Ten Years Transition:
Recalling the Events of a Historic Decade with World Bank Chief Economist Nicholas Stern
by Richard Hirscher

The Transition Newsletter recently celebrated its 10th anniversary. That occasion marks an appropriate time to look back and recall some major milestones in the past decade—with the help of Nicholas Stern, the World Bank’s new Chief Economist. Mr. Stern was in the “frontline” almost from the beginning, heading a task force in 1993 that forged a new path for the EBRD. He became Chief Economist of the EBRD in January, 1994, and joined the World Bank as Chief Economist and Senior Vice President in July 2000.

Czech President Vaclav Havel on the Intellectual Challenge of Globalization

Summary of a Panel Discussion at the University of Michigan
by Jan Svejnar

On September 5, Vaclav Havel, President of the Czech Republic, visited the University of Michigan to receive an honorary doctorate, inaugurate a Czech Studies Program, and lead a symposium on “Globalization’s Intellectual Challenge.” Since the challenges of globalization are at the forefront of discussion during the Prague meetings of the IMF and World Bank—and will continue to be debated in the years to come—we bring to our readers some of the main ideas from the Michigan symposium.

President Havel began his remarks by asserting that although the globalization of information transfer is neutral, the ideas and messages being transmitted may not be. One must thus question the nature of the ideas being disseminated rather than the process of global-
Q: After the early euphoria, the joy of regained freedom, and the installation of parliamentary democracies, many problems came to the surface in the transition economies of Eastern and Central Europe and the former Soviet Union. How should the obsolete enterprises be revived—reviving the fishes from the fish soup, as a joke of that time put it? Stabilize, liberalize, and privatize with one stroke, with a “big bang” or should the process be a slow one in order to delay the social consequences as long as possible? Few of these countries were able to evade the transitional recession.

A: At the end of 1993, Poland was starting to grow. Russia was only making the first steps. The Soviet Union broke up in January 1992, and then, in the summer of 1993, the attempted coup collapsed under Yeltsin’s leadership. So you could sense that in 1993 Russia was still trying to define its existence. The reform program was really only beginning. Institutions of the command economy fell apart, the fledgling structures of the market economy were only beginning to emerge. There was tremendous pressure on the reformers to move quickly because of all the uncertainty. They really didn’t know what the future would bring.

Reformers hoped that by moving quickly they could make the democratization irreversible. The resulting privatization was very unsatisfactory. Reformers gave away ownership and control to existing oligarchs—nomenklatura managers who dominated those firms—and cooperated with the new oligarchs. The new oligarchs enriched themselves during the final period of the old regime or in the early inflationary years of the new regime and used their money to snatch the most lucrative pockets of the Russian economy. The reformers leaned on them for support, and through the seriously compromised “loans for shares” scheme, transferred additional assets to these magnates.

Q: With hindsight, the fear of communist restoration can explain the reformers’ haste. But the stakes were too high, and the reformers lost the trust and confidence of many people.

A: The reformers also had an ideological urge to move quickly. They felt that creating the private sector would generate demand for positive institutional reforms. But in this they were wrong. In a distorted socio-economic system, in order to survive, the private sector would adapt to its environment and not necessarily have an incentive to establish good corporate governance or engage in competition.

Q: On the other hand, privatization in some Central and Eastern European countries really worked.

A: In contrast to the remorse one could sense in Russia over the collapse of the empire and the loss of superpower status, the atmosphere in Central and Eastern Europe was very different. Their economies were more open. It was much easier for them to turn westward, both to increase their trade and politically, as they felt part of Europe in a very natural way. There was a feeling of liberation, a wish to make a new start. With this atmosphere their previous experience of market economies, it was much easier to build institutions.

Q: It didn’t prevent great blunders. In the Czech Republic, for example voucher privatization failed to create genuine owners for companies.

A: That was a mistake. But Prime Minister Vaclav Klaus and his advisors genuinely believed that effective markets would emerge quickly once vouchers were auctioned off. Because voucher owners didn’t know what they were buying, in other words, the performance of enterprises that issued the vouchers was unknown, those markets didn’t work well. This is a clear example of the lack of institutional underpinnings—in terms of corporate governance, proper control, disclosure regulations, and so on. Real markets thus could not develop, and you ended up with a rather paradoxical situation in which the vouchers were eventually bought up by banks that were still under state control. These banks became the owners of the companies. The lender-borrower relationship with firms became quite complicated. This contributed to the weakness of the Czech banking system.

Q: However, transformation of the banking system in Hungary was quite successful.

A: Hungary opened the gates to foreign banks and succeeded in creating a modern competitive financial service sector by the mid-1990s. Poland, having successfully implemented a rapid stabilization and liberalization, became more cautious when it came to privatization, including foreign involvement in the banking sector.

Q: Among the unfinished business, we have to mention the social distress of millions of people, the big holes in the social safety net, and increased poverty.

A: Especially in Russia, but also in other countries of the former Soviet Union, hyperinflation, together with the collapse of the real economy, caused deep impoverishment, revealed not simply by the growing number of poor but also by the deteriorating mortality statistics. In Russia, for example, life expectancy for men has declined precipitously.

Q: So is it fair to say that after 10 years some hopes have been fulfilled but even more have been crushed?
A: This period has been extremely hard on many people. The frustration and disappointment have been exacerbated by the naive belief that political liberation and economic freedom somehow bring about Western living standards very quickly. Of course, it couldn’t happen overnight. In most transition economies, a complete re-adjustment was necessary. Millions of citizens in the former Soviet Union and other transition countries face hardships and discontent.

Q: Quite a few scholars have argued that adopting the Chinese model might have been more effective.

A: Not in countries that underwent dramatic political changes. Besides, the contrasting production structures at the outset of reforms really made a difference. In the Soviet Union, but also to some extent in Central Europe, there was a peculiar system of gigantic single production units, dominating huge areas and using inputs from other gigantic single production units. Whole cities were built around these colossal plants, which were supplied from other factory towns thousands of kilometers away. So an extraordinary artificial interdependency among different areas emerged that made the production structure very rigid and fragile. With the collapse of the Soviet-dominated trade organization Comecon, as different opportunities in trade opened up, industrial structures across the region, from the Elbe to Kamchatka, became obsolete. The collapse of this rigid structure was especially severe in the former Soviet Union.

The story in China has been different. China did not go through a drastic change in its political system. Of course, China endured a series of political upheavals, including the Cultural Revolution, prior to the reforms. But then in 1979 Deng Xiaoping restored order, stabilized the country, and launched economic reform. In addition, the Chinese economy consisted of self-sufficient regions, which—once the reform took hold—developed natural trade linkages with one another. With the advent of China’s opening to the outside world, a competitive manufacturing industry was gradually built with huge export capabilities.

Q: What do you think of the debate about the importance of “path dependence”? Institutions, history, cultural background, and geographical situation have had such great influence on the progress of the transition economies. It seems that good policy counts a lot, but good policy decisions are made in countries in which institutions are well developed. For example, the further you travel eastward from Germany, the more development problems you will be confronted with. Even those countries that were declared success stories early on—Mongolia and Kyrgyz Republic, for example—are having a hard time, with destabilized economies and declining living standards.

A: Indeed, we now realize that initial conditions were very different in the individual transition economies—something I don’t think we attached enough significance to initially. As I mentioned, the rigid production structure affected the countries of the former Soviet Union much more than the countries of Central and Eastern Europe. No doubt geography, cultural background, and historical familiarity with the market economy helped Central Europe quickly restore its traditional ties to Western Europe.

Q: How do you see the World Bank’s role in the transition economies over the next 10 years?

A: Supporting Russia presents a great challenge to the Bank. Russia now has a chance for a new start: it faces favorable macroeconomic conditions almost for the first time, partly as a result of rising oil prices. It also has a government that is interested in reform and, with better relations with the Duma, is strong enough to implement its program. In areas of tax reform, relations between the center and the regions, financial sector reform, and corporate governance, the Bank can make a strong contribution with analytical and sector work. It may also be able to provide loans. So over the next few years, the Bank’s role in Russia could be important. It is crucial that in this period Russia undertake the structural reforms that are fundamental in establishing a healthy market economy.

Q: What about the other transition economies?

A: We face similar challenges there. The challenges in Ukraine are perhaps even more difficult than in Russia. Ukraine has not had the opportunity to make a new political start, and the strong anti-reform forces there make decisionmaking very difficult. Corruption is a very serious and tough issue. In Central Asia, Kazakhstan has oil and Turkmenistan is starting to export its gas again, but it is important that those countries make an effort to build up small and medium-size enterprises. The World Bank Group can support these efforts. In Europe, as the 10 accession countries move closer to joining the European Union, they will have alternative sources of funds. Nevertheless, over the next few years the Bank will have a role to play in helping finance the necessary pre-accession changes.

Q: While the Bank is striving for reform in the transition economies, it is undergoing thorough changes itself. What is the direction in which we are heading?

A: I believe the Bank will move toward simplified conditionality and support of countries with strong track records. This change in direction is based in part on our research on aid effectiveness. It is consistent with the notion that borrower countries should participate more actively in World Bank projects. And it is consistent with...
President Wolfensohn's thinking about the Comprehensive Development Framework, expressed clearly in the recent poverty reduction strategy. These ideas will be increasingly operational and will have a strong effect on what the Bank does. The Bank could, for example, shift its activity in the direction of programs instead of projects.

Q: What direction will the Bank's research take?
A: That is something we are still looking at. As the largest research center on development in the world, the Bank must have good coverage of the issues. What particularly interests me is the investment climate: what kind of reforms in government behavior and policies should we seek, what kind of regulations should be applied, what kind of environment created, to stimulate foreign and domestic investment? This is enormously important in explaining the differences in growth across countries. Understanding these issues is vital to help our member states in creating favorable business environments.

World Bank/IMF Agenda

President Wolfensohn: World Bank Complements Private Finance

The World Bank should broaden its efforts to fight poverty in middle-income countries by developing services that complement private investment flows, World Bank President James Wolfensohn said during the International Monetary and Financial Committee meeting in Prague. About 30 percent of the world's poor live on less than $1 per day and about 40 percent of those living on less than $2 per day live in middle-income countries, broadly defined by the Bank as having per capita incomes above $885 a year. Although middle-income countries can obtain access to private capital, such access is often restricted and unstable. The role of the Bank is to deliver services that the private sector cannot or will not deliver. Like the IMF, the Bank needs to tailor its financial support to complement and catalyze—not replace—private investment flows. The Bank should develop assistance based on countries' own visions of development and be more selective in supporting social and structural agendas.

IMF Warns Accession Countries Not to Adopt Euro

Government budgets of the countries seeking EU membership could come under further pressure and exchange rates could see big fluctuations in the run-up to EU membership, according to IMF officials. Early adoption of the euro is a "dangerous option" for countries that have not completed their structural reform process. David Robinson, assistant director of the IMF's research department, cited the problems in the former German Democratic Republic—where industry faced severe adjustment problems after the country was unified with the Federal Republic of Germany under a common currency—as examples of the dangers of premature euro adoption.

To avoid high unemployment in the future, the IMF would like the countries seeking accession to retain their flexible labor markets rather than adopt the rigidities characteristic of many EU countries (low wage differentials between skilled and unskilled workers, generous unemployment benefits). It dismisses fears that large numbers of workers would migrate to Western Europe following EU enlargement, citing a study suggesting that only 335,000 more people each year will seek work in the EU after immigration controls are lifted.

World Bank Lending in FY00: Fewer Loans, Higher Quality

New lending commitments from the World Bank were down by almost half in FY00 (which ended June 30), falling from $29 billion in FY99 to $15.3 billion. Disbursements in FY00 stood at $18.5 billion, down from $24 billion in FY99, according to the Bank's 2000 Annual Report, released September 23. The share of projects that are at risk of not achieving their development objectives fell to an estimated 15 percent of the total in FY00, roughly half the rate in FY96. More than 80 percent of the funds lent now achieve a satisfactory or better outcome.

New Lending Declines, Disbursement Increases in Europe and Central Asia

New lending commitments from the World Bank to countries in the Europe and Central Asia region (which includes the transition economies plus Turkey) totaled $3 billion for 47 projects in FY00, down from $5.29 billion in FY99 and $5.22 billion in FY98. Since 1990 the Bank has committed about $40 billion to borrowers in the region. The decline in new lending—the result of deteriorating policy performance in a number of the former Soviet republics—was especially steep in the Russian Federation and Ukraine. Commitments to Russia, traditionally the largest recipient of Bank funds among the transition economies, fell to $90 million, down from nearly $2 billion in FY99. Lending commitments in Ukraine declined to $18 million, down from $600 million in FY99. No lending...
Vaclav Havel Continued from page 1


related to globalization, "We are now in the age of an information revolution, when hundreds of thousands or millions of pieces of information crisscross the globe every second at a fantastic speed, spanning our planet with an all-embracing coat of communication. This is undoubtedly a marvelous achievement, to which I have no objection whatsoever. However, it seems to me—especially after this global breakthrough in the field of information—that it is of paramount importance to understand the fine difference between information and truth," Havel said.

The second issue raised by President Havel was his perception of globalization as a process that reduces variety and quality. In the Czech Republic the 1989 revolution replaced the gray and monotonous landscape of half-empty state shops with a rich variety of small and colorful shops throughout Prague and other cities. By the late 1990s, however, this variety had been dramatically reduced, as hypermarkets established themselves at the outskirts of the cities, driving many downtown merchants out of business. At the same time, the quality and diversity of products diminished.

Following on Havel’s remarks, Lee Bollinger, the President of the University of Michigan, outlined the challenge the University of Michigan and other leading universities face of providing a globally oriented education. American students require more effective language instruction and greater possibilities for studies abroad. To increase its own global focus, the University of Michigan will consider doubling its number of international students, increasing the percentage of foreign students from 4 percent of the student body now to 8–9 percent within a few years. The increase will be facilitated by an expected increase in financial aid to foreign students.

Related challenges include increasing the use of modern technology in the delivery of education and increasing coordination and cooperation between universities in the United States and abroad. President Bollinger noted that the 62 leading American research universities meet regularly within the framework of the Association of American Universities, but no such information exchange exists with foreign universities.

In my presentation, I focused on two major problems associated with globalization, namely, that people around the world do not understand it and therefore fear it and that the benefits of globalization have so far been very unequally distributed across countries. These problems present a fundamental challenge for institutions such as the University of Michigan as well as for governments and intellectuals in developing and transition economies. Leading American universities provide the type of educational and intellectual environment that enables graduates to enter the highly rewarding sectors of the global economy. Two important elements of the American system are absent in most other countries: wide access to college education and intense competition among universities in research and dissemination of new knowledge to students, faculty, and society at large. This system ensures that new intellectual developments are rapidly incorporated into the process of higher education and benefits are passed on to society.

An important challenge of globalization is eliminating this gap. Governments and intellectuals must work to increase the quality and impact of universities and other educational institutions. Funding of universities needs to be tied to performance, and significant resources need to be allocated to higher education so that it becomes accessible to more students. Globalization accentuates differences. Unless countries such as the Czech Republic make these types of adjustments, they will not reap the benefits of globalization but will instead be left out.

The challenge for the University of Michigan and other leading universities is to become truly global in the delivery of education, in part by establishing alliances with institutions abroad. The William Davidson Institute and the Business School at the University of Michigan have already made important strides toward globalization. The vision and financial support of people like Bill Davidson have enabled us to involve thousands of students, faculty, managers, government officials, and journalists from other countries in our educational programs. Over the past decade the Institute and the Business School have sent thousands of students to work with hundreds of companies all over the world. In these and other initiatives, the university community can be a vital force in ensuring that globalization improves welfare around the world and provides benefit to our own community.

Jan Svejnar is the Executive Director of the William Davidson Institute and the Everett C. Berg Professor of Business Economics at the University of Michigan Business School.
From the *Transition* Archives: Wandering in the Past, Part I

"Why this newsletter? At the start of 1990, a new Socialist Economies Unit (CESCE) was established in the Country Economics Department of the Policy, Research, and External Affairs Complex (PRE). The objectives of the new unit are to catalyze and carry out analytical work and strengthen ties among researchers and also between research and Bank operations in these countries. This newsletter is one of the means for the new unit to fulfill its dissemination mandate. Its audience is primarily the staff of the Bank Group involved in work on socialist countries, although it is hoped that the information will be of use to a wider audience as well." With those words *Socialist Economies in Transition* was launched in April 1990. The first editor was Matyas Vince, from Hungary.

Times have changed in the decade since the World Bank's newsletter began publication. CECSE changed its name several times, but it survived until June 30, 1996, under the consistent leadership of Alan Gelb. The Transition Economics Division became part of the Macroeconomics and Growth Division, led by David Dollar. Alan Gelb was appointed Chief Economist in the Africa Regional Office; David Dollar is now Manager of the Development Research Group. Both contributed much time and effort to creating and keeping alive the newsletter, steering it to safe waters even amidst the turbulent waves of successive reorganizations.

