World Bank’s New Approach Helps Business in Transition Economies

Lessons Learned from the Latest Adjustment Loan to Latvia

by Lars Jeurling

The World Bank’s thinking about how to encourage the development of the private sector in the former Soviet Union has evolved considerably as it has learned more about the transition process. We started with the notion that macroeconomic reform, liberalization, and mass privatization would be sufficient to set economic incentives right and get the market and private sector going. We soon realized that this was not enough and began to focus on broad-based institutional and legal reform, such as civil service reform, budget management, and the enactment of laws governing the rules of the market. The institutional focus greatly improved our ability to promote successful reform. However, it is becoming increasingly clear that without bottom-up action to implement institutional reforms, disseminate knowledge, and change attitudes, the impact is limited. In many cases, such action has to precede broad-based top-down macroeconomic, institutional, and legal reform, because without successful cases showing that reform works it is hard to build a constituency for such reform.

The need to shift from a top-down to a bottom-up approach should not come as a surprise. For decades the Bank has been in the business of promoting micro-level reform through investment lending of various kinds. A number of private sector development operations in the CIS and the Baltic countries were successful, including rural credit operations in Latvia and Kyrgyzstan, enterprise restructuring and management training operations in Moldova, and the enterprise and finance operation in Lithuania.

These operations target public institutions (increasing their efficiency and responsiveness and improving their ability to implement laws and regulations) and enterprises and banks (supporting their privatization and restructuring). Training and technical assistance are the most widely used interventions, but other tools—such as twinning arrangements, capacity building of local consultants and professional and private enterprise organizations, and study trips and exchanges—have also been undertaken.

Finding the Right Lending Instruments

These experiences have not easily found their way into adjustment lending, perhaps because micro-level interventions seemed fraught with difficulties in the often distorted and corrupt environment of several transition economies. The Structural Adjustment Loan (SAL) instrument, with its short time frame and broad agenda, has not been well suited for pursuing long-term, bottom-up, micro-level reforms. Investment lending has not been well integrated into SAL programs either. It could not address the broad-based, top-down policy and institutional reform that is necessary to make bottom-up programs sustainable and reproducible.

A key challenge for the Bank has been to find effective lending instruments and tools for micro-level actions to promote private sector development. To address the issue, the Bank has developed new lending instruments, the Programmatic Structural Adjustment Loan (PSAL) and the Adaptable Program Loan (see box). These new products, which involve a series of shorter loans that build on one another, promise better results because they follow a balanced top-down and bottom-up agenda under the umbrella of a longer-term program.

The new model is based on several key premises:
Reforming public institutions is at least as important to private sector development as reforming private institutions. Private sector governance and business ethics are central to private sector development. Trust and a constituency for good governance are needed for reforms to work.

Institutional and governance reform takes time to implement. Reform cannot be legislated; institutions must be built over time.

Reform needs to come both from the top down at the macro level and from the bottom up at the micro level.

The New Thinking in Practice

The Latvia PSAL, approved in March, 2000, is a good example of how this thinking can be applied to the new-style adjustment lending. The PSAL is based on a three-year program of public sector and governance reform.

The program was supported by an earlier SAL. Good progress has been made to date on macroeconomic and structural reform, including institutional reform and creation of a legal framework. Latvia has also implemented a number of successful micro-level programs, such as the Rural Development Program, also financed by the World Bank. The success of that program helped build a constituency for reform. However, Latvia still has some way to go in making institutions work and implementing laws on the book. The PSAL program focuses on improving governance, providing training, reforming the civil service, and improving the management of public expenditures—in other words, on creating an appropriate macroeconomic and institutional framework for development of the private sector.

An important part of the program is promoting selected bottom-up reforms, introducing more transparent and efficient processes for case-by-case privatization, and establishing independent professional regulatory and inspecting bodies. These agencies must operate with clear and transparent procedures, keeping regulations and inspections as simple and as minimal as possible in order to protect the public interest.

Because these reforms will take years to implement, they require the longer-term

New Thinking on Adjustment Lending—New Loan Products

A recent inhouse review of five large adjustment operations of the World Bank concluded:

"In most cases the Bank needs to tilt away from broad coverage and toward selectivity in the policy reforms supported by a single operation. The five operations assessed involved conditionality on a fairly comprehensive set of reforms. This approach reflected an understandable tendency by Bank staff to push as many elements of reform as possible through the window of opportunity created by a crisis. But given the need for borrower ownership, analytical clarity, and institutional capacity, this tendency should be resisted. Excessively broad conditionality may reduce the probability that real progress will be made on key reforms.

During the design phase the Bank and the government should pay more attention to setting priorities and sequencing reforms. Doing so may help narrow conditionality. Setting priorities is difficult—especially in transition economies such as Russia, where creating an environment that attracts domestic and foreign investment requires that reforms proceed along an ambitiously broad front. Still, realism about the government's implementation capacity—both technical and political—requires that priorities be set." (PREM Note 27, August, 1999.)

Since that review, the Bank has begun to apply a new approach to adjustment lending. To address the problems identified in the review, it introduced two new products, the Programmatic Structural Adjustment Loan (PSAL) and the Adaptable Program Loan (APL).

The PSAL is a fast-disbursing loan that helps countries close external financing gaps caused by balance of payments or fiscal problems. It focuses on step-by-step capacity building and institutional reform, usually in the public sector, in order to strengthen public expenditure management, improve public sector governance, make public resource allocation more efficient, and enhance the quality of public service delivery, especially to the poor. Because such reforms generally take time, the PSAL serves as an umbrella for a series of individual loans, each building on the earlier ones and each supporting a phase of the medium-term reform program. The time horizon of a typical PSAL series is three to five years, with each loan typically supporting a one-year program. With the agreement of the borrower, the Bank can modify the conditions of remaining tranches in light of changing domestic and external developments and performance.

The APL also comprises a series of loans supporting the implementation of long-term development programs. Loan proceeds may be used to cover the procurement of goods, services, works, and equipment, and to fund incremental operating costs related to the program. The program provides flexibility in adapting project design and financing to meet development objectives.
PSAL program. To be effective, they will require a significant amount of technical assistance and hands-on supervision by the Bank. (Supervision could be provided through complementary investment lending. The recent Romania SAL is accompanied by a $25 million Technical Assistance Loan, which finances the retainer fees of investment banks that manage privatization.) We were initially worried that this would be a stumbling block, as Latvia seemed unwilling to borrow for technical assistance. After some initial reluctance, however, the Latvians warmed to the idea. The government agreed to set aside a significant amount of its privatization revenues to pay for such advisors, on the assumption that these expenses will pay off in the form of higher privatization revenues. The government has also committed significant resources to improving regulatory and inspection bodies and processes, which will be complemented with grant funding from bilateral donors and the Bank’s Public-Private Infrastructure Advisory Facility.

In designing the PSAL, we had to resist the temptation to focus on top-down, broad-brush reform—that is, to include too much—at the expense of implementing reform from the bottom up. Our initial program included issues such as licensing, customs, and tax administration, but we soon realized that to carry out an effective reform with a good chance of being implemented, we needed to be much more selective.

Links between Corporate and Public Governance

The PSAL has demonstrated that key elements of the private sector development agenda, such as privatization, regulation, and inspection, in fact concern about governance. Clear and transparent processes and institutions should be established, shielded from undue political and financial pressures.

An intriguing question that we were not able to pursue adequately in the PSAL is the extent to which corporate governance problems feed on and reinforce governance problems in the public sector. Do poor business ethics and nontransparent business dealings and accounting encourage and sustain public corruption? To what extent do problems of poor governance in the public and private sectors feed on and reinforce each other? Can the problem of governance be tackled effectively only by addressing public and private governance simultaneously?

So far the Bank has focused mainly on public governance; private sector governance issues have been addressed largely in the narrow sense of protecting the interest of investors and minority shareholders. There is a movement to broaden the perspective, to see corporate governance more as a question of how corporations should best be governed to serve the public interest. This seems to be a particularly urgent issue for the Europe and Central Asia region; work in this area could contribute significantly to dealing with the public governance problem. (Editor’s note: The following article tries to answer some of these questions.)

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Are Foreign Investors and Multinationals Engaging in Corrupt Practices in Transition Economies?

by Joel Hellman, Geraint Jones, and Daniel Kaufmann

Foreign direct investment (FDI) plays an increasingly important role in emerging economies. Among transition economies, substantial investment has gone to a few countries in Eastern Europe and the former Soviet Union, while little investment has reached other countries in the region. Between 1994 and 1999 Poland received $20 billion, the Czech Republic $13 billion, and Hungary $12 billion in cumulative FDI flows. In sharp contrast, Armenia, Belarus, Georgia, Tajikistan, and Uzbekistan received less than $1 billion over the period, according to EBRD data. During that five-year period, annual average FDI in Belarus, Kyrgyzstan, Moldova, the Russian Federation, Ukraine, and Uzbekistan was less than $20 per capita, while the Czech Republic and Hungary received about $200 per capita a year, and Poland and Slovenia received about $100.

