relationship between bribe payments, management time wasted with bureaucrats, and cost of capital. They find that firms that pay more in bribes are also likely to spend more management time with bureaucrats, negotiating regulations, and face a higher cost of capital.

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Rene Weber and Gunther Taube, **On the Fast Track to EU Accession—Macroeconomic Effects and Policy Challenges for Estonia,**WP/99/156, 1999.

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Koen Schoors, **The Credit Squeeze during Russia's Early Transition: A Bank-Based View**, No. 2229, September 1999, 45 pp.

The hypothesis that the 1994 credit crunch in Russia was caused by the tightened monetary policy turned out to be wrong. Russian banks—taking advantage of excess liquidity in the banking system—accumulated huge excess reserves but preferred to hold onto them rather than grant loans. This question is still relevant because Russian commercial banks in the aftermath of the August 1998 crisis have again accumulated excess reserves and decreased their lending to the economy.

Patrick A Puhani, **Public Training and Outflows from Unemployment: An Augmented Matching Function Approach on Polish Regional Data**, No. 2244, September 1999, 47 pp.

Dalia Marin and Monika Schnitzer, **Disorganization and Financial Collapse**, No. 2245, September 1999, 28 pp.

Charles Wyplosz, **Ten Years of Transformation: Macroeconomic Lessons**, No. 2254, 1999.

Many of the arguments in favor of Big Bang have now been proven right. Once more inflation has been found to be incompatible with growth, and the importance of a good microeconomic structure—especially an effective banking system—is confirmed. The choice of an exchange rate regime, another early controversy, appears secondary to adherence to a strict monetary policy. The decline of the state is both spectacular and puzzling, combining desirable and dangerous features.

Mathilde Maurel and Sophie Brana, **Barter in Russia: Liquidity Shortage versus Lack of Restructuring**, No. 2258, October 1999, 22 pp.

Jozef Konings and Guilia Faggio, **Gross Job Flows and Firm Growth in Transition Countries: Evidence Using Firm Level Data on Five Countries**, No. 2261, October 1999.

Using comparable firm-level data for1993–97 showing job flows in five transition economies—Bulgaria, Estonia, Poland, Romania, and Slovenia—the authors find that early in transition job destruction dominates job creation, while job creation picks up in the mature stage of transition.

Katherine Terrell and Vit Sorm, **A Comparative Look at Labour Mobility in the Czech Republic: Where Have All the Workers Gone?** No. 2263, October 1999, 37 pp.

The Czech labor market showed a great deal of flexibility during 1994–98. Many individuals moved into the newly created finance, trade, and tourism sectors, and there were considerable outflows from the agricultural and industrial sectors. The pool of unemployed is changing fast, and job-to-job flows are relatively high.

Gerard J. van den Berg and Louise Grogan, **The Duration of Unemployment in Russia**, No. 2268, October 1999, 39 pp.

Daniel Münich, Jan Svejnar, and Katherine Terrell, **Returns to Human Capital under the Communist Wage Grid and during the Transition to a Market Economy**, No. 2332, December 1999.

Under communism workers had their wages set according to a centrally-determined wage grid. For decades the communist wage grid maintained an extremely low rate of return on education. During transition the return increased dramatically and equally in all ownership categories of firms.

Constantin Sonin, **Inequality, Property Rights Protection, and Economic Growth in Transition Economies: Theory and Russian Evidence**, No. 2300, November 1999.

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Georges de Menil, Stephane Hamayon, and Mihai Seitan, **Romania's Pension System: The Weight of the Past**, Studies & Analyses No. 177, 1999, 28 pp.

By 1997 Romania's pension system had registered a deficit, and the average real pension had fallen to 45 percent of its 1990 level. In 1998 Romania launched its pension reform, based on the three-pillar system, which will introduce points to calculate benefits from the state pension fund, increase the retirement age, and divert one-third of the mandatory social security tax into new, private, fully funded universal pension funds. The third pillar comprises voluntary pension funds.

Mateusz Walewski, **A Short Play on the Idea of the Laffer Curve in Transition Economies**, Studies & Analyses No. 175, 1999, 28 pp.

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Marjan Simoncic and Franc Kuzmin, **Macroeconomic Effects of the Pension Reform in Slovenia**, Working Paper No. 3, 1999, 26 pp.

In Slovenia the contribution rate on gross wages was raised in 1991 to maintain balance in the pension budget. But in 1996 the government reduced the contribution rate by 5 percent to reduce labor costs. It is unclear how successful the measure was in stimulating growth in industrial production and exports. Eventually the government had to refund the pension budget for the lost revenue. The transfer payment from the state budget increased in 1996 by 12 percent, just enough to cover the budget gap. Further reduction of the contribution rate in the following two years claimed additional transfers from the state budget.

Planned reforms will radically change the pension system in the near future. Initially the pension system would have involved setting up a three-pillar system. Two pillars would have been mandatory—a slimmed down version of the present social security fund complemented by a private capital (pension) fund. Both pillars would have been fed by splitting the present social security contributions—85 to 15 percent—paid on gross wages. The capital fund—with government guarantee—would have offered a minimum 4 percent annual return. The third pillar—voluntary pension funds at banks and insurance companies—is already functioning.