It would take many pages to list all the friends who supported us in our goals of becoming a faithful chronicler of the command economies' historic transformation, providing a forum for often controversial views and ideas, reporting research work, and building a network of interested institutions and individuals. We traveled a long way to build a circulation of 15,000 for the English-language edition (the newsletter is also published in Russian and Chinese) and to reach tens of thousands of readers online.

As transition remains, alas, an unfinished business, our goal is to keep going in the years to come. To recall some memorable milestones of the past decade, we put together a selection of articles and cartoons from 10 years' harvest. We start our series with the tumultuous first years: 1990 and 1991.

**The Future of the CMEA (Martin Schrenk, May 1990)**

The future of the CMEA (Council for Mutual Economic Assistance) has a prominent place among the unresolved issues of system reform in the socialist economies belonging to this international organization. The urgency of the matter derives from three considerations. First, CMEA trade relations loom so large in the total trade of all members that the organization's role cannot be ignored without serious risks to the success of the reform programs. Second, the traditional CMEA regime has been rejected by reformers in the European "Small Six" (Poland, Hungary, Czechoslovakia, GDR, Romania, and Bulgaria) as well as by the USSR. And third, the January 1990 session of the CMEA Council in Sofia seems to have set into motion a process that will either lead to a change of the existing CMEA or to its demise.

**Vaclav Klaus on Economic Reform (May 1990)**

Fragmentary reform might be worse than no reform at all; there is no sense delaying a comprehensive reform program until every detail is clarified; the most crucial reform steps must be taken in proper sequence, even without knowing the full sequence a priori and the outcome in detail; ("When we play chess we have to know the opening strategies. But it is impossible to foresee the situation on the chess board after the 25th move"). The trap of decentralization should be avoided; a major obstacle is the lack of transparency in the economy. In the first stage, state-owned enterprises will be transformed into joint-stock companies. In the second, their shares will be sold mainly to the public at auction. Dr. Klaus added that his intention is to privatize large segments of the Czech economy in a few months.
The Human Challenge (Julian Schweitzer, June 1990)

Social sector reforms in Central and Eastern Europe require painful adjustments of attitudes and institutions. Central planning and decisionmaking must be replaced by decentralized control. Rigid occupational definitions and narrowly based education and training have to be replaced by flexible systems that prepare people for new technology and rapidly changing labor markets. Improvements in health care delivery and practice are urgently needed. The World Bank intends to play an important part in this process.

Privatization and Ownership (June 1990)

Certain questions deserve continuing reflection. Should the process be fast or slow? Does the state need the revenues from privatization? Should enterprises be demonopolized before being privatized? Should enterprises be financially and technically restructured before being privatized, or can this be left to the new owners? How can ownership arrangements be instituted where the new owners take an interest in performance? These questions invite multidimensional answers. Divestiture models are not exclusive. It may be perfectly possible, in fact, to give workers and managers a stake in their firms, give away a proportion of enterprise equity to the general population (either directly or through institutions), and obtain revenue for the state through general sales. Even in the best scenario, it is unlikely that most state assets can be divested in less than a few years. The near complete unpreparedness of the legal, financial, and fiscal environments underpin this expectation.

Janos Kornai’s Book: The Road to a Free Economy (June 1990)

For a number of systemic reasons, trying to make the social (state-owned) sector efficient, with few exceptions, would be a hopeless task. “Market socialism,” therefore, is an impossible goal—not because social sector managers are corrupt or incompetent, but because the culture within which they operate has not prepared them—or can it ever prepare them—to behave as entrepreneurs. Options for improving efficiency [include] unrestricted entry of new private firms and privatization of existing social sector firms. Kornai explicitly rejects the notion that society should distribute credits to “impersonal private ownership” or through the “intangible stock market.” Instead, only hard loans to stakeholders willing to offer their personal property as collateral [should be provided].

The Bank’s CEE Research Program (June 1990)

The most urgent analytical and research priority is enterprise reform. The responsiveness of micro-units to the changing economic environment in reforming socialist economies is problematic; it is not clear that market structure, internal enterprise organization, technology, management, and attitudinal patterns are conducive to a strong supply response once prices are liberalized and financial constraints are applied.

An Evolutionary Perspective on Reform (Peter Murell, July/August 1990)

A radical change in the environment (that is, reform) might diminish the productive efficiency of the state sector, while the private sector is not yet ready to take up the slack. In the short run, competition between the state and the private sectors has little chance of identifying the entities most suited to the environment that is the desired end-state of reform. The only possibility is to maintain a dual economy during transition. The state sector must be subject to the traditional bureaucratic controls. In some cases, recentralization might even be required during the early months or years of transition. At the same time, the private sector should be allowed to function freely without central help or hindrance.

Privatization in Post-Communist Societies (Branko Milanovic, September 1990)

Eastern European countries are facing the most momentous economic and social change of the last 50 years: privatization of state-owned enterprises. Failure of [earlier] reforms ultimately led to the realization that lack of ownership is the root cause of inefficiency in socialist economies. Privatization will provide a unique testing ground for economics: Can market institutions be created by design rather than through evolution and slow process, characterized by accumulation of knowledge and survival of more efficient forms of organization?

Estimated Bank Commitments and Proposed Commitments in Central and Eastern Europe, 1988–93 (September 1990), (millions of dollars)

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<tr>
<th>Country</th>
<th>Actual FY88</th>
<th>Actual FY89</th>
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<th>Proposed FY91</th>
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* Country-specific allocation to be determined.
  a. Admitted as new member in September 1990.
  b. Resumed borrowing after several years.

Turn the Fish Soup into an Aquarium (Timothy Garton Ash, September 1990)
A Russian joke about the transition from communism makes the point better than any learned disquisition. We know that you can turn an aquarium into fish soup, the question is, can you turn the fish soup back into an aquarium? Western models play a major part, both in the design of the new political institutions of East Central Europe and in the formation of parties. Everywhere, teams of Western experts have been called in to give their advice.

Transition is, as Ralf Dahrendorf has written, unavoidably a valley of tears. Even the Germans, with far better starting conditions in 1948, got poorer before they got richer. There is, to be sure, a general consensus among Western governments and political elites that "we should help" the transition to democracy in East Central Europe. But how many politicians are prepared to even contemplate action on a scale comparable to that which West Germany, after a very sober examination, considers to be necessary for East Germany? Above all, how many politicians are prepared seriously to make the case for such help to their own electors? Ironically, the kind of Western European consumer democracy to which East Central Europeans so passionately aspire may be the kind least likely to help them.

**Soviet Reform: A New Phase (Abram Bergson, October 1990)**

The difficulties in the way of the economic invigoration that Gorbachev has been seeking are formidable. The Soviet consumer goods market has lately ceased functioning almost entirely. Queues and empty shelves are as pervasive as ever, and some particularly scarce products are rationed locally or distributed preferentially to workers by their employers. The ruble is aptly held to be not real money but a kind of lottery ticket, redeemable for goods only with luck and perseverance.

In concluding a discussion of the new reform program in the Supreme Soviet, Gorbachev avowed to radically revitalize finances, stabilize the monetary system, and strengthen the ruble. Liberalization of prices is now promised on a considerable scale. But retail prices of most essential goods will continue to be fixed by the government, apparently at the current levels. The government proposes to continue the extensive control over materials supply, at least through 1991.

Gorbachev's new program has been criticized as being vague. With one republic after another asserting sovereignty, the very existence of the USSR as a viable political entity can no longer be taken for granted.

**Policy, Efforts, Dollars (Eugenio Lari, October 1990)**

[Editor's note: Eugenio Lari was in charge of Bank operations in the former socialist countries until 1991, when Russell Cheetam and Kemal Dervis took over as directors of the two new regional departments serving the CEE countries.]

The lending activities of the World Bank in Central and Eastern Europe (CEE) have increased dramatically in both quantitative and qualitative terms. Against five operations for $543 million (or 3 percent of total World Bank lending) in FY89, total World Bank commitments in FY90 were $1,839 million (or 12 percent of total World Bank lending) in 10 operations. With the expected return to active status of Romania and the new members (Bulgaria and Czechoslovakia), commitments in FY91 are projected at 15 loans for about $2.5 million.

**The Task of the State is to Clean up the Mess (Alex Nove, October 1990)**

An attack on "market socialism" is now coming from a number of East European economists, converts to free market ideology, who usually express regret at their own "naive" illusions of earlier times about the "reformability" of Soviet-type "socialism." A leading exponent of these ideas is Janos Kornai. He expresses his views systematically and cogently in *The Road to a Free Economy* (1990). Its basic argument is that there is no third way, no viable alternative to Western capitalism in one of its several forms, once one rejects Soviet-type socialism.

Electricité de France, the Dutch railways, Norwegian coastal shipping, American airports, Swiss postal buses, Swedish telephones, even Budapest's own municipal transport system could be contrasted with examples of wasteful or unsuccessful "public" activities, which exist also. And what of the role of the state as provider or financier of health, education, public parks, roads, and other infrastructure; old-age pensions; a better environment;
and low-rent housing? Do such things lead us along the road to serfdom? Perhaps we would both settle for a kind of welfare-capitalism-with-a-human-face, not easy to distinguish from a socialism with a big role for private capital and individual entrepreneurs. Much may depend in the end on the stability of the international system that the East Europeans are now so keen to join.

**Yugoslavia: The Dilemma of Reform amidst Political Turmoil (Srdjan Trifkovic, November 1990)**

It is hardly possible to analyze Yugoslavia's economic problems without an understanding of its present political predicament—not even the Soviet imbroglio provides a suitable parallel. Yugoslavia's peculiar intricate web of conflicting nationalities, religions, and values prevents its quarreling leaders from devising a blueprint for action. And since there are hardly any rules, there can be no coherent game. At the same time, some leaders of Yugoslavia's six constituent republics seem to have a vested interest in keeping nationalist emotions at the boiling point. In fact, many Yugoslavs are warning that a civil war may be but a few steps away.

**The IMF and the Challenge of Eastern Europe: Interview with IMF Director Massimo Russo (November 1990)**

Q. **How would you evaluate the region's economic prospects?**

A. The oil price explosion and the collapse of the CMEA trade and payment patterns will have serious implications for the region, resulting most probably in a deterioration of their terms of trade, disruption of their exports and imports, and general uncertainties. Many Eastern European exporters geared to the Soviet market will find it difficult to shift to the Western markets or even to preserve their positions in their traditional outlets.

Q. According to some commentaries, large segments of the population in the region reject austerity, unemployment, and hardship—unavoidable, if temporary, consequences of the stabilization programs. Shouldn't the IMF drastically change policy and work for general debt relief of the countries involved?

A. No, I do not think we need a revision of our policy. I believe the approach of stabilizing the economy and at the same time enhancing the role of the market forces is the right one, the most effective one. Of course, it is not easy to implement such a program. All countries involved in the transition process should work for a stable currency and sound balance of payments, but to achieve that, stabilization efforts should go hand in hand with market-oriented reforms.

**To Seek and Find a System (John Kenneth Galbraith, November 1990)**

If larger enterprises are given freedom from the disaster of ministerial (i.e., bureaucratic) control and they are thus accorded the right to set their own prices, procure their own materials, and make their own subcontracts, the location of actual ownership is not a matter of prime importance. I would urge that ownership be widely distributed, and I am attracted by the proposed action in Poland, which is strongly supported by my colleague Jeffrey Sachs, to distribute the shares widely to the citizenry, with a special advantage for employees of the particular enterprise. The equity of such an arrangement has an obvious appeal, as does also the resulting sense of participation.

**Transforming the Ownership System in Eastern Germany (Martin Schrenk, December 1990)**

On the eve of unification, East Germany's public sector, including cooperative farms, accounted for about 95 percent of total employment and output. The state trustee agency Treuhandanstalt (Treuhand) was set up in June 1990 to handle the management of this vast empire. Treuhand is de facto the largest and most diver-
sified holding company in the world, with a portfolio of some 8,000 enterprises, many of them multienterprise units, and reportedly holds 40 percent of the total area of Eastern Germany. At its inception, Treuhand also assumed all public debt.

Treuhand's mandate is to assume ownership of state enterprises and to carry out their privatization, reorganization, or liquidation. Proceeds from the sale of enterprises will be used to cover costs of other units' liquidation. The expected flow of transfer payments within Germany from the western to the eastern part of the country is anticipated to be well in excess of $3,000 annually per capita for the next decade, in addition to large interregional capital flows.

**Stabilization Efforts in Poland and Yugoslavia: Early Lessons (Fabrizio Coricelli and Roberto Rocha, January 1991)**

Restructuring the productive sector is urgently needed to provide a positive supply response and sustain reform. One important question is who will be in charge of restructuring and under what system of incentives? Centralized restructuring that excludes privatization not only may prove too slow to implement but also may produce an undesired selection of enterprises. Therefore, a more rapid move toward privatization may be required to minimize the risks of wasting resources during the restructuring process and to enhance the prospects of a sustained supply response.

Although forcing inefficient enterprises into bankruptcy is an important step, in the absence of well-functioning labor and capital markets it could create a large pool of unemployed workers. The issue of privatization comes up again, as it is impossible to develop a true labor market without simultaneously developing a market for capital. Policymakers should also address the issue of housing ownership and financing, a notorious obstacle to labor mobility in socialist countries. Failure to provide prompt solutions could jeopardize the early results of their stabilization programs.

**Interview with John Holsen: Study on the Soviet Union (January 1991)**

Disruption in the Soviet economy is much greater than in Eastern Europe or in China. There is a shift to barter, to dollarization, as well as much hoarding. The internal movement of goods is increasingly restricted—people simply do not want to take rubles for goods, points out John Holsen, head of the World Bank's team that together with the IMF, the OECD, and the EBRD have issued a study on the Soviet economy and recommended a radical economic reform program.

For Soviet officials the most controversial proposal was to move rapidly with price liberalization. That recommendation stems directly from the breakdown of the ruble economy. The government should go ahead with quickly introducing market-clearing prices. Right now, what the Soviet Union needs is simply to make the ruble a medium of exchange once again. The monetary overhang could be absorbed partly by the price increases that are expedited this year; partly by selling state assets to the private sector (small enterprises, retail stores, trucks, service industries); and partly by restricting application of funds held by enterprises. If other appropriate measures are taken, radical monetary reform is not necessary.

The day after the interview, the Soviet government withdrew from circulation all 50- and 100-ruble notes. Citizens can exchange those bills for the equivalent of their average one-month salary, up to 1,000 rubles. To exchange more than the specified amount, citizens must apply to a special commission and must document the origin of their banknotes.

**Go Carefully on Trade: Pro and Con (January, 1991)**

From the Economist's article "Value Subtractors of Eastern Europe":

[Post-socialist] countries should move gradually to free trade. All-at-once liberalization could flatten a large part of the economy overnight. To give enterprises a chance to adjust and to avoid a crunch that would undermine support for further reform, governments might need to start with high tariffs, promising to eliminate them over, a given number of years.... When reluctant reformers (of Eastern Europe) are willing to take their chance, they might be wise to do the opposite of what Poland did. They should privatize as fast as possible and preferably all at once, but then go carefully on trade.
Response of Jeffrey Sachs in the *Economist*:

Free trade is especially vital in Eastern Europe. It is the single most effective way—perhaps the only way—to instill real competition in the industries of Eastern Europe, which are otherwise too concentrated, too politically powerful, and too small to generate domestically based competition. Free trade will allow Eastern Europe to import a rational price structure. It will provide the principal source of contacts between Eastern European and Western firms—contacts that are vital for improved product qualities and technologies. Free trade will cause some firms to shrink or fail—but protecting such firms is unjustified.

**Priorities of Economic Reform (Rudiger Dornbusch, February 1991)**

Heavily managed economies, falling output, and unrealistic expectations of progress handicap the new leaders in Central and Eastern Europe. Market-oriented policies can help to decentralize decisionmaking and depoliticize the economic sphere. Progress will be slow, but the recovery will not begin unless restrictions on private initiative are withdrawn. Gradualism opens the door to an unstructured free-for-all: consumers will go to the black market, firms will produce for the black market. Therefore, a quick transition to a market economy is the most effective strategy.

For policymakers in Eastern Europe, there are two ways to go: backward to repressive control or forward to the market. The worst scenario is that of a mixed economy: capitalism without profit and socialism without planning. The new leadership is anxious to avoid hardship by exercising discretionary controls and restrictions on trade, property, production, and employment. But these tools were discredited under communism; they should be thrown overboard immediately.

**The Lab Rats Are Real People: The Pains of Transformation (Robert Kuttner, March 1991)**

Transition from a command economy to a market economy presents an extraordinary laboratory for economists, international bankers, repentant ex-Marxists, and assorted capitalist carpetbaggers plying their trades—and the lab rats are real people, desperately hoping for something better than they had under communism.

Communism has turned out to be a century-long detour from the nagging question that perplexed Marx and a great many non-Marxists as well: how to reconcile efficient production with a bearable society. Communism produced neither. The dilemma, however, persists, and the question now will be fought out on the terrain where it always belonged—among variations of a liberal, market society. The collapse of communism doesn’t end the debate about the appropriate boundaries between state, market, and civil society, any more than it ended History. The third way, however, is not reform communism but reform capitalism.