In countries rich in natural resources, such as Azerbaijan, Kazakhstan, the Russian Federation, and Turkmenistan, FDI was made, but flows were weaker than they would have been had better governance prevailed. In fact, for all 22 countries in transition for which data are available, after controlling for natural resource wealth, there is a significant negative association between per capita FDI and the extent of administrative and “grand” corruption—meaning kickbacks in large-scale government contracts. The assertion that corruption deters FDI is not new. In our research we concentrate on the converse question: compared with their domestic counterparts in the host country, do transnational firms (and local firms with substantial FDI or foreign ownership) exhibit higher standards of corporate responsibility? Do these firms engage in corrupt practices less often than other firms?

Conventional wisdom would answer in the affirmative. Most foreign firms are governed by additional legal constraints, the most recent being the OECD Convention on Combating Bribery of Public Officials in International Business Transactions, which went into force in early 1999. For more than 20 years U.S. firms have been subject to the Foreign Corrupt Practices Act, which prohibits U.S. firms from bribing foreign public officials to obtain international business. Foreign firms are also keen to enhance their reputations and respond to stakeholder pressures for more responsible corporate practices. In fact, many firms have adopted voluntary codes of corporate conduct, which typically include anti-bribery commitments. It might thus be expected that relative to their domestic counterparts, firms with foreign capital would tend to avoid corrupt practices.

To study in depth the issues of governance and corruption in 22 transition countries, the World Bank and EBRD jointly carried out the Business Environment and Enterprise Performance Survey in mid-1999 (A.C. Nielsen administered the survey). Using the survey data, we analyzed the nature of the relation between firms and government, focusing on various corrupt and noncorrupt means by which firms exert influence over the state. We took a multidimensional approach to corruption, governance, and influence, unbundling these concepts into specific subcomponents. Specifically, we analyzed the corporate behavior of foreign investors relating to legitimate influence (such as lobbying) as well as corrupt ways of exerting influence.

**Corrupting Influence**

Our study examined three types of corruption: administrative corruption (bribes to

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Figure 1. Bribes as a Percentage of Firm Revenues in Transition Economies, by Subregion

<table>
<thead>
<tr>
<th>Subregion</th>
<th>Domestic firms</th>
<th>Firms with FDI</th>
<th>Firms with HQ abroad</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central and Eastern Europe</td>
<td>2%</td>
<td>3%</td>
<td>4%</td>
</tr>
<tr>
<td>and Baltic States</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commonwealth of Independent States</td>
<td>6%</td>
<td></td>
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</tbody>
</table>

Source: the authors.
bureaucrats to alter the implementation of rules and regulations), state capture (the "purchase" of laws and policies by corporations), and public procurement kickbacks (payments made to secure procurement contracts). We also examined legal methods of affecting policy (such as lobbying). We found that transnational firms are just as likely to pay administrative bribes and to try to capture the state as other firms and that transnational firms headquartered abroad are more likely than other firms to pay public procurement kickbacks.

**FDI and Administrative Corruption.** In a companion paper ("Seize the State, Seize the Day: An Empirical Analysis of State Capture and Corruption in Transition," summarized in *Transition*, Vol.11, No. 2, April 2000, p. 8), we found that administrative corruption does not pay: on average all types of firms (with or without FDI) that engaged in administrative bribery experienced lower sales and investment growth than those that did not. The fact that the majority of firms in most countries still engage in such practices may reflect the fact that local bureaucrats exert extortionary pressure on them.

On average transnational firms pay just as high a percentage of their revenues in administrative bribe payments as do domestic firms without FDI. There are, however, important differences across subregions (figure 1). Administrative bribery by FDI firms is less prevalent in Central and Eastern Europe and the Baltic than in the CIS. Bribery in the CIS is particularly prevalent in firms with foreign ownership headquarters are located in the host country rather than abroad.

**FDI and State Capture.** State capture, a pernicious form of corruption prevalent in many transition economies, refers to attempts to extract benefits from the state by corruptly influencing the formulation of policy (public laws, rules, and regulations). The evidence suggests that state capture is particularly prevalent when firms face insecure property rights, insufficient economic liberalization and competition, and only a partial liberalization in civil society and media activities, impairing their ability to effectively monitor the activities of the state.

Despite the more stringent regulations governing their behavior, firms with FDI are involved in state capture just as frequently as domestic firms without FDI. Transnational firms with headquarters in the host country are more likely to engaging in state capture than firms headquartered abroad (figure 2).

**FDI and Public Procurement Kickbacks.** Firms with FDI whose headquarters are located abroad are most likely to pay public procurement kickbacks (figure 3). Such firms are more likely to pay procurement kickbacks than domestic firms with no FDI or transnational firms headquartered in the host country.

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At least for transition economies, these results challenge the efficacy of transnational anti-bribery conventions and laws or self-imposed codes of conduct to reduce corruption by themselves. The data—admittedly based on a small sample for each country of FDI origin and thus subject to a high margin of statistical error—do not support the notion that transnational anti-bribery laws (such as those that have been in effect in the United States for decades) have led to higher standards of probity in overseas public procurement. True, the implementation of the OECD convention is just underway, and it is thus too early to evaluate its impact. Yet it is suggestive that FDI originating in the United States—which has been governed by the Foreign Corrupt Practices Act for more than 20 years—does not appear to be characterized by higher standards of corporate ethics than domestic firms or FDI originating in other countries (figure 4). The impact of coordinated multilateral action under the OECD convention may or may not end up being more potent if and when countries fully implement, monitor, and enforce the recent agreement.

A positive benefit of transnational bribery laws concerns the behavior of potential investors. Transnational firms and foreign investors may avoid investing in countries with poor governance and high corruption. Reduced levels of FDI can thus indirectly exert pressure to improve governance within a country.

**FDI and Influence.** In contrast to the prevalence of corrupt practices by many firms with FDI in the CIS, exertion of influence is more prevalent in Central and Eastern Europe and the Baltics, particularly among foreign firms with local headquarters (figure 5). The evidence shows that firms that exert influence enjoy higher sales and greater investment growth than those that do not.

**Reducing Grand Corruption**

The causes and consequences of corruption are increasingly well understood; less is known about the reasons for its persistence. The analysis of state capture and kickbacks points to powerful private incentives to engage in these activities. In capture economies, where there is a large market for capture of policies and laws, successful captor firms enjoy strong private gains in terms of performance and improved security of their property rights (from an admittedly very low level). Private gains also appear to accrue to public procurement corruption. The private benefits that domestic firms and firms with FDI derive from state capture and procurement kickbacks (in contrast with pettier forms of administrative corruption) suggest why addressing these pernicious forms of corruption is a particularly challenging task.

It is unrealistic to suppose that firms will not try to influence the policy and regulatory environment within which they operate. Indeed, firms in advanced market economies exercise influence over public policy through a variety of channels. Our research highlights the fact that these strong lobbies are present in transition economies.

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**Figure 4. Percentage of Firms that Pay Public Procurement Kickbacks, by Country of Origin of FDI**

<table>
<thead>
<tr>
<th>Country of Origin of FDI</th>
<th>Average, domestic firms</th>
<th>Average, firms with FDI</th>
</tr>
</thead>
<tbody>
<tr>
<td>United Kingdom</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td></td>
<td></td>
</tr>
<tr>
<td>France</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Russia</td>
<td></td>
<td></td>
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<tr>
<td>United States</td>
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<tr>
<td>Austria</td>
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<tr>
<td>Belgium</td>
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<td>Greece</td>
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</tbody>
</table>

Note: Survey question was "How often nowadays do firms like yours need to make extra, unofficial payments to public officials to gain government contracts?" Firms responding "sometimes" or "more frequently" were classified as paying kickbacks. These figures are subject to significant margins of error and should thus be regarded as approximate.
countries, too, but are directed into illicit channels with highly detrimental social and economic consequences.

Policymakers can adopt a variety of measures to reduce grand corruption, in other words, procurement kickbacks. **First, they can make the relation between the state and firms with FDI more transparent by:**

- Monitoring meetings between firms with FDI and elected officials on the Internet (to make lobbying more transparent).

- Striving for greater transparency in party financing.