The three social partners—trade unions, the government, and employers—recently agreed to abandon the second pillar, at least for a time. But some changes in the pension system seem to be unavoidable:

- Full pension eligibility has required 40 years of work for men and 35 for women. The government would replace the working age with an old age limit: 65 years for men and 63 for women. The full working age assured a pension equal to 85 percent of one's highest average wage for 10 consecutive years. According to the reform proposal, this will change in the next 30 years. The accrual rate will gradually decrease: each year the pension basis will be reduced by 0.5 percent, up to 70 percent of net wage. So the pension basis for the new entrants to the pension system in 2000 will be 84.5 percent, in 2001, 84 percent, and so on.
- The 10-year period will be gradually prolonged up to 25 years. Each year one additional year will be added to the calculation of the pension base. The overall effect is the same as if the pension base were lowered from 85 percent to 70 percent of net wages.
- The social partners still debate whether pensions should be indexed to wage or consumer price increases. Reformers would like to index pensions to prices, not gross wage growth.

Tine Stanovnik and Nada Stropnik, **Economic Well-Being of the Elderly and Pension Reform in Slovenia,** Working Paper No. 2, 1999, 35 pp.

Vladimir Lavrac, **Exchange Rate of the Slovenian Tolar in the Context of Slovenia's Inclusion in the EU and in the EMU**, Working paper No. 1, 1999, 18 pp.

The costs and benefits for Slovenia of joining the European Monetary Union are in principle similar to those for the EU member countries. Slovenia has a small, open, and diversified economy with a high proportion of trade oriented to the EU. It is not expected to be specifically exposed to the so-called asymmetric shocks because its trade structure is similar to that of the EU and its economy is rather synchronized with the cycles in the EU economies. Slovenia's loss of the exchange rate as an instrument of adjustment, which would result from its

future inclusion in the monetary union, wouldn't affect Slovenia much, particularly if the emphasis of efforts to sustain the economy's international competitiveness shifted from the exchange rate instrument toward a more flexible labor market.

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Predrag Bejakovic and Alastair McAuley, **Welfare Policy and Social Transfers in Croatia**, Occasional Paper No. 8, July 1999, 33 pp.

Katraina Ott and Anto Bajo, **Public Investments in Croatia**, Occasional Paper No. 7, March 1999, 12 pp.

Financing of capital investment in Croatia needs broad reform, including setting up a government treasury; better dividing responsibilities between the payments clearing agency, other government agencies, and public enterprises; improving local government finance; and increasing the effectiveness of funds allocation through the Croat Bank for Reconstruction and Development. Foreign financing should be mobilized. Cost-benefit analyses are neglected because pubic projects lack transparent bidding and evaluation.

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Zdenek Lukas, **Agriculture in Transition: Widening Gap between the CEECs and Russia and Ukraine**, No. 258, June 1999, 28 pp.

The transformation of farming appears to have reached a mature stage in most Central and East European countries. By contrast, in Russia and Ukraine, only formally restructured farms dominate and the sale of land remains prohibited. The transition economies reduced agricultural subsidies during the 1990s and subsidies are much lower than in the EU and OECD countries. There was a large decline in agricultural output in several of the transition economies—especially in Russia and Ukraine—mainly because of declining demand for certain agricultural products and diminishing competitiveness in sectors requiring restructuring.

After the collapse of agricultural trade between the transition economies, the agro-food trade of the CEE countries shifted mainly to the EU countries. The financial collapse in Russia triggered a decline in prices in 1998 as the supply of certain key commodities greatly exceeded demand. To relieve tension among the farmers—and to protect their markets—countries used subsidies, tariffs, and import quotas. The 1998 agro-food trade of the CEE countries recorded a deficit of about $300 million, after a surplus of $600 million in 1997. Russia's agro-food deficit contracted by $3 billion to $10 billion because of a sharp devaluation. The Ukrainian surplus dropped by $600 million, to $300 million.

The upcoming negotiations with the World Trade Organization will put further pressure on the EU to reform its common agricultural policy before 2006. Inadequate reforms may postpone accession of the candidate countries, or may require prolongation of the transitional arrangements.

Peter Havlik and others, **The Transition Countries in 1999: A Further Weakening of Growth and Some Hopes for Later Recovery**, No. 257, June 1999, 94 pp.

Boris Majcen, **Measurement of Costs and Benefits of Accession to the EU for Selected CEECs: Country Report Slovenia**, No. 256, May 1999, 93 pp.

Johann Burgstaller and Michael Landesmann, **Trade Performance of East European Producers on EU Markets: An Assessment of Product Quality**, No. 255, April 1999, 15 pp.

Josef Poschl and others, **Transition Countries in 1998/99: Widespread Economic Slowdown with Escalating Structural Problems**, No. 253, February 1999, 85 pp.