**Telecommunications: A Crisis Sector in Eastern Europe (Timothy E. Nulty, April 1991)**

The explosion of demand in Eastern Europe for telecommunications services, after decades of neglect, will place unprecedented pressure on manufacturers, service providers, and government authorities. Eastern European telecommunications firms must reduce operating and investment costs and improve productivity (they employ up to 300 percent more people than do the world’s most efficient networks). They must overhaul their corporate structure, develop human resources, and raise productivity without heavy layoffs. In the medium term [they need to] transform telecommunications entities into independent joint-stock companies, set conditions for market entry by other providers (such as licensing and franchising), and establish prices and tariffs. For this, technical assistance from the West is critical.
Ownership Changes in the Soviet Union (Sergei Shatalov, April 1991)

Hardly six months have passed since the term "privatization" became official Soviet terminology. Privatization in the Soviet Union is perceived as the process of diversifying and decentralizing enterprise ownership and economic decisionmaking. To this end, the All-Union laws, drafted in early 1991, embrace three consecutive processes: elimination of direct administrative control over enterprises, transformation of state-owned enterprises into joint-stock companies (corporatization), and, transfer of ownership rights to private individuals, collectives, and other enterprises. The present All-Union government is the first one to attempt genuine large-scale ownership transformation in the Soviet Union. However, the central authorities allow only the economic and political elite to play an active role in the process.

Environment in Eastern Europe (Richard Ackermann, April 1991)

It has become almost axiomatic to refer to environmental pollution in Eastern Europe as a stark symbol of the old communist system. In fact, the new democratic governments have made little effort to hide the dire consequences, such as vast stretches of dead rivers so polluted that the water is not fit for industrial uses; massive air pollution from coal-burning and metallurgy industries, which is causing high rates of chronic bronchitis; contamination of agricultural lands above metal deposits, resulting in high exposure levels to carcinogens; large areas of forests lost or irreversibly damaged; and rural areas and many cities experiencing water shortages. How to clean up? [Through] market-clearing prices. Highest priority should be given to increasing energy and other natural resource prices to reflect their true scarcity, selective large investment pragmatic laws and regulations, strict fees and fines, and decentralization.


The World Bank has recently completed a retrospective study on the transformation of the economies of Central and Eastern Europe (CEE). All the CEE countries have taken major steps toward system transformation in the past 18 months. Hungary, Poland, and Yugoslavia led the way, beginning in late 1989, and Bulgaria, Czechoslovakia, and Romania followed in late 1990 to early 1991. All have adopted strict stabilization measures, implemented major price reforms, devalued their currencies (with varying degrees of currency convertibility), significantly opened their economies to international trade, and revised their legal framework to allow most forms of private ownership while trying to create a level playing field for private entrepreneurs. The countries have made less progress with restructuring and privatization of large enterprises or with development of the institutional capacity to implement the new legal frameworks effectively.

Spontaneous privatization has been discredited by the perception of abuse and inequity resulting from the wave of such privatizations in 1989 and 1990. Public sales are hampered by the inherent difficulties of valuation, the shortage of domestic capital, concern about equity, and the sheer number of firms. Mass transfer is inhibited by fiscal concerns (the loss of sales revenue) and by the fear that efficient corporate governance would be sacrificed through such widespread ownership.
Dissolution of the Council for Mutual Economic Assistance (COMECON) will take effect 90 days after the remaining nine members sign the termination agreement June 28. The Soviet Union, Poland, Czechoslovakia, Bulgaria, Hungary, Romania, Vietnam, Mongolia, and Cuba are still divided over a successor organization. The need to find an alternative method of financing trade among the former COMECON countries has become critical. East European finance ministers are considering a Hungarian proposal to establish a Central European payments union. This system would allow trade surpluses between countries to be cleared in hard currency. However, the free-market Czechoslovak finance minister, Vaclav Klaus, has dismissed the proposal as a "poor man's club" that would hinder the development of more orthodox trade financing and slow the integration of East European economies with Western Europe. Nevertheless, the central banks of Poland, Czechoslovakia, and Hungary are supporting proposals from the Soviet Gosbank and the West European Ecu Banking Association to adopt the ecb banking payments system for intra-COMECON trade.

CEE Challenges to the World Bank: Interview with Eugenio Lari (June 1991)

Q. Is the Bank ready for associate membership of the Soviet Union or for any of the Republics? Could the Bank dispense technical assistance immediately?

A. Representatives of the Bank and both the Soviet Union and the republics have had many informal meetings. Formalizing relations in one way or another is one thing, but how to provide technical assistance to the Soviet Union, which is not a full member of the World Bank? Of course, there is a solution: for example, members could establish a technical assistance fund, managed by the Bank. And if the light turns green? I have little doubt that unless there is a prompt and major allocation of Bank resources and staff for Soviet operations, the stress and pain—from bottlenecks and staff overtime—that accompanied the surge in the Bank’s CEE operations will be repeated. Nevertheless, I share President Conable’s view that the role of the World Bank as a multinational financial institution will not be fulfilled until the Soviet Union becomes a member. The Bank can play a major role there, but will it be enough to solve the huge problems of the Soviet economy? That is another question, which you fortunately did not ask.

Central and Eastern Europe’s share in Bank lending increased from a mere 3 percent only two years ago to 18 percent now—a rise from $500 million to $2.9 billion—and the rate of lending likely will stay at that level over the next two to three years.

Nuts and Bolts of Economic Reform (Jan Vanous, June 1991)

The fiction that has been spread by reform economists now in power in the East is that the key to the turnaround of East European enterprises is to change enterprise ownership. This is an extremely dangerous fiction. Just because an East European enterprise manages to garner a multitude of new private owners, little is likely to change—in fact, in the short to medium run, the structure of output will remain unchanged, the same production technology will be used, quality changes will be unlikely, and management style will stay the same. There is little reason to believe that a large number of inexperienced stockholders with no initial business experience would have a substantial positive impact on the running of a typical East European enterprise. A far simpler and more sensible method of privatization is to create various mutual funds in each country and transfer a portfolio of companies to these mutual funds.

If I were looking for a new Spain in eastern Europe, I would bet on Slovenia, Bohemia, and Moravia, Croatia, Voivodina, Hungary, and possibly some of the Baltic republics. I am somewhat less optimistic about Poland and least optimistic about the Balkan
The Soviet Union should renounce the old ways, give up on the dream of partial reform of Communism—we see how ephemeral it is—and move toward a market system and toward macroeconomic stabilization. The hard thing is to cut the knot; to unravel it is impossible. If you try to change prices without changing enterprises, you don’t get a supply response. If you try to change enterprises without changing prices, you get even greater distortions. So there is no alternative but to try to do all that at once. The World Bank can make an important contribution, sharing the experience it has gained in reform efforts all over the world and ultimately providing financing. But all the preaching in the world is not helpful unless policymakers in the USSR want to change. The problem is more a matter of finding the will than of finding the wallet.

On the big bang versus gradualism question, the problem is that one cannot do everything at once, and yet, at the same time, partial reform risks making things worse. The issue is more one of finding the appropriate overlap in reforms than it is an issue of sequencing. There is room for discussion on the appropriate speed for privatization, even perhaps on price reform, but there is one clear lesson of history: no hyperinflation has been eliminated gradually.

The Bank recognizes that while a shrinking public sector is desirable in these countries, it has to be combined with new roles. Social safety nets for the unemployed are required as well as an area other than its westernmost part—it simply is much easier for a country to recover to its “normal” rank, after having been temporarily depressed by the disaster called communism, than to rise from rags to riches as have the Republic of Korea and Taiwan (China). The sooner East European reformers regain this historical perspective, the more likely the prospect of their respective countries “rejoining” Europe.

Do Not Expect Business as Usual (Anne Appelbaum, June 1991)

Nearly every major Western consulting firm, investment bank, or accounting firm now has its own Eastern European research division, staffed by “regional specialists,” usually American-born executives with Polish or Hungarian surnames. But the Westerner who is willing to make concessions to local conditions is very rare. A businessman of my acquaintance recently arrived in Warsaw for lunch, announcing that he had been in Zurich yesterday and would be in Dusseldorf tomorrow. He professed total ignorance of Polish company structure. Like many other denizens of Eastern Europe's international hotels and fine restaurants, he may well be destined to emerge from his Polish adventures empty-handed, a victim of the assumption that business works more or less the same way everywhere.

Interview with Leonid Grigoriev: Will the Independent Republics Join Forces? (September 1991)

[Editor's note: Russian economist Leonid Grigoriev was one of the coauthors of the radical Five Hundred Days economic plan. Between 1992 and 1997 he was a senior official at the World Bank.]

Q. In one scenario, 15 new sovereign nation-states out of the former [Soviet] republics would implement 15 different economic reform programs. Is this likely?

A. We anticipate no more than three or four major reform variants—one plan for the Baltics, another for Russia and Ukraine.
and probably a different one encompassing the Central Asian republics. All the states will eventually create market economies, although at various speeds. In Russia, reform probably will proceed faster than in some other republics, where Gosplan-minded people are still in charge of the economy.

Q. Can the aspirations of the republics—to take charge of their own destiny, to recover their lost identities—be harmonized with the endeavors of the reformers to create a common economic space?

A. Geography has condemned us to live together. It is impossible to change overnight the common currency and the common legal system, nor is it possible to ignore our common history. Under those circumstances, political independence is no reason to stem the traditional trade flow. The Baltic states, for example, can hardly afford to give up their major fuel and energy sources and simultaneously lose the largest markets for their manufactured products.

Of course, if the republics implement widely different types of reforms, and at very different speeds, the coordination of economic policies, taxes, and customs regulations among other things will be hard, if not impossible. The ruble should remain the common currency for the time being, at least in this most crucial stage of reform, if only to preserve the normal flow of interrepublic trade. I believe that eventually there will be a three-tier currency system in the new states: rubles, dollars, and local currencies all will circulate.

Dump the Ruble as Common Currency! (Anders Aslund, September 1991)

A time of frightening crisis can also be a time of action and aid. Both in the short and long term, all the Soviet republics need as much technical assistance as they can absorb. The main aim should be to develop the skills for instituting and maintaining a market economy, since in the Soviet Union virtually all such skills are lacking in the fields of macroeconomics, auditing, and law. Concomitantly, a multitude of foreign consultants will be required. Whatever happens, the supply crisis in parts of the country is likely to grow so serious that humanitarian aid, food, and medicine, to begin with, will be necessary this winter.

The overwhelming need is for the Soviet Union—or its republics—to go ahead and introduce radical systemic changes as quickly as possible. Each republic will require its own currency. Preferably, each new currency should be pegged to an outside standard, such as the ecu, because there is no reason why the failure of one currency should be allowed to drag the others down. The republics that are successful in their stabilization will find their currencies indirectly pegged to one another. Since the ruble does not inspire confidence among the non-Russian republics, it seems particularly badly suited for the role of international standard. The West will have to accept the introduction of 15 new currencies and realize that little can be achieved until each republic undertakes its own comprehensive reform and stabilization.

Socialist Agriculture Transformed (Csaba Csaki, November 1991)

On the eve of transition, the agricultural sectors of Eastern Europe and the Soviet Union were characterized by large, inefficient farms, burdened with high production costs; subsidized food prices; excess demand for food at those prices; a high level of food consumption relative to other market economies at a comparable economic level; and pervasive monopolies in food processing and distribution.

Metamorphosis of the Century: From USSR to CIS (December 1991)

Eleven former Soviet republics—Armenia, Azerbaijan, Belarus, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan—signed protocols December 22 in Alma Ata, forming the Commonwealth of Independent States and putting an end to the USSR. [Meanwhile] Yeltsin announced Russia’s shock therapy program with the following main elements: price liberalization, tax reform, rapid privatization, removal of quantitative controls (import and export quotas) and most import/export taxes, and greater freedom in currency conversion.
In adopting a broad reform strategy and specific policies, the transition economies had to take into account the particular economic circumstances and political constraints they faced. Their strategies typically included six major components:

- Microliberization of prices, trade, and entry.
- Macrostabilization of inflation, public finance, and foreign debt.
- Structural changes (privatization, international trade).
- Creation of new market institutions (commercial codes, property rights, the financial and capital market sector).
- Complete remodeling of the welfare system (required by soaring unemployment and the elimination of most subsidies to households).
- External assistance. With the exception of the former East Germany and to some extent Bulgaria, Poland, and parts of the former Yugoslavia (Bosnia, Kosovo), external assistance was typically small and of limited impact.

Three broad reform strategies may be distinguished: shock therapy, rapid adjustment, and gradual change.

- The shock therapy approach was really applied only in the German Democratic Republic. Although the strategy offered the potential for the rapid reallocation of resources, it proved far too costly in the short and medium term to be of interest to any other postcommunist country.
- Rapid adjustment was virtually the only choice open to the former Soviet Union and Central Europe, which were in a state of total economic, institutional, and political crisis. Its stronger variant was adopted by Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia; its weaker variant was adopted by most other countries, particularly the Russian Federation and Ukraine.
- The gradual strategy has been pursued successfully by China since the late 1970s.

Klaus’ Ten Commandments

Vaclav Klaus, the then Prime Minister of the Czech Republic defined the basic principles of the strong variant by the following "Ten Commandments":

1. Reforms in postcommunist countries are the outcome of a complex social and political process and cannot therefore be preplanned or socially engineered by any one person or center.
2. The role of foreign aid is marginal.
3. An economic shock (a large fall in output) is inevitable.
4. Dramatic actions are required to impose a restrictive macroeconomic policy, liberalize prices and foreign trade, and establish a process for privatization.
5. A restrictive macroeconomic policy must be sustained.
6. The price shock resulting from price liberalization must be vigorously defended and continued.
7. Economic restructuring requires comprehensive privatization.
8. Transformation costs must be widely shared.
9. Successful transformation requires the opening of markets to foreign goods and the free flow of peoples and ideas.
10. Successful transformation requires successful politicians.

How valid are these prescriptions? The main initial objective of a stabilization policy (the sixth commandment) should be moderate inflation rather than stable prices. Once a country has moved from transformation to recovery and sustainable growth, macroeconomic stability becomes essential. This requirement applies, above all, to countries seeking EU accession.

A similar caveat can be made with respect to Klaus’s seventh commandment, concerning the need for rapid privatization. In Poland state-driven privatization has been slow. But rapid autonomous growth of the original private sector has ensured that the total private sector accounted for about 65 percent of GDP in 1999. Privatization of state-owned enterprises, while usually helpful, may thus not be as necessary as some reformers initially believed. The quality of privatization has proved to be very important, and there is a tradeoff between speed and quality.

The tenth commandment has also proved to overstate the case. Successful politicians can be helpful, but they are not necessary for a successful transformation. Reform must be legitimized through a democratic political process. From today’s perspective, it is clear that Klaus’ formulation understates the importance of creating a new legal and institutional environment and a new culture of habits and attitudes that a modern market economy requires. This task has been particularly important in the countries of the former Soviet Union.

The more successful transitions—in Central Europe and the Baltics—are associated with the strong variant of the rapid adjustment model. One of the most successful transitions has been in Poland, where real GDP was one quarter higher in 1999 than at the beginning of the transition in 1989—by far the best result in the region. After a contraction of about 15 percent in 1990 and 1991, the economy has
grown at an average rate of 5 percent a year. Estonia, Hungary, Latvia, Lithuania, and Slovenia have also experienced rapid growth in the past few years.

The Polish model of transition consisted of the following major elements:

- Adoption of the pre-1939 commercial code and abolition of Communist Party organizations in state-owned enterprises, giving real power to workers councils.
- Liberalization of entry (establishment and operation of private businesses).
- Rapid price liberalization (during 1989 the share of freely determined prices rose from 25 percent to 90 percent).
- Introduction of hard budget constraints on state-owned enterprises and the reduction of inflation through fiscal, monetary, and wage polices, followed by gradual disinflation.
- Convertibility of the current account and liberalization of trade.

The Polish program was gradual in many important respects. It took 10 years to reduce inflation to less than 1 percent a month, mass privatization was limited to small enterprises, social transfers were large (pensions increased substantially in relation to wages), and budget deficits remained significant throughout the 1990s.

The Hungarian model has been similar, although implementation of the major elements of reform was somewhat more gradual and workers councils had little importance. Hungary’s bankruptcy law may be the strictest in Central Europe. The growth of the domestic de novo private sector tended to be in services rather than in manufacturing, where there was fairly rapid development as a result of foreign direct investment. A larger external debt burden and weaker macroeconomic policies meant that stabilization of the GDP contraction took longer than in Poland, and the beginning of rapid growth was delayed by five years (until 1997).

Slovenia was unique, because pretransition reforms were more substantial than elsewhere in Central Europe and the initial crisis more limited. A more gradual transformation was thus feasible and was adopted in the early 1990s.