- Supporting the establishment of foreign investment advisory councils and foreign business clubs and associations (to give transnational firms a meaningful alternative channel of influence and create interactive forums among competitors).

- Setting up monitoring groups with international business associations and other civil society groups to oversee tenders, privatization deals, and large-scale procurement with FDI participation.

- Regularly monitoring and disseminating survey-based data on corporate practices of firms with FDI and disseminating evidence on the socioeconomic costs of firms' illicit activities.

- Improving governance through coalition building and collective action by associations of entrepreneurs, reformist government officials, lawmakers, and the media. The World Bank Institute is already playing a facilitating role in building coalitions and deepening awareness through participatory workshops in which participants discuss the link between corporate responsibility and national governance.

**Second, policymakers can promote global transparency through collective international actions.** These actions include:

- Concerted monitoring and enforcement of global initiatives that mobilize national governments, legislative bodies, civil organizations, domestic firms, and the international investment and financial community to work in tandem.


- Supporting the efforts of international NGOs, such as Transparency International and the International Chamber of Commerce, in advising firms on developing codes of corporate conduct that reject bribery.

- Widely disseminating information on transnational firms that have taken a proactive stance on corporate responsibility and ethics.

**Third, policymakers can design anti-corruption programs by:**

- Tailoring the national anticorruption strategy to the political and economic reality of state capture and other forms of grand corruption and putting particular emphasis on demonopolization, competition, and protection of property rights, as well as complementary public sector reforms.

- Paying special attention to the needs of civil society, the competitive media, and legislative bodies.

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This article is based on their article “Far from Home: Do Transnationals Import Better Governance in the Transition Economies?” It is part of a joint research project on governance and corruption by the European Bank for Reconstruction and Development and the World Bank Institute. This work is also an input into the ECA report “Anticorruption in Transition: Confronting the Challenge of State Capture,” which will be published in September. For further details on the research papers, visit http://worldbank.org/wbi/governance.
Is Foreign Investment Good or Bad for Transition and Emerging Economies?

In June 1999 the William Davidson Institute hosted a conference on Foreign Investment and Emerging Markets. Highlights of the conference appeared in the August 1999 issue of Transition. We showcase three papers from the conference, each focusing on some aspect of the effect of multinational investment on the host country.

Spillovers from Multinationals in Developing Countries: The Mechanisms at Work

by Richard E. Caves
Summary of WDI Working Paper 247

Early case studies of foreign direct investment identified several channels for spillovers—transfers of knowledge that result in productivity increases—from foreign subsidiaries to local host country enterprises. Statistical analyses, which were initially crude but have recently been based on improved data, have mostly confirmed the positive relation between the prevalence or productivity of foreign subsidiaries and the productivity of local firms that compete with or supply them. Some negative results appear in high-quality studies, however, and other investigations suggest that the incidence of spillovers varies substantially with the country and industry setting in which they (may) occur.

The central function of a spillover is to reduce the inequality of knowledge stocks. Few hypotheses and little evidence exist, however, concerning the factors that determine the leakage of knowledge stocks and their absorption and effective deployment by firms in developing countries. What knowledge-related assets get transferred to local firms, and when are foreign subsidiaries the premier source of supply? This article makes a start at answering these questions by specifying the economic behavior associated with the "spillable" knowledge possessed by foreign subsidiaries and the ability of local firms in developing countries to capture them.

Why local enterprises in developing countries should lack knowledge or skills that could have been acquired from foreign subsidiaries raises questions about the role of the representative firm's organization and growth as part of the process of economic development. But with a few exceptions, no systematic theory or empirical work has emerged to address this seemingly central issue. The Handbook of Development Economics, 46 chapters filling four weighty volumes, has essentially nothing to say about the subject, for example.

Organization of the Firm and Economic Development

Low levels of national economic development are associated with a paucity of large and complex business organizations. Put another way, the poorer the country, the larger the number of independent business units relative to the working population.

One study (Caves and Uekusa 1976) seeks to explain variation in enterprise densities (the number of employers and own-account workers as a fraction of the labor force) across countries. (An alternative measure added family workers to the numerator.) The sample includes 34 countries with widely varying income levels for which reasonably comparable census-based date for the late 1960s were available. The key explanatory variables are per capita GDP (expressed in U.S. dollars at the current exchange rate) and GDP squared. The results show that enterprise density decreases significantly with GDP per capita, although at a declining rate, leveling off at about the income level prevailing in Canada and Sweden.

The study also finds evidence of a lagged adjustment process in the decline of the enterprise ratio. The ratio increases with the country's growth rate in the preceding two decades, which suggests that the squeeze out or consolidation of very small enterprises lags behind the development
process (in principle, though apparently not in practice, it could be a leading component of the development process).

This empirical regularity suffices to demonstrate that the capacity to mobilize and run complex business organizations is a correlate of the development process. The correlation between development and the number of large business enterprises underlines the significance of spillovers from foreign subsidiaries and other external sources. It also shows that the role of spillovers depends on exactly what constraints the indigenous development of complex enterprises. We consider some possible explanations, treating them in isolation while recognizing that they are likely to interact:

- **Cultural traditions based on nonhierarchical interpersonal relationships may make it difficult to accept the hierarchical structures that exist in large firms.** Hierarchical relationships among individuals are surely unnatural in some societies. Rank-order tournaments as a standard way to staff an effective hierarchy require acceptance of interpersonal competition and of ways to compete interpersonally that are hardly natural for all cultures and religions. Such constraints could limit the feasible size of the business organization and promote decisions that diverge from the goal of maximizing value by responding to social norms of conduct formed outside the business environment. (Ponder, for a moment, the revenge culture of the Balkans run rampant within a business hierarchy.)

- **Local enterprises in developing countries may suffer from a lack of human capital.** Activities such as coordination and supervision require flexible and abstract problem-solving capability, specialized bodies of skill or training, or both. Most developing countries have made rather modest investments in advanced general education; some developing countries have invested more heavily in training, in particular technical skills. But the team aspect of business hierarchies suggests that skills tend to be complements rather than substitutes.

- **Local enterprises, lacking in both knowledge and experience, may not even be able to assess what types of information they are missing.** Shortages of knowledge are distinguishable from shortages of skills in several ways. Skills are encapsulated in individuals and subject to clear economic definition. Everybody knows that a firm needs a system of accounts and that specialized training is needed to be able to maintain them. In contrast, tacit and unencapsulated knowledge such as the process of forming a business partnership is an "experience good." Unless it invests in information, the firm remains highly uncertain about its value. Significant investment decisions (importing a proprietary technology, entering an export market) demand some stocks of knowledge that are identifiable, albeit probably costly to obtain. However, the firm may not even realize that it is missing other knowledge components salient to the investment decision. Consulting and other firms, of course, stand ready to sell such knowledge stocks, but the pervasive inability to guarantee satisfaction to the buyer in such transactions marks them for market failures of the familiar "lemons problem", in which the seller knows the true quality of a product, but the buyer does not. Low-quality products ("lemons") may drive out high-quality products.

- **Enterprises in developing economies may also lack general management and coordinating skills, a problem related to, but distant from, the lack of specific skills and information.** That managerial capability limits firm size in developing countries is consistent with a pattern that is well documented in industrial countries. The compensation of chief executive officers increases sharply and regularly with the sizes of the firms they manage, with an elasticity in the neighborhood of 0.3. An obvious explanation of this and related evidence is that the value of talent at the top increases with the volume and complexity of the activities to be coordinated, so that the managerial labor market allocates the best managers to the biggest tasks. Other factors might also explain the relation, including weaker governance by shareholders in the largest firms, but the efficient allocation of talent is surely the main force at work. A national economy less well endowed with managerial talent would likely adjust by reducing the average size of firms and making the widest possible use of the top managerial talent available, which is arguably done by the business groups commonly found in developing countries. In sum, the circumstantial evidence that managerial capability is an important constraint on the productivity and size of local business units in developing countries is compelling.

**Spillovers and Local Firm Shortfalls**

The four sources of local firms' shortfalls have different potentials for remedy through spillovers. A business organization based on community relations is probably least prone to spillovers. Such an organization is based on community and collective behavior patterns that punish deviations by individuals. No private benefit rewards those who shift to new ways, even if a collective shift would substantially increase the firm's value. Firms that operate within the traditional system instead lose market share where such tradition is a less productive institution. Such cultural patterns are not immune to change, of course. They may gradually give way, as individuals exposed to market-based systems (through education and travel, for example) swell to a critical mass that is willing to try different ways. That process is a sort of spillover, but not one that proceeds product market by product market.