Other Publications

Jiri Vecernik and Petr Mateju (eds.), **Ten Years of Rebuilding Capitalism: Czech Society after 1989**, Academia, Prague, 1999.

The first "social report" on the Czech Republic, this book describes demographic, economic, social, and political changes since the velvet revolution of 1989. In his concluding remarks, Jiri Vecernik warns that in an institutionally insufficient and morally corrupt environment, the democratic mechanism often serves to legitimate pre-existing power, and without rules or enforced order, the market can be taken over by monopolies. "The purpose of the subsequent flow of capital between the state banks and companies was to maintain the status quo, rather than cut old ties and create a business sphere governed independently from the state." Illegal accumulation of property, and the rise of the "new rich" harmed the interests of the middle class, the main pillar of the society.

Information: Institute of Sociology, Czech Academy of Sciences, Jilska 1, 110 00 Praha1, Czech Republic, fax: 4202-2222-1658. The authors can be reached at: Jiri Vecernik, email: vecernik@mbox.cesnet.cz, Petr Mateju, email: mateju@soc.cas.cz

M. Holt Russin and others (eds.), **The Post-Soviet Handbook: A Guide to Grassroots Organizations and Internet Resources, Revised Edition**, University of Washington Press, October 1999, 416 pp.

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Zoltan Csefalvay, Michael Landesmann, and Gyorgy Matolcsy, **Hungary's Accession to the EU: The Impact of Selected Areas of Hungarian-Austrian Relations**, The Vienna Institute for International Economic Studies and Economic Growth Institute, Budapest, 1999, 150 pp.

István János Tith, **Ownership Structure, Business Links and Performance of Firms in a Transforming Economy, The Case of Hungary**, Discussion Paper No. 1999/3, Institute of Economics, Hungarian Academy of Sciences, Hungary, June 1999, 82 pp.

Hungary's enterprise structure can be characterized by the following major factors: the company structure stabilized by 1996; ownership is concentrated; holdings do not have a dominant role; private Hungarian and foreign ownership is dominant; and foreign-owned companies are driving the modernization process. Hungarian enterprises have excellent production and profit figures—and strong growth potential. Financial discipline is still weak in the corporate community, however.

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Daniel Piazolo, **Welfare Effects versus Income Effects of Poland's Integration into the European Union**, Kiel Working Paper No. 940, Kiel Institute of World Economics, Germany, 1999.

To order: email: dpiazolo@ifw.uni-kiel.de, Internet: http://www.uni-kiel.de:8080/IfW/pub/kap/1999/kap940.htm.

This paper presents a dynamic computable general equilibrium model for Poland's integration into the European Union that allows for quantification of the income and welfare effects stemming from tariff reduction, border-cost reduction, reduction of the technical barriers to trade, and increased net EU transfers from Brussels. For all channels, steady-state national income increases substantially compared with the reference scenario (status quo). However, the welfare effects are surprisingly small. The findings show the importance of renouncing consumption today in order to build up the capital stock necessary to achieve higher output and higher consumption in the future. Large discrepancies between welfare and income effects illustrate the importance of the recent discussion on welfare versus income gains from trade liberalization, and stress the necessity of an overall welfare measure in analyzing effects of regional integration.

Cathal O'Donoghue and Holly Sutherland, **Accounting for the Family: The Treatment of Marriage and Children in European Income Tax Systems**, Innocenti Occasional Paper No. 65, Italy, 1998, 54 pp.

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Review and Outlook for Eastern Europe, PlanEcon, United States, June 1999, 285 pp.

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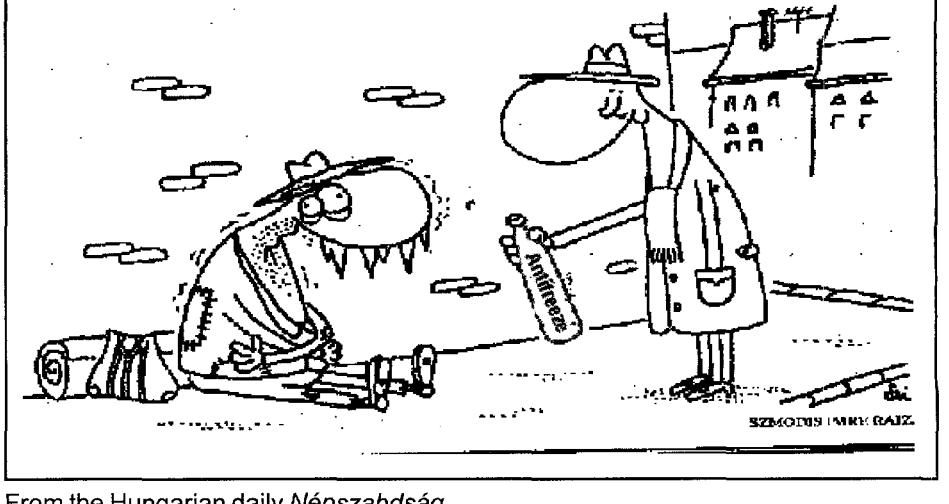

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