### The Russian Adjustment Variant

In the Russian Federation the Gaidar plan—the 1992 attempt to achieve budget hardening and disinflation combined with full price, trade, and entry liberalization—failed. As a result, enterprises have been under less pressure to diversify physical assets and shed labor they did not need, thus effectively denying new private firms the resources needed for their development. The failure to liberalize thoroughly kept the set-up costs for new firms high. For several years large subsidized credits and entry barriers undermined the credibility of the strategy, inducing capital flight, creating opportunities for tax avoidance and criminal asset stripping as well as slowing restructuring by old firms.

The Russian reform was nevertheless radical, since by and large prices and wages were liberalized quickly. As a result, markets

### Table 1. Population and GDP in 25 Transition Economies

<table>
<thead>
<tr>
<th>Country</th>
<th>Population (millions)</th>
<th>GDP per capita (thousands of ppp* dollars)</th>
<th>GDP (billions ppp* dollars)</th>
<th>GDP (billions dollars)</th>
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<td>2.1</td>
<td>47.0</td>
<td>13.1</td>
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</tbody>
</table>

*p=ppp=purchasing power parity.

started to develop, taking over the informational and coordination roles from planners. A large-scale privatization program was also initiated early on and implemented quickly. This embarking on privatization before full liberalization (involving not just product prices, exchange rates, and interest rates but also trade and entry terms) and the hardening of budget constraints for enterprises and disinflation were the key characteristic features of the reform strategy adopted by Russia and most other CIS countries in the first few years of transition.

Major Criteria for Growth

To be conducive to investment and growth, the macroeconomic environment in a transition economy should meet several criteria:

- The annual inflation rate should be in the moderate range of 10–40 percent, with good prospects of falling and remaining below 10 percent.
- The government budget deficit should be reduced from the current rate of 5–30 percent of GDP in most transition economies to below 3 percent, with a high premium placed on creating budget surpluses.
- Public debt should be stable at below 60 percent of GDP.
- Government expenditures should be reduced from pretransition levels of 50–60 percent of GDP to 30–40 percent.
- Official foreign exchange reserves should be maintained at least 4 months of imports of goods and services, they should exceed total (public and private) short-term foreign debt, and they should be equal to at least one-third of public foreign debt.
- Direct taxes (especially profit taxes) and social insurance contributions should bring in no more than 20 percent of GDP.
- Monetization of the economy (the sume of cash and all bank deposits related to the GDP) should be substantial, equal to at least 30 percent of GDP.
- The lending rate should be below 20 percent in nominal terms and 10 percent in real terms.

Ten Lessons of the Past Decade

What have policymakers learned over the past decade of transition? Ten lessons emerge:

1. Most former state-owned enterprises, especially large ones, have suffered from the British Leyland/Rover syndrome: the accumulation of structural problems of such magnitude that they are not amenable to significant "strategic" restructuring and growth, whatever their new ownership and regulatory framework. Given the financial, managerial, and other constraints and poor positive incentives, such enterprises are capable mainly of only "defensive" restructuring—unless they are taken over by large foreign investors.

2. The success of transition depends above all on the rapid creation of institu-

Table 2. GDP Growth and Reforms in 25 Transition Economies 1989–98

<table>
<thead>
<tr>
<th>Country</th>
<th>1998 from lowest level</th>
<th>1998 from 1989</th>
<th>Liberalization</th>
<th>Stabilization</th>
</tr>
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<tr>
<td><strong>Central Europe and Baltics</strong></td>
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<td><strong>Commonwealth of Independent States</strong></td>
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<td>Uzbekistan</td>
<td>6.1</td>
<td>-10</td>
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</tbody>
</table>

Note: Early liberalizers—defined as countries that had achieved "complete price liberalization, full current account convertability, and almost complete small-scale privatization"—receive a ranking of 5. Late liberalizers—countries that achieved these thresholds after 1993—are given a ranking of 3. All other countries receive a ranking of 1.

Early stabilizers (countries that stabilized before the end of 1993) receive a ranking of 5. Late stabilizers (all other countries) receive a ranking of 3.

tional, legal, microeconomic, and macroeconomic conditions conducive to the development and growth of a new private sector, domestic and foreign.

3. Development of this new private sector should be facilitated by increasing competition by liberalizing prices, permitting state-owned enterprises to sell capital assets, imposing hard budget constraints on them, encouraging foreign direct investment, and lowering entry barriers for new businesses. (In industrial countries small and medium-size enterprises account for about 50–60 percent of GDP.)

4. The inflation rate need not—and initially should not—be very low, but it must not exceed 40 percent a year and it should be seen as converging to the average level in the EU.

5. A disinflation policy should involve all the key macroeconomic components: fiscal, monetary, and exchange rate policy and (when applicable) wages and benefits. Given the close link between budget deficits and monetary growth in transition economies, tight fiscal policy is necessary. But it may not be sufficient, and other policies should be used in supporting roles. The cost of disinflation is lower if the monetary authorities are politically independent. Although an extreme solution, currency boards can be useful.

6. The choice of an exchange rate regime is not too important from the point of view of an anti-inflation policy, but a moderately or even fully flexible regime can provide the private sector with better information about exchange rate risk and so establish a better defense against speculative capital inflows and the growth of excessive private foreign debt.

7. In addition to an independent central bank and a solid regulatory framework for financial institutions, the essential institutional basis for a stable macroeconomic environment includes banks, insurance companies, pension funds, and stock exchanges.

8. External credibility is vital to attract foreign direct investment and eliminate capital flight. The exchange rate should thus be competitive to ensure that international reserves are high relative to imports and foreign debt, especially short-term debt.

9. Fiscal policy should aim to meet the Maastricht budget deficit and public debt limits, as well as keep taxes (and therefore public expenditures) low relative to GDP. Public expenditures should favor spending on education and infrastructure at the expense of social transfers, defense, and subsidies.

10. The high rate of structural unemployment requires changes in the labor code to increase labor market flexibility (by reducing hiring and firing costs, for example). It also requires an active role of the government in education and training.

In most countries of Central Europe and the former Soviet Union, GDP per capita was about 15–30 percent that of the United States at the beginning of the 20th century, just as it is at the beginning of the 21st century. The economic transformation of those economies in the past decade has contributed significantly to helping those countries realize their strategic goals and creating economic systems that should enable them to remove this income gap in the twenty-first century.

A Snapshot of Poland’s Economy
Fiscal Restraint Is Needed to Fight Inflation

Poland’s economy is growing, and projections for 2001 are strong. Inflation is rising, however, threatening economic stability. Poland’s exports—which have benefited from strong EU growth—underpinned a 6 percent real GDP expansion during the first half of 2000. Adjusted industrial production rose 6 percent in July over the same period in 1999. During the first half of the year, exports in dollar value terms were up 11.9 percent, while imports rose 9.7 percent, according to the Central Statistical Office (GUS).

Domestic demand in Poland has remained strong, pushing the current account deficit up to $5.64 billion (equivalent to 7.3 percent of GDP) for the first six months of 2000. In June the deficit reached 7.5 percent of GDP. As long as the deficit is financed by sufficient inflows of foreign direct investment (FDI) rather than an increase in debt, there is little cause for concern.

According to a recent report by the EBRD, the region’s transition economies have typically run into balance of payments trouble when the gap between the current account deficit and FDI inflows exceeds 5 percent of GDP. In Poland the gap between the external deficit and FDI inflows stands at 3.9 percent of GDP. Much of the FDI has been generated by proceeds from privatization, however, which is set to wind down in 2001, leaving the economy vulnerable to a severe correction unless the external balance improves.

Risky Food Prices

The larger than expected rise in inflation in July to a two-year high of 11.6 percent (up from 10.2 percent in June) was fuelled by high world oil prices and rising food costs caused by poor weather-related agricultural performance. Given these conditions, the government’s failure to tighten fiscal policy threatens economic stability.

Poland’s largely unprofitable farms are protected by subsidies and tax exemp-tions, but many farmers feel disenfran-chised. Government delays in purchasing grain to bolster prices have fuelled farmer protests. The real problem is one of over-production and a lack of alternative sources of employment for Poland’s many family farmers. Poland’s jobless rate rose to 11.8 percent in July, boosted by registrations from new graduates and lay-offs in industries hit by declining exports. Miners, teachers, and healthcare workers are disgruntled, making it all the more likely that the government will relax fiscal stringency as it tries to forestall protests.

Public Sector Criticized

Poland’s public sector is overstaffed, mis-managed, and ineffective, according to economists of the independent think tank Market Economy Research Institute. Public sector employment exceeds 3 million, or about 30 percent of the country’s workforce.

Public sector income—chiefly from taxes and mandatory fees—accounts for 47.3 percent of GDP, while spending stands at 48.7 percent of GDP. Public debt is 55 percent of GDP, and debt servicing costs incurred by the Treasury, communes, state-run special funds, government agencies, state-run higher learning institutions, and state and municipal institutions account for 7.7 percent of public revenue.

Difficult Budget Process

Under these circumstances, the only effective way to deal with the economic im-balance is through tightening fiscal policy. However, the political difficulties of recent months combined with the presidential election in October and the prospect of a general election next year are making the budget process unusually awkward. The process has become particularly difficult since Leszek Balcerowicz, of the Freedom Union party, a strong advocate of strict financial discipline, resigned as Finance Minister. His successor, Jaroslaw Bauc, faces a highly sensitive task.

The government recently announced an additional duty-free quota of cereal imports to counter agricultural inflation, and it will soon decide whether to lift tariffs on petroleum and fuel oil imports. Many observers note that the government is unwilling to take decisive but unpopular action and that it is particularly averse to reforms that would alienate the large and influential agricultural constituency.

Despite these problems, Poland’s government remains optimistic about the future. For 2001 it projects that GDP will grow 5.7 percent, the current account deficit will be reduced from 7.7 percent in 2000 to 7.1 percent, and average annual inflation will decline three percentage points to 6.1 percent.

Based on reports from Oxford Analytica International Research Centre in the United Kingdom, and news wires.
China’s Farmers Need Long-Term Land Tenure Security, Not Land Readjustment
by Brian Schwarzwalder

The first stage of China’s recent rural land tenure reforms was marked by the transition from communal farms to family farms with the introduction of the Household Responsibility System in the early 1980s. Farmland in China remains under collective ownership, but nearly all such land has been allocated in use to individual households. Until very recently, land use rights to arable land lacked clear legal definition and have typically been short term and insecure.

China has now embarked on a second stage of reforms, with the goal of providing nearly 200 million Chinese farm households with secure land tenure in order to facilitate long-term, productivity-enhancing investments and the development of markets for rural land use rights.

The adoption of a revised Land Management Law on August 29, 1998 represented a watershed in the reform process. The new law requires that collectively owned arable land be contracted to collective members for a term of 30 years, and that a written contract be executed detailing the rights and obligations of both parties. The law also restricts land readjustments.

Big and Small Readjustments

Land readjustments have occurred in about 80 percent of rural villages in China since the introduction of the Household Responsibility System. Under this practice, the collective leadership periodically (in some cases once a year) redistributed village land to reflect changes in household population size since the previous land allocation.

- Big readjustments involve changes in the landholding of all households within the collective; all farmland is given back to the collective landowner (usually the village) and reallocated among households so that each household receives a new parcel of land.

- Small readjustments involve taking land from households that have lost members and giving it to households that have gained members to maintain an overall egalitarian distribution.

Land readjustments have indeed allowed China to maintain an extremely egalitarian distribution of land within villages, but the uncertainty they have created represents the single greatest obstacle to long-term rural land tenure security in China.

Shortly after the adoption of the Land Management Law, the Central Committee of the Chinese Communist Party, during its Third Plenary Session in October 1998, issued the “Resolution of the CPC Central Committee on Several Major Issues Concerning Agriculture and Rural Work”.

According to this important expression of central policy goals, China must “staunchly and unwaveringly carry out the policy of extending the land contracting period to 30 years while at the same time firmly establishing laws and regulations that confirm and protect the long-term stability of rural land contract relations, giving farmers long-term, assured land use rights”.

To date, however, neither policies nor laws have definitively addressed the issue of land readjustments. The impact of a “non-readjustment” rule on agricultural productivity and rural living standards remains the subject of much debate among researchers, policymakers, and legislative drafters within China. Forthcoming legislation will once again provide the opportunity to address this crucial issue. The decision as to whether to prohibit, or merely continue to restrict, land readjustments will have a profound impact on China’s rural land system for decades to come.

The debate concerning land readjustments has taken on increased significance in light of the April 1999 US-China Agreement on Agricultural Cooperation and China’s impending accession to the World Trade Organization. China’s ability to compete in world agricultural markets will depend greatly on its ability to cultivate crops for which it maintains a comparative advantage—high value, labor-intensive crops such as fruits and vegetables. Many of these crops will require farmers to make investments in capital, know-how, or labor that were not necessary to produce grain crops. Farmers’ perceptions of their long-term land tenure security is likely to be an important factor in determining their willingness to make such investments, and therefore in the success of this important transition.

Survey Results Show Many Farmers Lack Confidence

The central government called for full implementation of 30-year land use rights by the end of 1999. To assess the extent and nature of implementation, and to inform the process of drafting additional legislation related to rural land tenure, the Seattle-based Rural Development Institute and Professor Ye Jianping of Renmin University conducted a random sample survey of 1,621 farm households in 17 of China’s major agricultural provinces in August 1999. The survey results revealed the following:
Chinese Farmers Bear Heavy Burdens

Twenty years of economic reforms, which started in the countryside, have transformed China, tripling its gross national product and bringing prosperity and unprecedented freedoms to many Chinese. But recently the boom has slowed. Township enterprises that brought wealth and jobs to millions of rural Chinese are faltering in many areas. Farm incomes in the countryside have remained flat for four straight years.

In a recent letter—addressed to China’s leaders and published in the state-run media in August—Li Changping, the 37-year-old party secretary in Qipan township (Hubei province) southwest of Beijing, describes in detail the poor state of the rural economy and farmers’ increasing burdens in the countryside. Li’s letter gives a long list of problems faced by farmers in his region. The main problem is taxes. The Chinese government has vowed for more than a year to reduce taxes in the countryside, but so far most of its efforts have actually led to tax increases, because local officials violate Beijing’s bans on excess levies. Around Qipan, Li said, a family of five working eight mu, or 1.3 acres of land, pays $365 a year—equal in many places to more than the annual farmer’s income—in poll and land taxes, not including the free labor they provide the state for flood prevention and irrigation works. They also must pay fees for having a house and farming a private plot. Random fees for education and livestock are common, although they have been banned by the central government.

Li noted that 80 percent of the farmers in his township are losing money. In 1995, 85 percent of the farmers had money saved; now, 85 percent are in debt. The average budget deficit of the villages in his township is $50,000. The average debt for each village is $75,000, on which the village must pay 2 percent interest each month. And, on average, village debt is increasing by 20 percent a year. The situation is just as bad in the other townships that make up Jianli County, where Qipan is located. Their average yearly deficit is $500,000, and their total debts are twice as high. “The burden on the farmer and the collective deficit in the villages and heavier each year, and the deficit in the townships is rising annually as well,” Li wrote.

People are leaving the land. “Most of our farmers have already left,” Li wrote. The township had 40,000 people; 25,000 have gone. This means that those remaining are now squeezed for more and more taxes. In some villages, the poll tax has risen to $60 a head a year—a whopping sum for many Chinese farmers.

Farmers believe their 30-year land use rights can be passed to children through inheritance.

Farmers believe land use rights can be retained by the household for the full 30-year term even if household members' residential registration changes from rural to urban.

Confident Farmers in Fuyang

What effect would increased confidence have upon agricultural productivity and land management practices of Chinese farmers, including both the decision to make long-term productivity-enhancing investments, and the decision to shift from grain production to the production of high-value crops such as fruits and vegetables? Located on the East China Plain in Anhui Province, Fuyang City encompasses a largely agricultural area, with 83 percent of its 12.1 million residents being farmers.

Having implemented a policy of 30-year rural land use rights combined with a strict prohibition on land readjustments in 1994, Fuyang provided an ideal opportunity for researchers from Rural Development Institute and the Ministry of Agriculture's Research Center for Rural Economy to observe and assess the impacts of a "non-readjustment" rule. Using Rapid Rural Appraisal techniques, senior researchers from the two organizations jointly conducted 25 detailed farm household interviews in May and June 2000.

The interviews found that farmers in Fuyang appear not only to strongly support the 30-year, no-readjustment policy, but also that they possess a high degree of confidence that readjustments will not occur. Eighteen of the 23 farmers we interviewed on this issue were highly confident that their land use rights would not be readjusted during the 30-year term. Only one farmer believed that land readjustments would definitely occur during the 30-year term. This apparently high degree of confidence is especially striking given the fact that land readjustments had been conducted in this area prior to 1994, when they had uniformly stopped.