Whether spillovers alleviate skills shortages depends on the subsidiaries' effect on the net supply of skills to local firms. As demanders of skilled labor, foreign subsidiaries tend to drive up its price to local firms. They likely induce positive shifts in
supply by providing training themselves, however, or by triggering the establishment of independent training institutions. The degree to which foreign subsidiaries are able to retain workers they have trained becomes an important factor affecting this spillover. The unfeasibility of binding long-term employment contracts works to the disadvantage of subsidiaries and reduces their incentive to provide training; it also increases the expected spillover benefit to local firms. The widespread finding that foreign subsidiaries in developing countries (though not elsewhere) pay higher wages than local firms for labor of a given quality may partly reflect an effort to realize the benefit of investments in training.

Knowledge shortages can be alleviated by the classic public-good property of information and its appropriation. The most helpful spillage from competing foreign subsidiaries may well be local firms’ chance to observe what is feasible. That a better-quality product can be made and sold at the observed price and that locally produced goods can be profitably exported to particular foreign markets, that a foreign-designed product serves well under local conditions (even before adaptive tinkering), are important facts for the local firm contemplating obtaining costly information and otherwise unable to confirm its likely value.

The responsiveness of managerial shortages to spillovers may depend on the situations of local firms and competing foreign subsidiaries. Managerial talent can be obtained or developed from various external sources, such as MBA programs. What a competing foreign subsidiary can supply incrementally is an exemplar of managerial talent at work in the specific context (industry, location) of the local firm’s operations. For this spillover to prove substantial, the two firms must be roughly similar in size. If they are not, the managerial tasks of the firms will differ too widely, and the subsidiary’s experience will be either irrelevant or impossible for the local firm to apply.

In thinking about the potential for spillovers of general management skills, it is important to keep in mind that multinational enterprises tend to operate mainly in industries in which the managerial task is most complex; that is, in the coordination of disparate skills in the pursuit of uncertain outcomes. Because of the complexity of the managerial task, spillovers in developing countries are not likely to occur until the development process is fairly far along. Spillovers of general management capability may be low for countries far from the global frontier of the industrial efficiency, high for countries that have reached a moderate level of development, and low for advanced countries in which local firms’ productivity is close to that of foreign subsidiaries. This is consistent with the fact that multinationals in developing countries flourish in industries that place fewer demands on managerial capability but also flourish in industries with requirements more differentiated between developed-country and LDC environments (Wells 1983).

Policy Implications

Interest in spillovers is motivated by two central concerns. First, although productivity spillovers from foreign subsidiaries to local firms are apparently widespread, they are neither ubiquitous nor independent of the market structure in which the firms operate. Second, and more important, the study of economic development has paid little attention to the seemingly vital question of what factors affect local firms’ ability to increase productivity by improving their managerial and organizational capabilities. Further research on both issues is needed to develop effective policies to promote development.

Spillovers may provide a justification for governments in developing countries to encourage inflows of foreign direct investment. The justification is likely to be conditional on the country’s state of development and the structures of industries in which foreign subsidiaries might compete. Favorable treatment might thus be prudent for some countries or industries but not others. Requiring multinationals to provide training or purchase inputs locally could increase the welfare of the host country. The effectiveness of such policies depends, however, on evidence that is not yet in hand (the evidence that does exist suggests that such programs have had very limited success [Conklin and Kecraw 1997]). The finding is thus no open invitation to bureaucratic whim (Caves and Uekusa 1976, Wells 1983, and Conklin and Kecraw 1997).

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President Putin Tames the Oligarchs

From the Moscow Times.
Do Corporate Global Environmental Standards in Emerging Markets Create or Destroy Market Value?

by Glen Dowell, Stuart Hart, and Bernard Yeung


Global companies have become major players on the world stage. More than 40,000 multinational enterprises, with some 250,000 foreign affiliates, invest more than $200 billion abroad each year. About 40 percent of world trade consists of intra-firm transfers of materials and components within multinational enterprises. The 10 largest multinational enterprises have annual sales that exceed the gross national products of the 100 smallest countries in the world. Foreign direct investment (FDI) now exceeds official development assistance by a factor of five—up from just 50 percent of development assistance five years ago. Multinational enterprises create, leverage, and engage in arbitrage of capabilities on a world scale. They make positive contributions to economic efficiency and serve as a conduit for the globalization of economies. But they have also proven able to elude public policy controls because of their economic power and ability to shift resources and production across borders. Questions have been raised about their social and environmental performance. Social critics have argued that in seeking to reduce costs, these enterprises play employees and countries against one another, creating downward pressure on wages and social standards throughout the world.

Our focus is on the environmental impact of multinational enterprises. Environmentalists contend that multinationals create pollution havens by moving dirty operations to countries in which regulatory standards are less stringent. Through flight to pollution havens, these companies avoid expensive pollution controls, cut costs by recapitalizing old equipment, and continue to produce products that are no longer considered environmentally acceptable in the more highly regulated markets of the industrial world. Over time, it is claimed, these practices lead to a "race to the bottom," as nations and localities vie for plants and facilities that seek only to minimize costs and externalize environmental responsibility.

While some multinational enterprises clearly engage in such practices, it is unclear whether there is systematic advantage in racing to the bottom. There appear to be forces that encourage multinationals to integrate and standardize their environmental practices globally. Indeed, it may make business sense in some cases to adopt global standards that exceed those required by some local laws or regulations, especially when environmental laws and regulations become more stringent as an economy grows.

By investing in state-of-the-art technology and processes in developing countries, multinational facilities may be able to simultaneously achieve world-class cost, quality, and environmental performance. In addition, multinationals may reap standardization benefits and other intangible advantages, such as positive reputation effects.

In this article, we seek an empirical answer to an intriguing and important question: Is firm value linked to a multinational's environmental standard? We analyze the corporate environmental standards and market performance of a large sample of U.S.-based multinational enterprises. Specifically, we examine whether adopting a single, stringent, corporate environmental standard enhances firm value relative to that of multinational enterprises that adopt less stringent, or poorly enforced, host country standards.

We find that firms adopting a stringent global environmental standard have higher market values, as measured by Tobin's q (market value over replacement costs of tangible assets). We thus refute the idea that adoption of global environmental standards by multinational enterprises constitutes a liability that depresses market value. On the contrary, our results suggest that poorer-performing multinational enterprises tend to adopt lower environmental standards. Thus developing countries that use lax environmental regulations to attract foreign direct investment end up attracting poorer-quality—and perhaps less competitive—firms.

The notion that multinational enterprises as a group pursue the lowest environmental standards and create a "race to the bottom" among developing countries desperate for foreign investments is not substantiated by the data. The most common corporate environmental practice in our sample is the opposite: multinationals adopt a stringent internal standard globally. We do not, however, suggest that the race to the bottom does not exist. In fact, our findings suggest that companies with lower market values tend to pursue lower environmental standards. Perhaps these companies opt to default to host country standards because they lack the means to make the investment in environmentally superior technology worldwide. They may also be less well-run companies, focusing on short-term cost savings. This strategy might include, but is certainly not limited to, recapitalizing old production assets, extending obsolete product life cycles, and exploiting low labor costs.

From a public policy standpoint, then, there are clear implications regarding these results. Developing countries may indeed attract foreign investment by lowering environmental standards, but the type of com-
companies they attract by doing so will be weaker firms not investing in state-of-the-art plant and equipment. After a temporary presence marked by the exploitation of the lower or poorly enforced host country standards, these companies may well end up as fodder for those globally competitive firms that have adopted worldwide environmental standards and are reaping the competitive and market benefits of that policy. Thus developing countries may be best served by promoting aggressive environmental objectives combined with a willingness to work collaboratively with the world’s leading multinational enterprises to define and implement policies that facilitate “win-win” environmental solutions.

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The Role of Human Capital in Foreign Direct Investment
by Juan Alcacer

In a survey published by the United Nations in the World Investment Report 1998, managers of multinational enterprises were asked to list the factors that, in their view, had greatly enhanced or represented the biggest obstacles to realizing their foreign direct investment (FDI) potential in Central and Eastern Europe. Among economic, policy, and business facilitation factors presented, labor costs and labor skills were the most often cited.

The relation between quality and cost of labor has been the subject of debates in public forums, government, and academia for many years. One popular belief holds that low wages in developing countries attract FDI. This perception creates anxiety about the potential threat to domestic employment and wages. However, a detailed study of FDI trends reveals that most FDI occurs between industrial countries with similarly high wages. In fact, countries with low wages systematically show the lowest levels of FDI.

Policymakers tend to focus their attention on labor skills. A well-educated work force is perceived as an important incentive for international investment location decisions. Eager to attract FDI, governments engage in location tournaments to promote investment through policy adjustments, incentive programs, and promotional campaigns that highlight national features such as physical infrastructure, proximity to world market centers, and recently, work force quality.

This article attempts to determine whether the wage rate or work force quality (measured as human capital) of a given country is more important for explaining investment decisions by multinational enterprises. It shows that wages have a negative and significant impact on FDI only for countries with high levels of human capital.

These results shed some light on the tradeoff between wages and productivity for attracting FDI. They allow us to predict the impact of wages and human capital on FDI based on the level of schooling in a given country. For countries with poor endowments of human capital, low wages would not be enough to compensate for lack of productivity in their labor force. Countries with large human capital endowments compete among themselves for attracting FDI based on wages. One of the big puzzles in the transition literature is the low level of FDI experienced by transition economies, especially in Eastern Europe. Three possible causes are often mentioned: lack of trained personal, political and economic instability, and underdeveloped infrastructure.

Lack of trained personal should be associated with low levels of human capital. But the mean human capital level in Eastern Europe in 1990 was higher than in the rest of the world. If that is the case, why do Western managers still complain about lack of skilled workers in these countries? Anecdotal evidence suggests that even highly educated workers lack the training that is useful for free market economic activities.

Our results—based on analysis of responses to the annual surveys of managers and policymakers performed for the World Competitiveness Yearbook—indicate that the main problem with workers’ skills in transition economies is at the managerial level. The lack of senior managers could be the reason for the perceived lack of trained personnel.

Analysis of additional survey results shows that both infrastructure and political risk could be deterring FDI in transition economies. Economies in transition are perceived as riskier than those in the rest of the world, and their infrastructure is perceived as less developed. The results on labor force skills are less clear. Human capital levels in Eastern Europe are higher than in the rest of the world, and no significant differences are perceived in skilled labor or economic literacy. However, managerial skills are perceived as lower.

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From the magazine *Hungarian Economy.*
Linking Local Suppliers to Multinationals: How Can Governments Play a Useful Role?

by Xiaofang Shen

Countries that have attracted significant foreign direct investment (FDI) inflows in recent decades are more eager than ever to see that this investment is linked to domestic companies supplying parts, components, and services. Success will mean more employment and profits for the companies, more and higher-quality FDI for the host countries, faster technological progress, a stronger balance of payments, and in general a more successful entry into and participation in the world economy.

In recent years multinational companies have been moving away from internalizing much of their production or procuring mainly from a large number of arm’s-length supplier companies, which are left to sink or swim as the buyer shifts supply sources. Instead, these companies are concentrating their own activities on their core skills and subcontracting out for parts, components, and services to an ever smaller number of carefully chosen key suppliers with whom they develop strategic collaborative arrangements. In a developing or transitional economy, multinational companies may bring in the first-tier multinational suppliers, who in turn look for second- and even third-tier suppliers in the host country.

Opportunities and Challenges

While this evolving trend provides enormous potential benefits to aspiring supplier companies in host countries, it also represents a big challenge to them. Multinational companies work with their suppliers and help them in many ways, but they are tough customers. They demand top-quality service, which means close to zero tolerance of product defects, just-in-time delivery, quick responsiveness to market demand changes, and competitive prices.

In today’s globalized economy, strengthening suppliers is the only way to improve buyer-supplier relations between multinationals and local suppliers. Exhortations and informal pressures will accomplish little. Formal requirements on foreign investors violate international treaties and would be counterproductive in any case: multinationals themselves work in a highly competitive environment and cannot afford less than first-class suppliers.

Creating successful suppliers first requires the strong commitment of potential supplier companies, who must understand the needs and requirements of multinational clients, recognize the improvements that are required of them, and make the necessary efforts to achieve the improvements. Their success will also need the support of a wide range of services providers, particularly those providing technological services (testing centers, research and development centers, standardization institutions, and so forth); managerial and labor training services; and financing. Although these services are often provided by the public sector in developing countries, they are increasingly being provided by the private sector around the world.

Lessons from Experience

The market does not work perfectly in all these interactions, especially in developing and transitional economies, and there are important roles for well-designed government policies and programs. Such policies and programs must be designed to achieve two objectives. First, they must ensure that competition thrives, so that both buyers and suppliers strive for business performance that meets the highest international standards. Second, they must help all key actors in the drama—multinational buyers, domestic suppliers, and the various providers of technological, educational and training, and financial services—play their roles more effectively.

Many governments have adopted special policies and programs to promote buyer-supplier relations between multinational and domestic companies, often with mixed results. A few governments have enjoyed success with such policies, however. Successful programs include the National Linkage Program, run by the Industrial Development Authority of Ireland from 1983 to the late 1990s; the Local Industry Upgrading Program, run by the Economic Development Board of Singapore since 1986; and the Center Satellite System Development Program, run by the Industrial Development Bureau of Taiwan, China since 1984.

Despite the different country contexts, which affected the structural and operational style of these linkage programs, all three programs shared similar basic approaches and some key features. Lessons drawn from these programs’ experiences may benefit other countries. All three programs:

- Were market and demand driven and aimed at upgrading domestic suppliers to meet multinationals’ high standards of quality and delivery requirements. They did so by targeting the most aspiring suppliers as their clients and, through self-selection and other mechanisms, selecting the winners on the basis of their proven abilities and commitment to future improvements.
Worked closely with multinationals or large domestic buyers in running their activities, tapping those companies' interests and resources to help domestic suppliers. They provided a channel through which buyers and local suppliers could better communicate with each other. Buyers were invited to help potential suppliers understand their supply needs and requirements, help them identify areas in which they have good opportunities, and draw their attention to weaknesses they must overcome in order to succeed. This assistance helped enhance the mutual understanding and trust between multinational buyers and local suppliers, and it prepared the ground for further business contact between the two parties based on their specific business interests.

Acted as active intermediaries between supplier companies and industrial service providers. The programs themselves rarely provided credit, training, or technology assistance. Instead, they identified available services and helped supplier companies access the services they needed. These linkage programs fed back information to the various service providers on the priority needs of supplier companies, so that the providers could tailor and improve their services more effectively. The programs thus helped supplier companies succeed in what is basically a costly, risky, and difficult business by tapping the broad resource base available.

Provided some monetary incentives, but they were applied through performance-based and cost-sharing mechanisms. In Singapore the program shared salary costs of experienced engineers and managers of multinational companies, who agreed to devote time to the supplier upgrading activities under the program. In Ireland the program provided cash grants to promising suppliers to help cover the initial costs and risks of capital investments. In Taiwan, China the program subsidized training, technology consultation, and other needs essential to supplier capability enhancement.

Were staffed with a few but highly professional and motivated people who worked for clients and drove for results. Government commitment—demonstrated in the consistent provision of sufficient, though modest, budget support to these programs—was essential to their success. Neither large staffs nor large budgets were necessary to achieve results: in Ireland and Singapore the programs operated initially with no more than a dozen staff.

Suggest that government intervention needs to evolve in response to the changing market needs. Ireland, Singapore and Taiwan, China all started the linkage promotion programs at a time when the level of foreign direct investment suggested significant local procurement potential, but the actual level of local procurement was low. The low level of procurement reflected the large business and cultural gaps between foreign and local companies and the lack of adequate industrial services needed by supplier companies. Over time, as domestic companies improve their capability, as more service providers become available on a commercial basis, and as the gaps between foreign and local companies narrow, government programs can shift focus or be cut back. In Ireland, for example, the National Linkage Program was terminated recently. After 15 years of fostering domestic supplier industries and service providers, local companies were finally up and running on their own.

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From the World Press Review.
Global Development Network Helps Transform Economics in Transition Economies

by Noemi Lea Giszpenc and Lyn Squire

Launched in December 1999, the Global Development Network (GDN) is an emerging association of research and policy institutes worldwide that generate local knowledge and transform that knowledge into country-specific policy. The goal of the network is twofold. First, it seeks to enhance the capacity of researchers to analyze development issues in their own countries. In Eastern Europe and the former Soviet Union, it also helps researchers analyze transition-related issues. Second, it bridges the gap between research and policymaking, allowing policymakers to tap local knowledge and expertise in formulating policy. (For more information about GDN, visit its Web site at www.Gdnet.org.)

In Eastern Europe and the former Soviet Union, a better understanding of market realities appears to be the key to improving policy at all levels of government. Yet the universal difficulties of bridging the gap between knowledge and policy are compounded by the need to manage a transition within the economics profession itself. A generation of economists has developed skills and techniques for an economic system—central planning—that no longer exists. To equip economists in the region to function in a market economy, economics curricula and textbooks have to be rewritten, faculty have to be retrained or replaced, new research and policy institutions have to be established, and so on. It may take a while before efforts to update the economics profession produce tangible results.