High confidence levels appeared to contribute directly to increased long-term investments in land. Despite the relative lack of long-term investment opportunities—land is already level, soil quality is high, drainage doesn't represent a significant problem, and water for irrigation is readily and cheaply accessible—farmers have made substantial long-term investments since 1994. The interviews made it clear that the security provided by the 30-year no-readjustment policy was an important factor in those investment-related decisions.

Eight of the 23 farmers we asked about long-term investments related to 30-year land use rights reported that they had made such investments themselves. The specific investments made by farmer-interviewees included the introduction of long-term crops such as apples or grapes, digging of irrigation wells at substantial cost, making significant drainage improvements where necessary, introducing or increasing the use of organic fertilizer, buying electric pumps for existing wells, and building fixed greenhouses.

Seven farmers further reported that many other farmers in their village had made similar long-term investments related to 30-year land use rights. Many interviewees told us that farmers had been unwilling to make similar investments under Fuyang's previous land management system, which included periodic land readjustments.

Recommendations

Providing farmers with long-term land tenure security alone may be insufficient to ensure the success of China's ongoing agricultural transition. Indeed, a variety of factors, including agricultural product prices, land quality, and access to extension and marketing information, will influence farmers' willingness to make productivity-enhancing and diversification-related investments in their land. The experience of farmers in Fuyang and the results of numerous other studies, however, strongly support the hypothesis that land tenure security directly influences farmers' willingness to make long-term investments on their land.

Fuyang's experience and the results of our larger sample survey suggest that continuing legislative reforms could address farmers' lack of confidence in their 30-year land use rights by:

- Prohibiting the practice of land readjustment in all Chinese villages.
- Adopting and issuing a national 30-year land use contract and a set of core requirements for local variations, including a provision unequivocally prohibiting land readjustment.
- Clearly defining farmers' right to pass their land rights on to children through inheritance and to retain land use rights after household residential status changes.

The author is Staff Attorney and China Program Coordinator at the Rural Development Institute, (RDI), a non-profit organization of attorneys in Seattle, Washington.

Since 1987 the Rural Development Institute has conducted research on China's ongoing rural land tenure reforms with a variety of Chinese counterparts.

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Challenges of the Second Transition Decade in Russia
by Willem H. Buiter

Perestroika and the decade of the 1990s brought us the Second Russian Revolution. Unlike the First Russian Revolution, the more recent one has been largely peaceful. Its economic, political, and social consequences have been every bit as far-reaching, however. This Second Russian Revolution, 70 years after the first, is not yet complete. In particular, an effectively functioning Russian state has yet to be reconstituted. There are signs, however, that the period of post-revolutionary anomie and free-for-all (or rather free-for-some) is coming to an end.

Second Revolution Uncompleted

The widespread predation and insecure property rights that have characterized Russia during these past 12 or so years have depressed capital formation in all its dimensions. The elimination of the conditions that gave rise to predation and insecure property rights is a necessary condition for the kind of sustained economic growth the Russian government anticipates in its new economic strategy, promulgated June 29, 2000.

Revolutions are destructive, cataclysmic events. The established mechanisms of political and social control are destroyed. The state is weakened, sometimes fatally. As a result, everything is up for grabs. Title to the wealth of the nation is insecure. So are claims to rank, status, prestige, and privilege. Established entitlements become contestable. Possession becomes rather more than nine-tenths of the law.

The "theft of the state" in Russia began early in the perestroika process. While formal privatization did not occur until the end of 1991, well before that time managers of state enterprises used a loophole in the law on cooperatives to set up within-enterprise cooperatives—private firms in all but name—that contained the potentially profitable bits of these state enterprises. Gorbachev's attempts to decentralize political and economic control led to systemic collapse because they allowed lower-level bureaucrats to circumvent supervision by their superiors. Gorbachev's decentralizing reforms, openness, and political democratization coupled with economic liberalization, set in motion centrifugal forces that caused a systemwide collapse of authority relations and permitted large-scale theft of state assets by opportunistic and entrepreneurial officials, almost all of whom were drawn from the existing elite, the nomenklatura.

Failed Privatization

Later stages of the privatization process contributed further to the current extreme inequality in the Russian distribution of wealth. The voucher privatization of the early 1990s was followed by a rapid concentration of voucher ownership by members of the old nomenklatura—often the directors and managers of the former state enterprises, who obtained these vouchers at bargain basement prices.

By now, most state assets have been privatized (outside of infrastructure enterprises, utilities like Unified Energy Systems [UES], and a few financial institutions). There is a widely held view, going back at least to Coase, that economic efficiency requires only that private property rights be assigned unambiguously and that the specifics, including the perceived fairness of the allocation, do not matter. (Editor's note: The Coase Theorem states that when property rights are clearly assigned, private transactions can result in a socially optimal solution.) An extension of this view is the proposition that yesterday's thief is today's staunchest defender of the sanctity and inviolability of property rights. The policy implication is that it is best to grandfather the existing distribution of property rights (in other words, make it legally valid), no matter how outrageous the manner in which it came about.

There are many qualifications to Coase's "distribution does not matter for efficiency" proposition. Private information severely weakens its applicability. So do transaction costs, including (re)negotiation costs. More important, Coase's proposition requires property rights to be unambiguous and secure. The legitimacy of any distribution of property rights—and therefore the security of those rights—cannot be independent of the manner in which those property rights were acquired or assigned.

The fact that the redistribution of state property in Russia since 1988 is unlikely to be viewed as legitimate by the vast majority of Russians who did not share in the free-for-all (or rather free-for-some), cannot but be an obstacle to the efficient utilization of those assets in productive enterprise. Extreme inequality and widespread poverty coexist uneasily with secure property rights. This creates a dilemma. The existing distribution of property rights lacks legitimacy. Yet any serious attempt to redistribute improperly acquired property rights would itself create uncertainty about the se-
curity of all property rights, now and in the future. Most of the successful raids on the assets of the state were at best conducted under ambiguity about the exact legal status of these assets; at worst they took place in a legal vacuum. Renationalization followed by yet another round of privatization would in all likelihood be pursued in an arbitrary, selective, and politically motivated manner and could end up being viewed as evidence not of a belated attempt at justice but of further degradation of the rule of law. There is no elegant, efficient, and fair solution to this problem. We cannot undo history’s earlier throw of the dice. Probably the best we can hope for is that a combination of sustained growth, efficient and equitable government tax, and expenditure programs and economic reform aimed at eliminating monopoly rents throughout the economy will gradually diminish the significance of the initial distribution of property rights.

Absence of the Rule of Law

Today, with the transition process almost a decade old, Russia and the other successor states of the Soviet Union, continue to suffer from chronically weak legal cultures and severely defective mechanisms for contract enforcement. Discretion, in the negative sense of opportunistic behavior, characterizes legal procedures and law enforcement. The rule of law is the exception rather than the rule. Real negotiations start after a contract is signed.

The Russian state, at all its levels, has a dismal reputation as a guarantor of property rights. Domestic and foreign investors’ confidence in the enforceability of their rights has been weakened by inadequate laws and, even more prominently, by a continued failure to enforce what laws are on the books. Legal rights of creditors and minority shareholders are routinely trampled. Even a majority ownership stake is no guarantee of control. Entrenched managers, often backed by local or regional authorities, restrict access to information and ignore the wishes of the legal owners. Insiders strip enterprises of their valuable assets and leave the legal owners with a shell containing the liabilities and the unproductive and nonperforming assets.

Several comparative studies of corruption rank Russia, and most of the other former Soviet states, as among the most corrupt in the world. According to a 1997 EBRD study, Russia does not score particularly high on the administrative (or petty) corruption index. It is on the two grand corruption indices that Russia’s performance is most worrisome. Grand corruption includes public procurement-related kickbacks and state capture (the efforts of firms to influence the contents of legislation, rules, laws, decrees, regulations, or judgments through unofficial payments by private actors to public officials).

Since the public good of secure property rights, enforcement of contracts, and the rule of law is not provided effectively by the state in Russia, what provision of these public goods there is has often been privatized. Criminal protection racket—using threats, intimidation, extortion, and blackmail, backed with the threat of violence against property or persons—are thriving. A cynic might consider this an efficient adaptation to an unfortunate environment. Apart from the obvious moral shortcomings of these arrangements, the huge transactions costs and abiding uncertainty associated with these extralegal methods of contract enforcement cause any society that is forced to rely on them to function very inefficiently.

The absence of the rule of law and chronic and widespread insecurity of title has two unsurprising consequences. The first is that effort is diverted from productive activities to predation, including rent-seeking and “dupe” activities (lobbying, corruption, and other illegal forms of influence-seeking, theft; the involuntary and unrequited transfer of property rights through the use of inside information and intimidation; extortion; and threats of and use of violence against property or persons). The talents that make a good productive entrepreneur are not that different from the talents that make an efficient predator. When the returns to productive activity are low and the returns to predation high, talented individuals will tend to choose predation over productive activity. The result is an inefficient use of existing resources, or static inefficiency.

The second consequence is dynamic inefficiency: the accumulation of capital is discouraged and distorted. The national saving rate will become suboptimally low, and within this diminished national saving rate, the allocation of saving across instruments will be heavily influenced by the perceived security of the owners’ title to these instruments. When the tax collection system is both inefficient and arbitrary, taxation tends to become source based rather than residence based: the jurisdiction of the tax authorities tends to be restricted to tax bases located within national boundaries. In addition, title to offshore assets is less easily contested than title to onshore assets. Financial assets abroad are superior, from this point of view, to financial assets at home. Hard currency under the bed is superior to ruble accounts in the bank; deposits in Sberbank, the state-owned savings bank, are superior to deposits in private banks. Real, tangible enterprise assets at home become an especially unattractive proposition, because the owners often have insecure title and the asset is highly visible and accessible to the tax authorities and private predators.

We therefore expect to see in post-perestroika Russia a declining saving rate, an even greater decline in fixed domestic capital formation, and capital flight. We see all three, dramatically.

Russia at the Crossroads

Russia today stands at a critical juncture. After almost 15 years of economic, social, and political disorganization and disjunction, there is now a unique opportunity to turn away from predation and negative-sum redistribution games to a future of growth and widely shared prosperity, made attainable through in-
creased efficiency and higher rates of accumulation of all types of capital. To make this a reality, comprehensive reform of the institutional framework must take place that permits an efficient market economy to function.

The first, and most difficult, institutional reform needed to put Russia on a path of efficient accumulation is a strong and capable but limited state. Since the collapse of communism, Russia has had an incapable, but overreaching and overstretched, state. The state should only do only those things the private sector truly cannot do. The list is familiar: providing internal and external security and the macroeconomic public goods of price stability and stability of the financial system, enforcing the rule of law, defending legitimate property rights, securing a level economic playing field for incumbents and newcomers, encouraging competition and regulating natural monopolies, financing (but not necessarily providing) public goods, financing public health and education, ensuring that a proper social safety net is in place, and raising the revenues necessary to fund these essential state activities in a nondistortionary, administratively efficient, and equitable manner.

The problem with the prescription of a strong and capable but limited state is that it is almost an oxymoron. A strong state will be an irresistible target for capture by sectional interests who aim to turn it into the ultimate predator.

To a certain extent, the design of the institutions of the state—the constitutional arrangements—can keep Leviathan in check. The horizontal separation of powers—an independent judiciary and an independent legislature—can check the might of the executive. So can a vertical separation of powers, through a federal constitutional design that grants each tier of government distinct, nonoverlapping jurisdictions and competencies. Russia has been wrestling with the design of constitutional arrangements of this kind that suit its unique historical and cultural traditions and its ethnic diversity. Ultimately, however, the state cannot keep itself in check; only a confident citizenry, backed by the institutions of a varied and dynamic civil society, can do so. A strong civil society and a confident citizenry can even help sustain an equilibrium in which the political players and the state bureaucracy internalize norms and notions of acceptable behavior that dilute the prevailing miasma of suspicion and mistrust between the governed and those who govern. The international finance institutions cannot make a significant contribution to the emergence and flourishing of civil society in Russia; only the Russian people can create and sustain a healthy civil society.

Other than the meta issue of the creation of a strong and capable but limited state, there remain a large number of policies, programs, and reforms to be implemented throughout the country, its regions, sectors, industries, and markets. The program outlined by Prime Minister Kasyanov June 29, 2000, contains a comprehensive outline of what needs to be done. Of course, many of the details still need to be fleshed out, and the devil is always in the details. The experience with a long list of past comprehensive reform programs—many of which also said exactly the right things but all of which sank effectively without leaving a trace—should make one cautious, but not cynical.

Policy Recommendations

The international financial institutions can make an important but limited contribution to the government’s reform program, once the reform of the state has gained momentum. They can provide financial support and technical assistance. The EBRD—which operates exclusively in the transition economies and whose main instrument is the financing of projects, predominantly in the private sector—is well positioned to advance the rising tide of market-oriented reform.

The policy recommendations made by the EBRD as part of an ongoing process of policy dialogue are perfectly congruent with the Gref plan and the program announced by the Russian government. They include the following:

- Help create a climate for domestic and foreign investment by imposing and enforcing the rule of law and eliminating unnecessary administrative obstacles to enterprise. Specific examples include effective protection of creditor rights and the rights of minority shareholders.
- Create a level playing field for new private businesses. Both entry and exit of enterprises should be made easier. Unnatural monopolies should be eliminated and natural monopolies effectively regulated. Only then can the benefits of a thriving small and medium-size enterprise culture be realized. A level playing field in the financial sector means that the special position of Sberbank (with its monopoly of deposit insurance) and the other state banks will have to end. Permitting the entry of foreign firms and foreign capital into previously sheltered sectors can be a swift and effective means of introducing effective competition.
- Harden budget constraints on nonviable businesses, and insist on international accounting standards for all enterprises. Only then can the information necessary for effective governance—public and private—be disseminated widely. Provide an adequate social safety net and support retraining and mobility to ensure that the necessary restructuring of enterprises does not imply hardship for redundant workers.
- Foster the adaptation of skills for a modern, service-dominated economy, and restore educational and public health standards.
- Enhance access to essential business services, including infrastructure, finance, and the judiciary.

Russia’s tomorrows can be so much better than her yesterdays. Only the Russian people can make the necessary choices to make this come true.

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Competition, Geography, and Firm Performance: Lessons from Russia
by J. David Brown and John S. Earle

Although the virtuous consequences of competitive product and factor markets for enterprise efficiency are fundamental tenets in most economists’ thinking, the empirical case for those beliefs is relatively weak. Most empirical studies of firm and industry performance have focused on some measure of profitability as the outcome variable, rather than efficiency, but there is little necessary connection between the two.

Previous Studies of Competition and Efficiency

The relatively few studies examining efficiency have mostly produced rather weak results with respect to the effects of competition, and they have been hampered by data and identification problems. Three types of problems occur in this type of research. First, some studies, while informative, face difficulties controlling for unobserved heterogeneity and the possible endogeneity of market structure. For instance, market structure may be endogenous (or determined within the structure of equations) in that better performance of some firms may lead to higher concentration, so that there is no necessary relationship between the two variables in a cross-section.

A problem with studies using panel data is that data availability has typically limited them to examining only small numbers of firms spread across a wide variety of industries. In the stable economies of the West, there have been few opportunities to analyze firms that have undergone substantial changes in their market environments, particularly large numbers of firms undergoing diverse experiences of such changes simultaneously.

A third problem with most of the studies is that the potential efficiency gains due to competition that may be observable by the researcher are rather small, insofar as most of the economies in which such studies are undertaken are dominated by “workably competitive” markets, so that the general environment may still exert a disciplining force, even if the particular conditions facing the firm do not. Natural monopolies in the West, after all, usually operate in competitive markets for managers, labor, and most other factors; they can avail themselves of the latest technologies, organizational innovations, and managerial techniques; their performance can be compared at least along some dimensions with neighboring competitive firms; and instances of gross malfaisance can be publicly evaluated and remedied through a democratic process. All of these factors would seem to go quite some distance toward mitigating inefficiencies associated with monopoly power.

New Evidence: The Russian Experiment

The situation in Russia stands in stark contrast. Russia’s “product market structure” at the beginning of the transition was determined by decisions that had been made by Soviet central planners rather than by market forces. Those decisions were motivated to a considerable extent by the need to monitor and control the production units and by political considerations, which tended to skew choices of location, scale, and integration; economic efficiency was frequently secondary. Moreover, prices and wages were controlled, output quantities and types were set by plan, sales were virtually guaranteed, soft budget constraints prevented bankruptcy, and firms could grow (or shrink) only by order of the central authority. Although there is some debate over the extent to which the planning system resulted in monopolized or highly concentrated sectors, it is clear that relative to market economies, the Soviet system had very few small firms and very low rates of entry and exit.

This ossified industrial organization was suddenly liberalized on January 1, 1992, when prices, foreign trade, supply arrangements, labor mobility, and the entry of new businesses were simultaneously freed. Where before there was little or no effective competition in any product or factor markets, suddenly Russian firms were forced to compete with one another and with new foreign competitors, while demand became more fickle and budget constraints became harder. Thus Russia presents an unusual quasi-experiment in which we may test whether an exogenously determined market structure affects firm efficiency. We may also examine the time pattern of adjustment to the liberalization shock (how quickly the increased competition may have improved enterprise productivity).