Links with Institutions in Eastern Europe

After 70 years of almost complete isolation and more than 10 years of muddling through transition, researchers in the Russian Federation work in very trying circumstances. They still lack exposure to modern economics, including direct access to modern research literature. University professors in Russia are expected only to teach, so they lack experience conducting research. The situation is scarcely better at research and policy institutes. Only a few institutions have emerged in recent years that are able to take a truly nonpartisan and methodologically sound approach to economic policy analysis. Because of their nonpartisan nature and the unstable political environment, these institutions have consistently failed to effectively inform and influence policymaking at the federal level.

GDN has partnered with institutions in the former Soviet Union and Eastern Europe to help address the issues of relevant research and policy effectiveness. One institution is the Economic Education and Research Consortium (EERC), initiated by the World Bank and the Eurasia Foundation early in 1996. EERC’s mission is to promote the reform of economics education and develop economics research capacity in the CIS. The coordinating institute for the Eastern European Network is the joint Center for Economic Research and Graduate Education of Charles University and the Economics Institute of the Academy of Sciences of the Czech Republic (CERGE-EI), located in Prague. CERGE was founded in 1991 as an American-style Ph.D. program. The Economics Institute was established in 1992 as a research institution. Both institutions share the goal of furthering modern economics in the former communist countries of Central and Eastern Europe.

Global Research Project on Economic Growth

In addition to supporting the activities of these institutions, GDN enlists the participation of regional economists in global projects. Institutions in the transition economies are participating in a GDN-sponsored global research project to determine the sources and consequences of economic growth. This research project, unprecedented in size and scope, is a promising way of strengthening the links among researchers and policy implementers in developing and transition economies. Nearly 50 researchers in seven regional research networks are taking part in the first phase of the project. The purpose of this project is to explain the growth experience of the seven regions participating in the Global Development Network (East Asia, South Asia, Latin America and the Caribbean, Eastern Europe, the former Soviet Union, the Middle East and North Africa, and Sub-Saharan Africa). The goal is to take a long historical perspective—30–50 years, depending on the data—but with an emphasis on more recent events and prospects for the future. If successful, this project will result in the most comprehensive account of growth in the developing world to date.

The first papers—on the sources of aggregate growth, markets and growth, microeconomics of growth, and political economy of growth in transition economies—have been completed. (Papers from Eastern Europe and the former Soviet Union are available at www.gdnet.org/grproject.htm.) They were reviewed at a workshop organized by the International Economics Association and hosted by CERGE-EI in June 2000.
Many of these papers explore the role and importance, especially in a transition context, of such institutions as the rule of law and real property rights. The paper on aggregate growth highlights factors that are having significant effects on growth in transition economies but have received less attention in the general literature, namely, the role of institutions and government expenditures. The markets paper focuses on policies that promote the accumulation of physical and human capital and on the development of social and natural capital. Its authors do not agree with the view that even if the use of current inputs is increasingly efficient, it has no relevance to long-term growth prospects, finding such a view an oversimplification, especially in the transition context.

The paper on the microeconomic determinants of growth explains the striking contrasts in performance in restructuring enterprises between Central and Eastern Europe and the newly independent states. The paper on the political economy of reform highlights differences between the transition experience and the conventional wisdom that applies to developing economies. It finds that greater democratization spurred transition and growth, unless economic transition caused the collapse of institutions, thereby weakening the democratic process (a link between institutions and political competition not previously analyzed in the literature).

Support of Regional Development Networks

GDN is also helping each region build up its research capacity and networks. Through GDN, the World Bank is providing seed money to help foster empirical, policy-relevant development research by individuals and institutes in each region.

To date the Bank has provided $10 million in funding. The funds are provided through the Bank’s Development Grants Facility, which is financed by the interest borrower countries pay on World Bank loans. These funds are meant to help create and strengthen regional development networks. In all of the regional networks, the Bank supports open, competitive allocation of research funds; peer review by professionals from within the region and from outside; and the dissemination of research results to all interested parties. It is expected that development research networks that meet these high standards will attract additional funds from other donors.

GDN Awards

GDN is also using another channel to encourage high-quality research. Sponsored by the Government of Japan and the World Bank, the GDN Awards seek to recognize and reward excellence in development research. Researchers compete for more than $500,000 in prize and travel money. Awards will be based on the content, innovativeness, quality, and potential policy impact of the research proposal. The winners of the awards will be selected and announced at GDN’s Second Annual Global Development Conference, to be held in Tokyo in December 2000. Joseph Stiglitz will chair the selection committee, on which Nobel laureate Amartya Sen will serve. It is hoped that the competition will both raise research standards throughout the developing world and attract attention to high-quality, policy-relevant research. It will also provide researchers throughout the transition economies an opportunity to test their skills and gauge their progress against the best that the rest of the world has to offer.

The emphasis on competition and peer review in all of the GDN’s programs is essential to ensure high-quality research. But it runs the risk of striving for short-term results at the expense of long-term quality. To counteract this fear, authors whose proposals show promise are encouraged to revise and resubmit their projects. Encouragement takes the form of detailed substantive feedback on projects, coupled in many cases with a proposal development grant—a modest stipend and an allowance with which to purchase economics literature, Internet access, and so forth. This kind of support is aimed at younger researchers based in the regions.

Seminars and Research Advice

Since 1998 GDN has been sponsoring a regular series of targeted methodological seminars. These seminars, designed to address particular shortfalls in formal training (such as econometrics), facilitate an incremental adjustment in the competition’s thematic coverage (for example, in the direction of applied labor economics and the economics of federalism).

To improve local capacity, the GDN also provides guidance and advice from top-flight researchers. Researchers working on the global research project, for example, have benefited from input from such notables as Robert Solow (MIT), Angus Deaton (Princeton University), and Dani Rodrik (Harvard University), among others.

Moving Forward

The model being implemented by GDN throughout the developing world—and in particular, by EERC in Russia and CERGE-EI in Eastern Europe—appears to be adequately designed to cope with the “underdevelopment trap” in which the economics profession finds itself in many developing and transitional settings. Emulating and strengthening the initiative are the top items on the immediate agenda. GDN is supporting EERC’s effort to replicate its successful experience elsewhere in the CIS through the Transition Economics Research Network. The aim of the network is to establish a small “common economics space” within the CIS, opening the way for joint research projects, training activities, publications, policy seminars, and much more.

Efforts to strengthen the GDN are proceeding on several fronts. Key among these is an attempt to develop a permanent donor community that will meet regularly to discuss support for research and policy analysis. Twenty-five donors at-
tended the launch of GDN in Bonn in December 1999, and many showed up at an interim meeting held in Brussels in June 2000. Representatives of donor countries and other organizations pledged fresh support for the GDN at an interim donors meeting held in Brussels on June 7. New commitments confirmed at the meeting included $2 million a year over five years from the U.S. National Institutes of Health (NIH) for research on health policy issues and $300,000 from the Swiss government for capacity-building training. A permanent group of donors is emerging that is interested in supporting GDN activities. Through them, GDN will be able to mobilize more resources for capacity building and networking.

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Homepage of the Global Development Network

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We want your input into the Draft GDN Constitution. Deadline: July 31, 2000

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The Global Development Network (GDN) aims to enhance the quality and availability of policy-oriented research and strengthen the institutions which undertake this work. The GDN offers tools, services and networking opportunities to help these institutions and their members join together to fight poverty.

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Without a Map: Political Tactics and Economic Reform in Russia

by Andrei Shleifer and Daniel Treisman
Reviewed by Daniel Treisman

Recent commentators on economic reforms in the Russian Federation have almost without exception declared them a disappointing—and avoidable—failure. Different observers place the blame on different factors: "naive" reform plans, corrupt politicians, misguided advice or pressures from international organizations, even alleged defects of the Russian population itself.

In this book, Andrei Shleifer and I take the goal of our book is to explain why some attempted reforms were implemented (at certain moments) while others were blocked or diverted. We argue that the answer lies in the realm of politics. The successful reforms were combined with political strategies that managed to coopt or isolate potential opponents. We call the crafting of political strategies the "how" of reform and contrast it to the question of the "when" of reform—predicting when particular reforms will occur.

Resistance from Stakeholders

Efficiency-enhancing reforms almost always threaten the interests of certain social actors with the power to block reform. The stakeholders in the Russian Federation varied from issue to issue but generally included the parliamentarians in the Duma, major bankers, raw materials barons, and regional governors. These four sets of stakeholders defined the central reformers' room to maneuver. In each sphere of economic reform, stakeholder groups formed coalitions to protect their interests and impede central attempts at change. They could be overcome only by skillfully designed strategies that mobilized supporters of reforms while dividing the opposition to them.

On some occasions in the 1990s, Russia's reformers quickly found the mixture of tactics that could overcome stakeholder resistance. On others, they stumbled into a tactically astute position almost by accident, after a number of false starts. In one important case—the reform of state finances—they never found a way forward. This failure had severe consequences that weakened, at least temporarily, some of the other successes of reform.

To overcome opposition to privatization, central reformers agreed to give a controlling tranche of shares to insiders—managers and workers. Though the government lacked the power to fundamentally redraw the structure of informal control that had developed in industry, it could turn the claims of "squatters" into tradable securities, laying the groundwork for a voluntary reassignment of control rights through trade. And it could side with the most powerful stakeholders to appropriate others—the industrial ministries—thus reducing the number of veto points over efficient use of assets.

Mass privatization succeeded in rapidly converting state property into private property and distributing shares to a large part of the population. Serious problems of corporate governance remained, however. The clearest failure of economic reform in the 1990s was the inability of central policymakers to define, enact, and implement tax reforms that would remove incentives for bureaucratic predation on businesses, especially small firms.
subsidiaries—manufacturing, agriculture, public services—were appeased with large energy subsidies. Through these policies, the government prevented a coalition of commercial banks, inefficient industry, and agriculture from uniting in 1995, as it had in 1992, to defeat monetary austerity.

In the case of federal taxation, the reformers did not find a strategy to dislodge the anti-reform coalition. As a result, tax revenues continued to fall, while evasion and unofficial economic activity spread. In large part because of the distortions of the existing tax and regulatory systems, economic growth was slow to resume. When the international financial crisis of 1998 reached the Russian Federation, the weakness of public finance precipitated investor panic and the crash of the ruble. The Russian government responded in counterproductive ways.

Each successful strategy for breaking the anti-reform front of stakeholders had significant real costs as well as substantial benefits. The government’s mass privatization program created widespread private ownership, accelerated the restructuring of state firms, and surely reduced the corruption that would have accompanied continued state ownership. But the acceptance of “Option 2”—the privatization method in which workers and managers received 51 percent of voting shares in their enterprise—legalized a pre-existing structure of control that was less open to outside investors than the reformers would have liked. The decision to coopt major banks through the protected GKO (Treasury Bill) market and the loans-for-shares auctions was a critical aspect of the successful stabilization plan. But it accelerated the concentration of economic power in the hands of a small group of oligarchs who headed different financial-industrial groups. This concentration was an obstacle to further institutional reforms, such as reform of corporate governance, and helped defeat all tax reform efforts.

How Valid Are Criticisms?

Most criticisms of reform in the Russia Federation adopt one of two standpoints. Some compare the outcomes to a wish list of items that would be desirable. On this criterion, reform in Russia is disappointing. But this standpoint is absurd: not everything desirable is feasible. Other criticisms implicitly or explicitly compare reform in Russia with that in countries such as Poland or the Czech Republic (though not usually to, say, Kazakhstan or Ukraine).

We argue that the obstacles to reform in the Russian Federation were incomparably greater than in Poland or the Czech Republic, for two main reasons. First, neither Poland nor the Czech Republic had the problems of national integration or the federal structure that the Russian Federation has. Federalism creates pressures for central redistribution that a politically weak central regime ignores at its peril. Indeed, Prague’s failure to respond to the economic distress of Slovakia’s heavy industry helps explain why Czechoslovakia no longer exists. Building coalitions to overcome anti-reform stakeholders is often harder in politically decentralized countries. In the Russian Federation, regional governments were among the most powerful stakeholders, opposing reform of the tax system and macroeconomic stabilization programs that might have required large transfers across regions or cuts in federal subsidies and would have caused geographically concentrated increases in unemployment. A more secure federal structure was never successfully created by Yeltsin or his governments.

Second, the competitive parts of Russia’s economy were more concentrated, both sectorally and geographically, than they were in any of the Eastern European countries. A few raw materials industries, located in a handful of regions, accounted for a large share of profits, exports, and tax payments. The concentrated economic power of the leading oil and gas barons was virtually pre-ordained, especially after the decentralization measures of early perestroika. So were the close—though sometimes troubled—relations of these industries with their regional governments. Since the survival of any government depended in part on preserving energy supplies to the country’s regions, this stakeholder group had enormous political power that could not simply be commanded by presidential decrees. There was no realistic alternative to bargaining with the raw materials barons, attempting to divide them, and persuading them to exchange highly inefficient rents for less inefficient ones. No cohesive industrial group in the Czech Republic or Poland had such concentrated economic and political power to obstruct or divert reform.

The Mountaineer’s Dilemma

President Putin faces the same set of challenges faced by earlier reformers. The power of different stakeholder groups may change over time. But implementing any drastic policy or institutional change will require an effective strategy to coopt some of the energy barons, banks, and regional leaders while isolating and expropriating others.

In our book we compare the task of an economic reformer to that of a mountain-ee crossing a steep, uncharted mountain range. There is no map to guide the mountaineer through the terrain. Even if a path exists, the mountaineer may not find it. The mountain range is different in different countries, so maps used by reformers in one setting will be of little help in another. More important are the skills of the mountaineer, his or her techniques for rappelling over boulders or circumnavigating new obstacles as they emerge. These techniques can be studied. It is our hope that the techniques for successful reform strategies that we discuss in the book may help inform those who attempt restructuring economies in other parts of the world.

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The Russian Lesson: A Market Economy Needs an Effective State
by László Bruszt

After nearly a decade of struggling to liberate economic activity from the state, the Russian Federation and most of the former Soviet Republics now face the question of how to liberate the state itself.

What is the role of the state in creating market order and competition? In the early 1990s the dominant answer was that the state should reduce its role within the economy and economic activity should be freed from state intervention. Once the necessary level of economic freedom had been attained, once economic activity had become a private business (through liberalization of prices and trade and privatization of property), market order and competition would emerge. Reform progress was measured by the level of economic freedom attained. This idea played a major role in the choice of policies introduced in the region.

After nearly a decade of experimenting with economic reforms, many countries in the region have been unable to introduce market order and competition. Economic actors don’t trust contracting partners, investors don’t trust other shareholders. Powerful economic groups regulate access to markets, siphoning away resources from weaker segments of the economy.

In the second half of the 1990s it became obvious that the state should be strong enough to maintain the rule of law, enforce contracts and uphold universal rights and regulate relations among economic actors. The state should create a level playing field, making sure that none of the economic actors—or the state, for that matter—misuses the uneven distribution of economic and informational capital.

The Grab for the State

At the time of the first wave of radical reforms, in 1992, reformers in Russia were aware of the weakness of the state bureaucracy and its low capacity to maintain the rule of law and regulate economic activity. They believed, however, that rapid economic liberalization would create a strong market order and with it the economic basis for a competent state. Moreover, they believed that profit-oriented actors in the market, pressed by efficiency considerations, would create the missing institutions necessary for corporate governance. They perceived the low level of the accountability of government officials as an asset, believing that it allowed for the imposition of fast and radical reforms.

The calculations of these Russian reformers have proven wrong. Firms that had never been exposed to competition were unprepared for the radical shock caused by the sudden liberalization of prices and trade. A chain of nonpayment dragged down even the better-performing firms. Money surrogates took over the scene: today about 75–85 percent of all transactions are carried out either as barter (mutual nonpayment) or with money substitutes. Investment in the formal sectors of the economy remain extremely low, the shadow economy is overwhelming, and capital flight is continuing.

The state rushed to provide support to selected groups of economic actors. Powerful business leaders, taking advantage of their special relationship to state officials, routinely received (mainly extrabudgetary) help, such as toleration of nonpayment of taxes, social security, utility bills, even wages. This practice of bailing out firms further weakened the states’ capacity to say no to strong economic groups. Assistance also weakened the incentives better-performing enterprises faced to restructure and make sound investments, instead sending them the signal that the state is up for grabs. Enterprises realized that they had to accumulate political capital in order to survive, that they needed to improve their position in the struggle for subsidies and special benefits. The powerful networks of big companies and large banks under the oligarchs’ management and regional leaders grabbed the opportunity to take state resources away from the politically weaker sectors and regions.

As a result, public trust in the state, which was never very high, sank even lower. As a World Bank survey from 1998 revealed, the public in the CIS countries has less confidence in the government’s commitment to preserve market order than the public in Sub-Saharan Africa or Latin America.