The shock of liberalization was not only unexpected, but also hit a set of enterprises that had been operating far from the production frontier when the “big bang” policies took effect. The plant and equipment, labor force, managerial skills, organizational capital, and modes of operating of these firms were built up during a period when there was nothing approaching a competitive market environment, essentially no private ownership existed, and efficiency and profits were not primary objectives. Since competitive shock hit, therefore, Russian firms have had the potential to exhibit large changes as they restructure along many dimensions and reorient their objectives from the state toward the market. For the researcher, the
situation holds out the possibility for observing substantial differences in behavior.

Some peculiarities of Russian geography suggest that it may be fruitful to investigate regional dimensions of market structure. By far the largest country in the world, Russia is characterized by widely scattered industries frequently separated by vast distances and connected by poor infrastructural networks. While the possibility that product market scope should be defined by region as well as industry has been considered in research on U.S. market structure, the distances and transport and communication costs appear to pose much greater obstacles to unifying markets in Russia.

The geographic argument also has implications for factor markets, in particular for labor. While in principle it is clear that monopsony power may create slack that permits inefficiency precisely analogous to the slack under monopoly power, there have been no empirical studies of the relation, possibly because Western economies show rather little labor market concentration. Concentrated labor markets—in the limit, one-company towns—are much more common in Russia, suggesting the possibility that monopsony power may indeed be a significant factor in cushioning firm behavior.

A small number of other studies have examined the impact of competition in Russia and other transitional economies. Our research has several distinct advantages over earlier work in terms of the size and coverage of the data set, the time span of observations on each firm, and the availability of a variety of measures of market structure and competition. The panel data set we use for estimation purposes is comprehensive, including 75 percent of total employment in Russian industry in 1992, the year of the liberalization shock, and covering the seven years from 1992 to 1998. Since we have nearly the entire population of medium-size and large industrial enterprises, including information on their exact locations and disaggregated five-digit industries, we can use much more precise measures of market structure than those available to other researchers in Russia or many other countries. The size and scope of the database, as well as the unusual characteristics of Russia, permit us to investigate several geographic dimensions of competitive pressure and to examine competition in local labor markets. Our data also contain useful controls and instruments and much better and more disaggregated information on import competition than was heretofore available. We use this rich database to trace out the impact of several dimensions of market competition and other factors on firm-level efficiency.

Testing the Competition Effect

Our analysis embraces a variety of dimensions of competitive pressure, including not only domestic market structure at the national level but also import competition, regional variation of product markets, transportation infrastructure, and labor market competition. We study the time path of the impact of the competitive shock—the abrupt liberalization of prices, entry, imports, and labor mobility—in January 1992.

We first test for determinants of firm survival. We find no statistically significant effects of competition on survival. Demand shocks have the expected effects: industry and regional growth and relative price changes all increase the probability of survival. Initial conditions also matter, as

Conference Announcement:
Managing in Transition and Emerging Economies: A New Beginning

Penetrating and achieving growth in emerging economies will be one of the corporate executive’s greatest challenges in the new millennium. To help senior managers succeed in these dynamic markets, the University of Michigan Business School and the William Davidson Institute have designed the Managing in Transition and Emerging Economies: A New Beginning Program.

Managing in Transition and Emerging Economies combines the functional expertise of the University of Michigan’s Executive Education Center’s faculty with the regional and political economy expertise of the William Davidson Institute associates. Afternoon workshops allow participants to discuss challenges and experiences, with Davidson Institute experts facilitating the exchange of ideas. The interactive program format will also allow participants the opportunity to communicate with experts around the globe through distance-learning technologies.

This program has been designed for men and women in senior positions, such as chief operating officers, strategic planners, corporate development executives, new business initiative leaders, regional vice presidents and directors, and directors of functional areas in operations and finance. It is highly recommended that more than one executive per company attend to make this a team learning experience. The five-day program will be held December 11–15, 2000, at the University of Michigan Business School’s Executive Education Center in Ann Arbor, Michigan.

For further program information contact: Keven Burchfield, Program Manager: email: burchk@umich.edu, tel. 734-763-5020.
higher initial profitability, exporting activity, and size increase the probability of survival, while military-industrial complex affiliation lowers it. Foreign joint venture and predominantly private ownership lower the probability of survival relative to other ownership types.

The production function results provide strong evidence that domestic product market competition and local labor market competition have strong positive effects on efficiency, while import competition has no statistically significant effect. Domestic product market concentration has an effect, however, only once we take into account the fact that the geographic scope of the market differs across industries. The impact of liberalization appears only gradually in the domestic product market, taking about four years to attain about 90 percent of the long-run value, but we find no such lag with respect to labor market competition. Domestic product market and labor market competition show increasing marginal effects.

Better and lower-cost transportation infrastructure; more complete implementation of economic reforms such as privatization, price liberalization, limitation of production subsidies; reductions in bureaucratic regulation, and greater control of the regional economy by criminal groups all are found to facilitate domestic product market competition. Economic reforms facilitate import competition. Better and lower-cost transportation infrastructure also improves firm efficiency, by making workers more mobile, thereby reducing firms' monopsony power in the labor market.

Our results suggest that downsizing firms have more difficulty maintaining productivity in industries and regions with more negative demand shocks. Positive price shocks appear to have cushioned firms from having to adjust. Initial conditions are significant as well: higher initial profitability and being an exporter raise productivity, while the extent of exporting activity and military-industrial complex affiliation lower it.

We find that joint ventures and predominantly privately owned firms outperform other firms, even after controlling for potential selection bias in the determination of ownership. There is some evidence of decline in the relative performance of joint ventures and predominantly privately owned firms in recent years, however.

### Policy Implications

The results have implications for competition policy. Previous research has shown that Russia's industrial structure is not more concentrated on average at the national level than that of the United States or other market economies. Russia's vast size, poor transportation infrastructure, and political barriers could potentially segment markets geographically, however, creating a large number of regional monopolists. If markets are indeed segmented, the competition authority might wish to focus more on reducing geographical barriers to competition than on reducing concentration.

Our results provide strong evidence of geographic market segmentation. Specifically,

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they suggest that a policy of reducing national or regional concentration that does not pay close attention to the geographic scope of the particular firm's market would lead to no gain in productive efficiency. A reduction in geographic market segmentation—which could be accomplished through investment in transportation infrastructure and implementation of pro-competitive policies such as privatization, price liberalization, reduction of production subsidies and bureaucratic regulation, and elimination of interregional trade barriers—would lead to significant productivity gains, however, by making it easier for already existing potential competitors to start competing with one another.

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Concentrated Market Feeds Barter in Russia: A New Explanation for the Spread of Nonmonetary Transactions
by Sergei Guriev and Dmitry Kvassov

Rapid growth of nonmonetary transactions is one of the most striking features of Russia's transition to a market economy. The Russian economy has become highly demonetized: barter reportedly accounts for 30-70 per cent of interfirrm transactions. Russia's demonetization experience is therefore a challenge to the modern economic theory of money, which explains why barter is crowded out by fiat money in all developed economies.

There are a number of competing explanations for the proliferation of barter in Russia. Most firm managers maintain the view that barter is explained by the liquidity squeeze due to tight monetary policy. In contrast, Russian government officials often claim that managers use barter to avoid paying taxes in full. Outside investors often claim that managers use barter to divert profits, protect their jobs, and delay restructuring.

In an attempt to clarify this debate, we argue that discussion of barter in Russia is incomplete without taking into account the role of market structure. Indeed, the anecdotal evidence suggests that natural monopolies are the most likely of all Russian firms to engage in barter.

Building a model of barter as a means of price discrimination, we find that even though barter is inefficient, it can emerge in equilibrium if markets are sufficiently concentrated. In fact, the amount of barter increases with concentration. The intuition is straightforward. Since monopolies, in equilibrium, will usually underproduce relative to the social optimum, sellers may be interested in an additional channel of sales, even if that channel is costly.

In order to test the model, we built a data set that matches a survey of managers on the degree of barter in their firms with firm-level data from official statistics. The empirical analysis supports our model: barter positively and significantly depends on market concentration.

Our result raises a legitimate question. If barter is explained by high concentration of market power, why is it observed in Russia but in virtually no other economy? One answer to this question would be that Russian markets are more concentrated than markets elsewhere. This claim is well accepted by the general public and policymakers, but it is not supported by the data.

Our model may offer another explanation. For the same level of concentration there may be two stable equilibria: one with barter and one without barter. Therefore there may be a path dependence. In 1995 a liquidity shock threw the economy into a high barter state. Since that time, price flexibility should have restored an equilibrium level of real money balances. The real money supply, however, remains two to three times lower than before the liquidity shock, supporting the multiple equilibria hypothesis.

What our model suggests is not simply a restatement of the fact that Russia is in a low-level equilibrium. We show that at some level of competition the barter equilibrium disappears and industry jumps to the no-barter equilibrium. This argument has important policy implications. In order to reduce barter, government should promote competition. Moreover, even if competition policy may have had only a small effect on barter so far, the government should not give up. Our model (along with empirical analysis) suggests that barter may fall dramatically when a certain threshold level of competition is achieved.

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New Approach to Getting Ukraine Out of the Pit: 
Integrating the Social Capital Paradigm in Development Politics 
by Veniamin V. Sikora

Ten years of experience have not provided convincing evidence of successful transformation in the post-Soviet societies. The failure of traditional approaches to transition has been fully demonstrated in Ukraine, where the economic, political, and cultural-psychological prerequisites for a democratic transformation to a market economy have been eroded as part of the process.

Ukraine's policy in 1992–94 was determined by its highest priority: preserving Ukrainian statehood. The policy succeeded, but the price of success was high. In order to preserve the country's integrity and independence, the government granted concessions and privileges to political and economic actors that had been influential under the Soviet system—the Communist Party nomenklatura, directors of the military-industrial complexes, leaders of the powerful trade unions, primarily the coal miners—who were often indifferent or even sometimes even hostile to Ukraine's statehood building.

Deepening Crisis

The government, under pressure, caved in and allowed them to become the major beneficiaries of a peculiar form of "market-oriented reforms." As a result, the social structure in Ukraine radically changed. A small group gained tremendously in power and wealth—by unlawfully acquiring public property, engaging in corrupt practices, abusing their monopolistic position, and operating in the shadow and black economies. At the same time, the income and social status of the middle class—the embodiment of human and social capital as well as the driving force behind national-democratic revolution—sharply declined.

The traditional radical economic reforms implemented after 1994 did not improve the situation in Ukraine. GNP declined, falling to about 25 percent of its 1990 level by 2000. The traditional reform program proposed by Western experts envisioned implementation of formal market rules and property rights. It did not take into account conditions specific to Ukraine and was difficult to adapt to local conditions. No wonder the traditional methods of privatization failed to produce the expected results.

As time went by, the crisis only deepened. What emerged can be considered neither a rational, innovative, modern market economy nor a pseudosocialist or postsocialist economy. Rather Ukraine has been left with an amalgam of market institutions and informal social networks, characterized by citizens being abused by public officials, the use of connections to bend rules or the paying of bribes to break them, avoidance of taxes, widespread stealing of property and money, and fraudulent business behavior toward both partners and consumers.

New World Bank Strategy

The new strategy and program proposed by the World Bank and Ukrainian scholars and government officials represent a big step in the right direction. (For a description of the program, see three 1999 World Bank papers: "Ukraine: Restoring Social Capital: The Glue Holding Society Together

Social capital refers to the institutions, relationships, and norms that shape the quality and quantity of a society’s social interactions. Mounting evidence shows that social cohesion is critical for societies to prosper economically and develop sustainably.

Social capital is not just the sum of the institutions underpinning a society—it is the glue that holds them together. A narrow view of social capital regards it as a set of horizontal associations among people, consisting of social networks and associated norms that have an effect on community productivity and well-being. Social networks can increase productivity by reducing the costs of doing business. Social capital facilitates coordination and cooperation. Communities, groups, or networks that are isolated, parochial, or working at cross-purposes to society’s collective interests (such as drug cartels, corruption, rackets, or hybrid forms of all them) can hinder economic and social development.

The broadest view of social capital includes the social and political environment that shapes social structure and enables norms to develop. It includes formal institutional relationships and structures, such as government, the political regime, the rule of law, the court system, and civil and political liberties. It recognizes that the capacity of various social groups to act in their interest depends crucially on the support (or lack thereof) they receive from the state as well as the private sector. Similarly, the state depends on social stability and widespread popular support. In short, economic and social development thrives when representatives of the state, the corporate sector, and civil society create forums in and through which they can identify and pursue common goals.

(For more on social capital, see the World Bank's Website: http://www.worldbank.org/poverty/scapital/whetsc.htm.)

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Growth with Equity: A Participatory Country Economic Memorandum," "Economic Growth with Equity: Ukrainian Perspectives," and "Economic Growth with Equity: Which Strategy for Ukraine?") The new strategy starts to integrate the concept of social capital (see box on previous page). It recognizes that sustainable economic development needs formal and informal institutions—social networks—to complement and enrich the macroeconomic and market structure. This new vision is driving development thinking beyond debates over the role of the state and the market.

The new development strategy also recognizes that program implementation requires accommodation to conditions specific to Ukraine. It is clear that the government should play a vital role in development policy, but its role in the economy varies, depending on its capacity, capabilities, the country’s level of development, its degree of transformation (in the case of transition economies), external conditions, and a host of other factors. Much depends on whether the country is a newly independent or an established nation-state, and whether it is large or small.

What It Takes to Succeed?

If the new strategy is to succeed, several points will need to be addressed:

- Those investing in the Ukrainian version of social capital must realize that nation building in Ukraine is not yet complete. Successful long-run policies require national dignity, self-confidence, and self-respect; the lack of integrity of the nation-state hampers the identification and realization of political will. Social capital is needed to consolidate the Ukrainian nation-state. "Ukrainization," of course, should go hand-in-hand with protection of minorities’ rights. Unless these factors are considered, the current economic reform of state administration will not succeed.

- The spheres of science, politics, education, culture, and health, legal, and social services often need special protection and support from the government and at the grassroots level. In these areas, rules of professional ethics need to be established and the power of codes of behavior and peer judgment restored. Ukrainians should understand that the market is a place where the rule of law, trust, and social responsibility can lead to economic success.

- Sustained development should be rooted in socially inclusive processes.

The concept of social capital is an effective bridge to link mainstream economics with less traditional ideas. In such a way development economics will be better able to provide a compass to the transition economies.

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From the Soviet magazine Krokodil
Is There a Need for a Baltic Sea Investment Bank?
by Erik Berglöf and Enrico Perotti

The three transition economies in the Baltic region—Estonia, Latvia, and Lithuania—are facing a growth and development challenge in catching up with their Western neighbors. To what extent does access to finance constrain their development? What can be done to relieve such constraints? Are existing international financial institutions doing enough to support the countries in meeting their challenge? Or is there a need for a new institution, a Baltic Sea Investment Bank?

Investing in the three Baltic countries and Poland is perceived as less risky than investing in the Russian Federation but much riskier than investing in the EU. The high risk premium especially constrains the development of new and innovative sectors essential for growth and integration. Bringing down this premium is key to unleashing the development potential in these countries.

The risk has several sources, but political risk, macroeconomic instability, limited microeconomic information, and legal uncertainty are the most important. The first two issues are largely resolved. The EU has been successful in reducing local political risk, promoting reform through a top-down approach with strong conditionality. The Baltic governments have shown a credible commitment to stability, and the fragility of domestic financial institutions has been gradually addressed.

The main residual risk premium in the Baltic countries and Poland comes from the weak enforcement of laws and the lack of transparency. The problem is not a shortage of capital but poor governance leading to misallocation and a poor composition of finance.

Even in industrial economies, financial constraints arise from poor information structures or difficulties controlling the use of funds by insiders, but the problem is more serious in the transition economies. Standard, sophisticated legal codes have been introduced, but these laws have not been fully tested and enforced. Business practices have not yet fully adopted the use of legal proceedings, and they remain too reliant on either informal solutions or state intervention. There is still not sufficient experience and ability to use the rules created for promoting an environment supporting decentralized and entrepreneurial activity. Limited public information hinders access to financial markets and undermines proper legal enforcement in a vicious circle. Long delays and ambiguity in enforcement persist, and current economic practices often bypass formal mechanisms. The result is potential illegality, lack of transparency, and vulnerability to corrupt practices.

This institutional gap creates significant financial constraints, particularly for new and smaller companies with limited access to connected lending and other informal enforcement mechanisms. What can be done to fill this gap? The record of national development banks is not encouraging. These institutions saw a massive expansion in the 1960s, then stagnated in the late 1970s and have largely run down or closed since then. State ownership of banks tends to politicize resource allocation, and the state is weak at enforcing financial obligations. Large institutions tend naturally to focus on larger firms. Centralized allocation systems such as state development banks also often outlive their usefulness. Predictably, the creation of development banks has almost invariably led to disasters, with lending directed by political, often regional, interests, leading to very low repayment rates and losses that almost always exceed two-thirds of assets. These banks build little expertise in credit analysis, and their lack of a retail basis means their ties to the local economy are weak. In short, the evidence shows that state development banks lead to financial underdevelopment, reduce productivity growth, and fail to promote economic growth.

Creating such an institution would replicate the top-down approach dominant in the region, applied by the EU and the IMF. The EU has been able to induce significant change through strong conditionality, which has supported the operational ability of the large international financial institutions. The presence of the EBRD, the World Bank, the European Investment Bank, and NIB ensure sufficient funding for large-scale infrastructure and commercial investment. The EBRD and the World Bank have also directed conventional funding to entrepreneurial and smaller firms.

It is thus difficult to argue that there is scarcity of traditional bank lending in the region. Rather, there is a lack of entrepreneurial finance. In countries at a late stage of transition, this lack reflects the institutional gap between the formal rules of a market economy and their concrete
use. What is needed is a more bottom-up approach that reinforces grass-roots initiatives to improve access to legal remedies for business, increase public knowledge on new rules and accountability for new institutions, build an implementation record, and create dedicated service institutions with the necessary expertise to guide firms through this process.

A special public agency, a “venture catalyst”—let us call it the Baltic Sea Investment Bank—could help new private initiatives activate the new institutions needed to support market transactions (regulators, courts, arbitrators, independent evaluators, enforcement agencies). This agency, which would have a charter clearly delimiting its life span as a state-sponsored development entity, would pursue a portfolio of service and investment activities. Its focus would be on advice at least as much as investment, with possible areas of service activity including legal advice, consulting, market research, and trade promotion. Its portfolio of activities would include helping to set up venture capital funds and contributing to the creation of exit markets (by helping to create a credit rating institution, for example).

Another critical task should be to establish a policy of helping companies test existing legal institutions—by bringing about lawsuits, demanding disclosure or market access, or pursuing bankruptcy procedures, for example. The agency should also promote various bottom-up initiatives promoting entrepreneurial and civil society activities. Constituencies must be built for greater transparency and improved implementation and enforcement of existing laws.

Most important, the institution should bring together private and public interests. From the start, it should be destined for ultimate privatization, wholly or partially, to motivate top-quality personnel. Personnel and management could have an explicit title to shares in the institution after a vesting period.

In designing the charter for such a temporary agency, policymakers must address the following issues: Are there parts of the charters of existing international financial institutions that constrain them from filling the institutional gap? In what significant way would the new agency be different? Is it easier, and cheaper, to change the charters of existing institutions rather than to create a completely new entity?

Erik Berglöf is director of SITE Stockholm School of Economics. Enrico Perotti is professor of finance at the University of Amsterdam. The article was prepared for the Baltic Development Forum summit on partnership and growth in the Baltic Sea region, held September 17-19, in Malmö, Sweden. Some 250 top decisionmakers from government, business, finance, culture, media, and academia met to discuss the conference’s themes, “Shaping a Larger and Stronger Europe” and “Business and Finance as Drivers of Transition.” For more information, visit the Forum’s Website, at www.bdforum.org. The full version of this article can be downloaded from http://www.hhs.se/site

The Fifth Annual Stockholm Conference on Baltic Sea Region Security and Cooperation October 19, 2000

This international annual conference has become an important forum for discussing the strategic developments in one of the most dynamic areas of the new Europe. This year SITE joins the conference’s co-organizers—the American Embassy in Stockholm, the Swedish Institute for International Affairs, and the Stockholm International Peace Research Institute (SIPRI)—as a new partner.

Dramatic developments occurred in the Baltic Sea region in the past year. The EU invited Latvia and Lithuania to join Estonia and Poland, among other candidates, in discussions about eventual membership. The Russian Federation experienced a democratic change in government with the resignation of President Yeltsin and the election of President Putin as his successor. The foreign ministers of nine Central and Eastern European countries, including Estonia, Latvia, and Lithuania, confirmed their intention of joining NATO by 2002. And for the first time since 1998, all of the Baltic Sea region states, including Russia, registered positive economic growth.

A main focus this year is the Russian economy and its influence on the region. The morning session will focus on security-related issues, the evolution of the U.S. State Department’s Northern European Initiative (NEI), and the growing importance of the EU’s Northern Dimension as Sweden prepares to assume the Union’s presidency January 1, 2001.

The afternoon session will offer perspectives on Russia’s role in the Baltic Sea region as well as on the Putin administration’s economic program, with remarks by key policymakers involved in its design and implementation.

The conference can be viewed live from the Website of the American Embassy in Stockholm (www.usemb.se). Archives will be accessible for at least one year after the conference date.
Shining Bright: CEFIR, a New Think Tank in the Russian Federation

SITE announces the advent of CEFIR, a new Russian institution that is already making a difference in Russia. The Center for Economic and Financial Research (CEFIR) has been formed on the basis of the highly qualified core Russian research group recruited over the last three years under the RECEP project. CEFIR is an independent Russian think tank providing policy advice to the Russian government and conducting high-quality economic research.

Bringing Together Russia's Best-Trained Young Economists

The RECEP project repatriated the first Russians with Ph.D.s from leading Western institutions (Harvard, MIT, Manchester). Staff at the new institute are also top graduates from leading graduate programs in the transition economies, such as the Moscow-based New Economic School and the Budapest-based Central European University. Through its international network—which includes the Centre for Economic Policy Research, the William Davidson Institute, SITE, and several top universities—CEFIR is developing a program for continued training. Already, several Ph.D. students share their time between Moscow and leading Western institutions. Most staff regularly visit Western institutions and participate in special courses arranged by the Economics Education and Research Consortium (EERC). The ultimate objective is to develop a Western-style Ph.D. program together with CEFIR’s partners in Russia.

Building High-Quality Data Sets for Advanced Research

CEFIR researchers have created some of the best data sets available in Russia, including the unique Russian Enterprise Registry Longitudinal Dataset (RERLD) and its extensive regional database. A broad program of high-quality policy-relevant research has been developed based on these data sets. The research program is one of the most advanced in the country, matched in the region only by the Prague-based CERGE-EI and the Central European University.

Producing Internationally Acclaimed Papers

The academic achievements of the Russian staff are exceptional by Russian standards and on a par with those of colleagues at even the most established research centers in Western Europe and the United States. Two Russian faculties are affiliates of CEPR (the only ones in Russia). CEFIR economists received the first two academic excellence awards granted by EERC Russia, awarded based on the results of nationwide competitions in 1998 and 1999. Six of the staff’s research projects were awarded EERC research grants in 2000. The center was the most successful individual institution in the grant selection.

CEFIR has also been successful in international competitions, with a number of papers selected for presentation at the 1999 and the 2000 annual conferences on transition hosted by the William Davidson Institute (University of Michigan), CEPR, the World Bank, and the EBRD (four papers in 1999 and six papers in 2000, more than any other institution in a transition economy). Several papers were selected in international competition for presentation at the 1998, 1999, and 2000 annual

BICEPS’ New Research Project: The Baltic Rim Regional Agenda—Developing a New, Innovative, and Cooperative Mindset

Regional agendas typically focus on macroeconomic issues and trends that are best described using official statistics or on large infrastructural projects in which the political sphere is deeply involved. While taking these issues into account, the Baltic Rim Regional Agenda puts strong emphasis on the underlying microeconomic environment: clusters, industries, firms, entrepreneurs, and processes of innovation and change. Through cluster studies—including studies of the network of suppliers, buyers, firms in related technologies, and research and education institutions—it develops new empirical material that describes the everyday realities facing managers in the region. The cluster studies will highlight both successes and failures and will point to the many barriers (economic and cultural, formal and informal) confronting firms doing business across borders in the region.

Two of the project’s leaders are Örjan Sölvell, Director of the Institute of International Business at the Stockholm School of Economics, and Michael E. Porter, of Harvard University, who has led several similar initiatives in other regions, including Central America and the Middle East. The project’s research team will operate out of a new center—the Baltic International Center for Economic Policy Studies (BICEPS)—established in Riga by SITE.
meetings of the European Economic Association. In 1999 a paper on fiscal federalism in Russia by Ekaterina Zhuravskaya, CEFIR’s academic director, won the Young Economist Competition sponsored by the Nobel Foundation and was selected for presentation at the Fifth Nobel Symposium in Economics on the economics of transition. Several papers produced by CEFIR researchers have been accepted for publication in top Western and Russian economics journals. In recent years CEFIR scholars have published more in these journals than all other Russian economists combined.

Working with Policymakers

On the policy side, the CEFIR group contributed to the Putin Administration’s new economic program. The center interacts most closely with the Economic Expert Group led by Arkady Dvorkovich, Special Advisor to the Minister for Economic Development and Trade, German Gref. Over the past three years, CEFIR/RECEP has also provided regular policy memoranda to decisionmakers in the Prime Minister’s Office, the Administration of the President, the Ministry of Economy, the Ministry of Finance, the Central Bank of Russia, committees of the state Duma, and other policymaking bodies.

Shaping the Future

Thanks to generous donations from private foundations for capacity-building initiatives such as “Reversing the Brain Drain: The Rausing Retention Program,” and to support from several international organizations, this group can continue its contribution to the Russian policy process and the building of economics in Russia. Led by academic director Ekaterina Zhuravskaya, CEFIR has a strong in-house research unit and is open to individuals from other Russian institutions and to international economists. Initially, CEFIR will be managed by SITE and will interact closely with the New Economic School, the EERC, and the Higher School of Economics. The overarching aim is to build a “Russian house of economics” that can bring together components of a sustainable renewal of Russian economics: high-quality education, research, and outreach to policymakers and other academic institutions.

An important factor in CEFIR’s development has been the strong sense of ownership among its core Russian staff for institution-building. They possess a deep sense of responsibility for quality research and policy advice, as well as recruitment, fundraising, outreach, dissemination, and management. The group shares a common vision of how to build and renew Russian society. They are the future leaders, policymakers, and professors of Russia.

For inquiries or more information on CEFIR, contact erik.berglof@hhs.se or jody.lanfrey@hhs.se

RECEP/CEFIR Research:

Capture of Bankruptcy: Theory and Evidence from Russia

A well-functioning bankruptcy institution is an important component of the transition to a market economy. It aims to protect creditors, impose financial discipline on managers, induce restructuring, and free assets from inefficient use. The Russian Federation recently enacted new bankruptcy legislation. This article addresses whether and how the new bankruptcy law and practice have changed managerial incentives and increased creditor protection.

We argue that a distinguishing feature of the Russian bankruptcy institution is the capture of arbitrage courts by regional political powers. Arbitrage court judges, who are vested with significant discretion in bankruptcy procedures, are not independent. Based on massive anecdotal evidence, we conclude that regional governors have the ability to influence the decisions of arbitrage court judges.

Governors may benefit from their influence on courts in different ways. They may extract rents from the managers of insolvent firms in exchange for protection from losing control in bankruptcy. They may also receive benefits from the managers of profitable enterprises who fake insolvency, using bankruptcy procedures to avoid federal taxes and debt repayment to creditors outside the region. Governors may also use their influence to prevent the bankruptcy of large enterprises for political reasons.

In this article we focus on the first two cases. Based on evidence and a theoretical model, we conclude that the capture of arbitrage courts results in a failure of the bankruptcy institution to protect creditor rights and put pressure on managers to restructure.

The Russian Federation has had bankruptcy legislation since November 1992. The first bankruptcy law was completely ineffective. Its failure motivated the adoption of a new law in March 1998, drafted according to Western standards. The new law makes the initiation of bankruptcy proceedings very easy: a creditor can file a bankruptcy petition against a firm that has a debt of as little as $5,000 that is overdue by at least three months.

The law was expected to vastly improve managerial incentives because it is harsh on the incumbent management: under the law, the manager loses control in bankruptcy. It was drafted, however, to avoid inefficient liquidations: judges are given the discretion to refuse liquidation suggested by creditors. We show that the discretionary powers granted to the judge are abused and the law has not achieved its goals.
Experts had predicted that the law would cause a flood of bankruptcies. Before 1998 most Russian firms accumulated large arrears to the government and private creditors. The number of bankruptcies has, indeed, increased since the law was adopted—a fact that many economists interpreted as evidence of hardening managers’ budget constraints. Aggregate figures, however, are insufficient to reach such a strong conclusion. By looking at which companies went bankrupt and what happened to these companies in bankruptcy, we provide evidence in favor of the opposite conclusion: bankruptcy has softened managers’ budget constraints. To explain this, we build a simple theoretical model of capture in bankruptcy and show that empirical evidence is consistent with the model.

The model investigates how bankruptcy capture affects managerial incentives, the financial positions of firms, and the protection of creditor rights by considering a firm with a system of regional taxcollection. The prob- gional protection of firms againstfederal tax
government and the federal center, federal because the bankruptcy law does not se-
currence is consistent with the model. ment procedure is initiated against a par- eses of the capture model and test them using the data on Russian industrial ent-
mony's budget constraints. Aggregate figures, economy by noting that the federal govem-
governor when the governor places a high value on tax income or is weak (unable to influence judge on his own).

We apply this model to the Russian economy by noting that the federal government, with its tax arrears claim on the regional enterprises, plays the same role as any outside creditor. We formulate hypoth-
probability of external management is higher for very large firms in efficient and profitable industries. In contrast, the probability of a liquidation procedure decreases with the strength of the regional governor, tensions between the governor and the center, and federal tax arrears in the region. The prob-
liquidation is higher for smaller firms operating in loss-making industries. In addition, we find no evidence that the ini-
tiation of external management procedure (imposed by the judge) changes the performance characteristics of firms.

Our results suggest that the managers of large enterprises and regional governors collude to expropriate the federal government and investors from outside the region. Large insolvent firms are not restructured. And incumbent managers stay in control even under the external management procedure, possibly because they are protected by regional governors.

The dependence of arbitrage courts on regional governments has important implications for the Russian economy. First, there is no pressure on managers of industrial enterprises to restructure. Second, it is difficult to obtain financing from outside investors even for very profitable projects because the bankruptcy law does not secure investors’ property rights. Third, regional protection of firms against federal tax authorities seriously undermines federal attempts to improve tax collection.

Ariane Lambert-Mogiliansky is research associate at CERAS-ENPC (École Nationale des Ponts et Chaussées). Constantin Sonin is an economist at RECEP/CEFIR. Ekaterina Zhuravskaya is the academic director of the new CEFIR. This article can be downloaded at www.recep.org.

Crime in Russia: Understanding Its Development During Transition: A Regional Approach
by Rudiger Ahrend and Yury Andrienko

The decade of transition in the Russian Federation has been accompanied by an unprecedented rise in crime. We investigate the reasons for this increase and for differences in crime rates across Russian regions by analyzing panel data for 70 Russian regions from 1990 to 1998. Using homicide as a proxy for violent crime and larceny as a proxy for property crimes, we find three factors that explain the proliferation of crime during transition: the reduction in the percentage of crimes solved by the police, the increase in alcohol consumption, and the increase in poverty and income. We find that the largest share of violent crime in Russia is associated with aggression within neighborhoods and families rather than connected to Mafia-like structures.

Rudiger Ahrend is an economist at RECEP and DELTA. Yuri Andrienko is an economist at RECEP/CEFIR. For copies of this article, please contact the authors at rahrend@recep.glasnet.ru or yandrienko@recep.glasnet.ru.
World Bank/IMF Agenda

Continued from page 4

commitments were made to Belarus, the Czech Republic, FYR Macedonia, Moldova, Slovakia, or Turkmenistan. The sharp decline in lending was partly offset by a steep rise in new lending to Turkey, which received nearly $1.8 billion in loans. Turkey is now the Bank's second largest borrower, after India. Despite the decline in lending in the region, net disbursements increased, rising from $1.6 billion in FY99 to $2.3 billion in FY00, due largely to the rise in disbursements in Central Europe.

Czechs Praise World Bank Technical Assistance

The Czech Republic has benefited from the World Bank's technical assistance, Finance Minister Pavel Mertlik said during the World Bank-IMF Annual Meetings in Prague. World Bank studies, such as the Country Economic Memorandum and an analysis of the Czech capital market, have been useful in helping draft new Czech laws. The Bank is supporting the government's efforts to streamline the finance system and introduce pension reform. The IFC has invested $283 million in the Czech private sector. The Czech Republic will continue to cooperate with the Bank after it graduates to lender status next spring.

IMF Overhauls Loan Plan

In an attempt to discourage better-off developing countries from relying on the IMF for low-cost financing, the Fund has overhauled its lending program, increasing borrowing rates and shortening maturities. The new approach effectively divides IMF borrowers into three categories.

IBRD/IDA Lending in Europe and Central Asia, in FY 2000 by Country (millions of dollars)

- The poorest nations will continue to receive low-priced, long-term loans, as they did in the past through the Poverty Reduction and Growth Facility.
- Countries that have recently graduated from low-cost concessional finance and certain low-income countries that lack access to capital markets will face shortened repayment periods and higher interest rates, in an attempt to discourage moral hazard and encourage rapid repayment. Standby loans now have maturities of 5 years (down from 3 1/4 years) and Extended Fund Facilities are due in 7 years (down from 10). The Supplementary Reserve Facility will remain the IMF's main emergency tool for resolving crises of capital market confidence, but stricter conditions will apply.
- Countries that have embraced sound economic policies but suffer the effects of a wider financial upheaval will be offered cheaper "insurance" against future currency or financial crises. The interest rate of the Contingency Credit Line—for which countries prequalify by getting their economies in shape so that they can borrow in case of a financial emergency—has been reduced significantly and the conditions for qualification eased, addressing the concerns of developing countries that shunned this program because they found it too expensive. (Based on a report of Damian Milverton from Dow Jones Newswires.)

Environment in Transition Countries

Environmental dangers are growing in Eastern Europe and Central Asia. While the demise of many communist-era industries has reduced air pollution, air quality has suffered in many urban areas as a result of rapidly grow-
Larry Summers: U.S. Vision of Development Banks’ Future

During the World Bank-IMF Annual Meetings in Prague in September, U.S. Treasury Secretary Larry Summers provided insight into Washington’s vision of how the World Bank and other multilateral development banks should operate in the future. We summarize some of his major recommendations:

- **Investment in global public goods should be expanded in three core areas:** stemming the spread of infectious and childhood disease, protecting the global economic environment, and creating knowledge in sectors such as agriculture. (The Bank defines global public goods as commodities, resources, policies, or services that have significant cross-border externalities that are important for poverty reduction and that cannot be provided adequately without some degree of international collective action.) The World Bank should identify internal resources for increasing funding to the Development Grant Facility.

- **The Bank should intensify its work on financial abuses, such as money laundering, inadequate bank supervision, and corruption, which undermine the credibility and efficiency of the international financial system.** There is a natural fit between the Bank’s work in this area and its mandate to reform the financial sector, promote good governance, and fight corruption.

- **A more selective lending framework is required,** with differentiated pricing based on the country and the activity being funded. Over time, the Bank and its regional counterparts should reduce the share and volume of lending to the more advanced emerging market countries, with graduation as a clear objective. Differentiated pricing should be based on the length of the loan, the amount borrowed, and the borrower’s income level. Middle-income countries could be charged more than poor countries to encourage them to look at international financial markets for financing. The Bank should also lend more to countries that use the money well.

- **A more careful assessment of the Comprehensive Development Framework experience is needed before an informed decision can be made on using it as the basis for significant changes in the Bank’s organization, policies, and procedures, and resource allocations.** The pilot experience underscores the complex operational problems—including the constraints posed by the lack of government capacity and the lack of cultures supporting participation in many borrowing countries—that still have to be addressed before the model can be replicated more generally in Bank operations. “We specifically disagree with the view that the Comprehensive Development Framework necessarily requires programmatic lending,” said Summers.

- **Development institutions must own the programs they support.** There is no question that full country engagement and commitment are vital for aid to have a significant and positive impact. But the fact that a country owns a particular set of priorities does not in itself validate their economic viability. “It is also essential that ... the stewards of scarce development resources also own the programs we support and make our own assistance decisions on the basis of a roadmap ensuring real and sustainable development results,” said Summers.

- **Multilateral development banks should limit their support during financial crises to cases in which lending is needed to avoid unnecessary contractions in fiscal expenditure, restructuring banking and other financial institutions, or minimize the adverse impact of the crisis on the poor (by strengthening social safety nets, for example).** The adoption of more selective, performance-based lending programs will provide a large and flexible contingent financial capacity for the IBRD and its regional counterparts to respond effectively to borrowers affected by future disruptions in private market finance. None of the nonconcessional multilateral development banks’ windows should expect new capital increases, however. Transparency and accountability these institutions should be increased.
No serious attempt has yet been made to change regional boundaries. In every other respect, the position of regions has changed dramatically since the break-up of the Soviet Union in 1991. After being subdued under the strictly centralized Soviet regime during their previous existence, regions today exist as undefined states with no clear framework for cooperation between them and the center.

Regions Were Left Alone

The 1992 federal treaty and the new constitution of 1993 established a formal legal basis for center-region relations, but both documents were unclear on many issues. This lack of clarity strengthened the growing inequality among regional units. At the beginning of 1993, President Yeltsin stated, "The Russian government does not conduct any kind of a regional policy. This does not mean that the process of defining the contents of Russian regional policy is under way, but really that such a policy does not exist."

Thus the regions were left to cope with the economic hardships of the 1990s as they saw fit. Some, notably the few resource-rich ethnic republics, decided to maximize their political and economic independence. Many regions resorted to anti-market measures, such as export restrictions, import tariffs, and local money surrogates in their pursuit of self-sustainability, especially in the food sector. Every region tried to maintain good relations with the government to attract the most subsidies, transfers, and cheap loans for its regional development.

The center tried to clarify the situation by negotiating "power-sharing" arrangements with certain regions. These secret bilateral agreements, however, did little to improve the situation. The federal authorities were both unwilling and incapable of controlling a rapidly growing jungle of contradictory and unconstitutional regional laws. In 1996, as part of President Yeltsin's re-election strategy, governors were for the first time elected and not appointed by the President.

Putin's Administrative Reform

The Putin era so far seems to be based on a completely different set of ideas from those of his predecessor. In his inaugural address in early May, Mr. Putin stated that he would seek to strengthen the role of the state, which implied greater efforts to establish respect for the law, crack down on crime, and implement economic reforms without endangering the emergence of democracy.

One of his first acts as President was to initiate an administrative reform that reallocated Russia's 89 regions into seven federal administrative districts led by representatives picked by Mr. Putin. Numerous regional-level regulations in conflict with federal law were also abolished. After tough negotiations, he even succeeded in passing a law on formation of a Federation Council. The act diminishes the powers of regional leaders by eliminating their automatic right to a seat on the Federation Council. Mr. Putin also now has the right to dismiss regional leaders and disband regional parliaments.

While it is too early to judge the merits of these legal reforms, Russia clearly needs simple, enforceable legislation to elaborate the division of powers among federal, regional, and local governments.

The Reverse Side

But, as always, there is the reverse side. We see imposing more control on regional activities as a good move—but only to a limit. Overwhelming decentralization and excessively light restrictions on regional economic policies are bound to be detrimental. The Soviet-type impossibility of doing anything without permission from above is incompatible with innovation, imitation, and economic reform at the regional level. The big danger is that regional initiatives will be killed before they are ever born.

Due to the large number and variety of natural, economic, and social conditions, Russia needs to allow for regional variation in policies within a clear legal framework.

Laura Solanko and Merja Tekoniemi are economists at BOFIT. This article was published in Russian Economy: The Month in Review, 5 September 2000.
Baltic Privatization Bogs Down
by Likka Korhonen

Although the three Baltic countries chose somewhat different privatization approaches in the early years of transition, the overwhelming majority of Baltic companies today are privately owned. Lithuania relied heavily on the voucher method in privatizing its state-owned assets, while Estonia was particularly vigorous in seeking tenders for cash payments coupled with additional commitments from the buyer, such as capital investment. All three countries used voucher systems to privatize housing.

By 1995, even with different approaches (and different speeds) in privatization, the private sectors produced some 65 percent of GDP in Estonia and Lithuania and about 55 percent in Latvia. The private sector's share of GDP currently exceeds 70 percent throughout the Baltics. Despite these impressive gains in privatization, the Baltics still retain large infrastructure companies in state hands. Privatization of these remaining state assets has proven difficult.

Privatizing Infrastructure

Privatization of energy companies, on the other hand, has been fraught with political battles. The Latvian government, for example, has had major difficulties in its attempts to push through the privatization of Latvenero, the national power company. Originally, Latvenero was to be restructured and a majority stake sold off. In the ensuing political battle, the opposition succeeded in collecting enough signatures to call for a referendum on the sale. This, in turn, forced the parliament to cancel the privatization altogether in August. It is uncertain at present how the necessary investments for Latvia's energy infrastructure will be financed in the future. In Estonia successive governments have negotiated with U.S.-based NRG Energy for close to five years about the partial sell-off of the national power utility, Eesti Energia. The main complaint was that the privatization process itself has been very opaque.

These examples show how difficult it can be to privatize large infrastructure companies, which serve most of the population either directly or indirectly. The common view is that privatization usually is followed by price increases, but it should also be noted that the public sector often lacks the resources for needed capital investment and modernization.

Privatizing the Banking Sector

Estonia and Latvia were quick to privatize their larger banking institutions, while the Lithuanian state still retains a majority in the country's second- and third-largest commercial banks. Privatization of these two banks has proven very difficult. A tender for the sale of Taupomasis Bankas (Savings Bank) will be announced in early September, but the bank will remain in state hands well into 2001 even if the tender goes well. Moreover, it is by no means certain that the government will be able to sell the bank at reasonable terms. In a tacit acknowledgement of this, the Lithuanian government recently increased the yield on the government securities held by the Savings Bank. Investors still fear that the credit portfolios of the state-owned banks will contain unpleasant surprises. Estonian and Latvian authorities, meanwhile, have been involved in a second round of bank privatization.

In the aftermath of the Russian crisis in 1998, the central banks in Estonia and Latvia were forced to take over illiquid banks that threatened the stability of their financial systems. A little more than a year ago those banks were again sold to private investors. It now seems that further privatization will be a long and drawn-out process. Projects will encounter opposition for both economic and political reasons, and this is bound to influence the behavior of international investors.

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If corruption and bad governance reduce international trade and investment more than domestic trade and investment, a naturally more open economy (as determined by its size, geography, and language) would devote more resources to building good institutions and would display less corruption in equilibrium. As globalization deepens, the natural openness of all countries increases, raising the opportunity cost of tolerating a given level of corruption and possibly providing new impetus for countries to fight corruption.


Dimitri Vittas, Pension Reform and Capital Market Development “Feasibility”
This report examines corruption in the transition economies, analyzing its potential repercussions on each country's strategy. It distinguishes between state capture and administrative corruption, proposing strategies with which to prevent both.


Over the past decade, more than 150,000 large enterprises in 27 transition economies have undergone revolutionary changes in their political and economic environments. Some enterprises have responded to the challenge, others have not. To assess the effectiveness of the different reform and privatization strategies, this study examines enterprise-level data, including the degree of economic restructuring at state-owned and private firms, the role of managers, and the effect of government's support to enterprises in distress.


Strategies required to change the education system in the transition economies include realigning education systems with market economies and open societies; combating poverty by increasing educational fairness; providing financing for sustainability, quality, and fairness; spending resources more efficiently, and improving governance, management, and accountability.


Before the dissolution of the communist state, utility prices were driven by political priorities in Central and Eastern Europe and the former Soviet Union. Utility prices were kept artificially low until the early 1990s. When these price subsidies became unaffordable, one government after another decided to bring residential tariffs closer to supply costs. The resulting price adjustment process, however, turned out to be more painful than originally expected. The required increase in the prices of utility services coincided with a decline in household income; paying utility bills became a major challenge for the rapidly growing army of poor households. By the mid-1990s, utility companies started to experiment with various subsidy schemes aimed at low-income households. To help decisionmakers choose the mechanism best suited to their specific needs and priorities, this volume provides a conceptual framework and methodology for evaluating utility subsidy mechanisms. It also presents the results of applying this methodology in Poland and the Russian Federation.


Governments could reduce poverty and stem the increase in inequality by enhancing income-generating opportunities for all citizens, providing greater security by reforming safety nets and social insurance programs, and empowering the poor through institution building, at both the official and the community level.

Dena Ringold, Roma and the Transition in Central and Eastern Europe: Trends and Challenges, September, 2000, pp. 66.

The transition process in agriculture is far more complex than originally envisaged by either the countries themselves or the international community, including the World Bank. Increased social problems and the alarming growth of poverty have added a new, unexpected dimension to the transition process. The region's rural economy is still struggling to adjust to new economic realities, a problem that will require further adjustment of the Bank's approach. This volume summarizes the revised World Bank assistance strategy for rural development in the region.

**Rural, Environment and Social Development Strategies for the Europe and Central Asia Region.** September, 2000, 80 pp.


Informal payments in the health sector in Eastern Europe and Central Asia are a fundamental aspect of health care financing and a major impediment to health care reform. Private payments to public doctors, nurses, and other health care personnel represent an informal market for health care, outside the financial controls, policy rubric, and audits of national health care systems. This paper spells out the policy implications and proposes possible strategies for addressing the problem.


**IMF Working Papers**


Sanjeev Gupta, Hamid Davoodi, and Erwin Tiongson, *Corruption and the Provision of Health Care and Educa-

**CASE Publications**


Centre for Economic Policy Research Publications


Economic growth and development cannot be achieved simply by barring government interference in the economy. In several areas—including privatization, fiscal policy, agriculture, labor policy, and financial sector development—reform should overcome institutional factors and incentives that impede development. Areas that require attention include the relations between the center and states and their impact on policy; the poor incentive structures faced by both taxpayers and government officials; inadequate coordination among different levels of government, which results in the poor delivery of services; outdated marketing strategies, which impede agricultural growth; and the operations of the financial and labor markets.

To order: Jennifer Munro, IRIS Center, 2105 Morrill Hall, College Park, MD 20742 tel.: 301-405-3721, fax: 301-405-3020, email: jenniferm@iris.econ.umd.edu.


This study examines the governance role of Russia’s financial-industrial groups and their impact on the allocation of capital. It compares firms that belong to groups with a control set of firms in which ownership is dispersed or managers and employees are in control. It distinguishes between hierarchical financial-industrial groups, in which a bank is in firm control, and industry groups, which are looser alliances without a common control structure. Investment is sensitive to internal finance for independent firms and firms that belong to industry groups: the worse the internal financial situation, the less they will invest in branch companies. In contrast, in bank-led group firms, the correlation between the internal financial situation and investment is negative, suggesting extensive financial reallocation and the use of profitable firms as cash cows. The authors conclude that hierarchical group firms allocate capital better than other firms, presumably because the controlling bank has a stronger profit motive and authority. However, controlling shareholders often appropriate value.

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Requirements for the transition toward a market economy overlap with the requirements for EU accession. The acceding transition economies still have substantial reform tasks ahead of them. Expanding EU membership also requires significant reforms within the EU to reduce the danger of standstill for European policymaking.

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Increasingly, small cities and towns are being recognized as key players in creating sustained economic development in Eastern Europe. Whether they are able to execute this central role will depend on their ability to undertake essential investments—which in turn requires the availability of finance and the strengthening of local administrative capacity.

This paper describes a series of actions—based on lessons learned in the EU and
elsewhere—for promoting regional growth. Together these actions constitute a coherent program that national governments can undertake to improve the absorptive capacity of smaller local governments and the attractiveness of these communities for private investment. A communal credit program could be adopted throughout the region. The program consists of three closely related and mutually reinforcing elements: project preparation facilities, bond financing facilities, and matching grants for priority projects.


Is the Russian Federation a single economic area? Why are regional economic inequalities increasing? Are there significant regional differences in the economic regime? What influence do leaders have in their own regions and on federal economic policies? To what extent do central policymakers affect regional outcomes? How are Russian regions affected by their new openness to foreign trade and investment?

Based on research carried out by an international and interdisciplinary group of experts, this book examines these questions through case studies of eight regions and analysis of data from Russia’s 77 main administrative regions. It shows that regional average real income levels are still diverging, and that intraregional real income inequalities are even greater than differences between regions. The federal government is exerting little influence to reduce these inequalities: the scale of net transfers has been small and their effects weak. The study concludes that initial conditions have been a dominant factor in accounting for income differences across regions.


This book identifies the central problems with the Czech approach to privatization. First, the largest and most powerful strategic state enterprises were excluded from the program. Second, foreign direct investors, who were required to draft projects based on estimated current values, were at a disadvantage relative to domestic investors, who were permitted to draft projects based on book value. Third, privatization of the state banks was postponed. As a result, the banks did not adopt efficiency-oriented policies. Fourth, the sequencing of reforms was poorly planned: although privatization took place quickly, other institutional measures, such as the supervision and regulation of banks and capital markets, were adopted too slowly.


To take an active role in the transition process, economic policymakers, business leaders, and government officials need a thorough grounding in market-based economics. This article describes five centers of excellence—the Central European University (Budapest), the Centre for Economic Research and Graduate Education (Prague), the New Economic School and the Economic Education and Research Consortium (Moscow), and the Economic Education and Research Consortium Master’s degree program (Kyiv)—that could serve as models for teaching and research in the Caucasus, Central Asia, and Southeast Europe.


This book analyzes the policy responses of the Czech Republic, Hungary, Poland, and the Russian Federation to global financial turbulence.


This year’s report examines health conditions in the Democratic People’s Republic of Korea, the ongoing health consequences of the Chernobyl nuclear disaster, the health effects of the Kosovo reconstruction and other issues.
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