The Mighty Networks

Three types of network developed in the Russian Federation. After the removal of the branch ministries, at the start of the radical reforms, entire sectors, firms, and banks and other financial institutions organized into networks of cross-ownership in order to stabilize their economic and political positions. These financial industrial groups were complemented by another, even more powerful type of group, organized mainly by Moscow-based banks with closer ties to the government.

A third type of network was formed by regional and local state agencies. These agencies were stripped of their economic
powers at the beginning of the reforms, but they took on more and more responsibility for coping with the social and economic dislocations caused by the policies of the center. The only option left to them was to regain economic control over the largest firms once under their control by buying those company's shares. Purchasing these shares allowed them to maintain and stabilize local and regional economies by using the old strategies of bargain planning and redistribution. This strategy of local and regional renationalization of property allowed the local elites to save the most profitable assets from buyouts by the increasingly predatory Moscow-based FIGs. The building up of powerful local and regional conglomerates has improved their bargaining power with Moscow.

State weakness has contributed to the growth and growing power of these networks, in several ways. First, these conglomerates took over some of the functions of the state, substituting for the missing institutions of third-party enforcement. Second, the incapacity of the state to say no to powerful economic groups increased the payoff for forming large networks faster than other groups in order to increase their competitive power in the struggle first for rents and later for favorable regulations and policies. Third, diversification of the revenue basis of the state delivered left it at the mercy of the small number of FIGs that could still provide cash. (Editor's note: Recently, President Putin has been trying to “retake” the state apparatus from the oligarchs. See accompanying articles.)

What Are the Lessons to Be Learned?

Russia's experience reveals several important lessons. Liberalization without creating a well-functioning capital market, privatization without strict regulation of competition, and “marketization” without prior strengthening of the state's capacity to enforce contracts proved to be a misguided policy that served only the interests of particular economic groups. Government officials who are not forced by autonomous institutions to take diverse interests into account in their decisions are easy prey to powerful economic groups. The weak credibility undermines the authority of the state and its capacity to coordinate among nonstate actors with diverse interests.

In contrast, a strong state is able to maintain a functioning market order, uphold universal rights, and regulate the highly uneven distribution of economic power. It should have the capacity to:

- Find a balance between the public concerns of the day and long-term developmental considerations, between the interests of the regions and the interests of the national economy, between the need to maintain competition on the domestic markets and the requirements of competitiveness on the world market, between the interests of small-scale producers and the interests of large corporations, between the interests of consumers and the interests of the producers, between liberty and the misuse of liberty.
- Say no to powerful economic interests and intervene in the interests of the public.
- Create wide consensus over developmental goals and allocate rights and obligations to attain those goals.
- Break alliances among powerful economic actors and forge new alliances based on visions of economic transformation.

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A Decade of Transformation: Russia and Hungary Compared
by László Csaba

It would be difficult to find two more different countries than the Russian Federation and Hungary. Size, history, factor endowments, the role of ideology, the role of ethnic and regional strains, all are different. Still, it is interesting to compare the efforts toward and outcomes of reform in these countries. Both countries were once integral parts of the Soviet empire. Both experienced systemic changes once the empire collapsed. The standard panacea of stabilization, liberalization, and privatization, followed by institution building, constituted the backbone of transformation in both countries.

The paths the two countries have followed have diverged markedly in the transition era. GDP in Hungary is equivalent to its pretransition level, and the output is produced within a competitive economic structure; in the Russian Federation output stands at just 54 percent of its pretransition level. Real gross capital formation in Hungary reached 115.4 percent of the 1989 level in 1998; in the Russian Federation it dropped to just 18.5 percent. Inflation in Hungary fell to the single-digit level in 1999; in the Russian Federation prices rose about 80 percent over the previous year. Unemployment in Hungary was 9.1 percent in 1998 and 7.1 percent in 1999; in the Russian Federation 13.3 percent of the population was out of work in 1998 and more than 14 percent were unemployed in 1999. Hungary attracted $20.5 billion in foreign direct investment between 1989 and 1998; the Russian Federation attracted just $10 billion over the same period. Hungary's exports grew from $9.6 to $23 billion between 1989 and 1998; Russian exports rose from $47 to $58 billion over the same period. Machinery and equipment (SITC 7) made up more

than 53 percent of Hungary’s exports in 1999; in Russia such goods represented less than 5 percent of foreign sales. All of these indicators reflect the structural improvements made in Hungary and the structural rigidity of the Russian Federation.

Why Do They Diverge?

How can this divergence in development paths be explained in standard economic terms? While history matters and the type of capitalism emerging in the long run is likely to differ across countries, there is a minimum set of necessary measures and means—the stabilization, liberalization, privatization, or “SLIP” strategy—that cannot be avoided if a country wants to be successful. It remains disputable whether historical and institutional legacies allow or prevent the “right” policy mix from being adopted or whether instead policies are dominant in shaping institutions.

Differences related to the role of the state, the role of special interest politics, and the manner in which policies and programs were implemented became important criteria that determined the diverse development of the two countries economies.

The Role of the State. The fundamental factor effecting other developments in the Russian Federation has been the ongoing erosion of the state, which has been discernible since the second half of the 1990s. In what contemporary analysts called “a confrontation between branches and layers of power,” a dangerous game emerged. The failure of stabilization efforts in 1995–98 was essentially due to the unsustainability of the fiscal stance: no one could seriously believe that a government deficit in the range of 6–8 percent of GDP was sustainable at a time when the central government was collecting only 10–11 percent of GDP in revenues. Two-thirds of tax revenues accruing to local powers and only one-third to the central fiscal planners in Moscow change the distribution of tax revenues. The rule of law could not be established on the ruins of communist lawlessness. (The basic law of the Russian Federation still does not include guarantees for private ownership of land, ensure that contracts are enforceable in the courts, or allow citizens the freedom to start any economic activity without licensing by the authorities.) As it did in the United States in the nineteenth century and Italy and China in the twentieth century, violent entrepreneurship, based on private enforcement, has gained the upper hand in Russia.

The collapse of the totalitarian state has not given way to the free market, as some naive reformers postulated. Instead, just as neoinstitutionalist theories would predict, informal institutions have come to dominate. Meanwhile, expectations that the state would be captured by the new business groups failed to materialize, as the financial oligarchs concerned themselves largely with their own businesses. Their involvement remained restricted to their areas of primary concern, such as limiting foreign penetration and securing various forms of rent.

In Hungary, where the share of public property declined from 75 percent of GDP in 1989 to 15 percent in 1999, traditional vested interests have withered away in all areas, except for the still overregulated farming sector.

In contrast to the Russian Federation, legal arrangements in Hungary ensure the smooth functioning of the state. The Constitutional Court was set up with essentially unlimited jurisdiction. It can overrule any law passed by the parliament if it is not consistent with the principles of the constitution, as interpreted by the Court. The national bank has also emerged as truly independent, earning a reputation as a nonpartisan institution concerned with monetary stability alone.

Under these circumstances the rollback of the state did not mean a disproportionate loss of revenue in Hungary. As a result of the reforms of 1987, the prevention of hyperinflation, and the continued strength of the administration, public dues continued to be collected. Whenever overspending occurred, corrective measures on both the revenue and expenditure sides became feasible (though not always popular). Hungary’s public debt, which peaked at 84 percent of GDP in 1995, fell to below 60 percent in 1999. The fact that business groups did not need the state for their purposes and foreign ownership was strong (foreign interests currently own more than 35 percent of Hungary’s assets) made bargaining with the state less and less relevant.

The Role of Special Interest Politics. Pluralism requires the formation and representation of special interests in an organized fashion. However, it makes a difference if special interests exert influence on policies or dominate the political system outright. The predominance of regional and sectoral interest groups is obvious in the Russian Federation. Local officials affect legislation, determine tax rates and regulate the trade in foreign currencies. Meanwhile, the formation of established political parties that reflect ideologies, lifestyles, and values rather than sheer interest—and which are typical of mature democracies—remains in its infancy.

In Hungary special interest politics used to be a dominant feature of “goulash communism.” One major reason why the Kadar regime could survive decades without resorting to massive violence— and was easily brought to the negotiating table when it came time to eliminate the one-party system—was the strong presence of quasi-formal interest groups. During the system change, the entrepreneurial stratum with the managerial skills and aspirations to become owners aligned with the westward-looking intellectuals who headed the opposition movements. Since then a decline of special interest policies has been noticeable.
The blossoming of small businesses and the emergence of mass unemployment eroded the position of the unions in Hungary. With big business gradually handed over to foreigners, groups representing medium-size businesses and other local entrepreneurial interests found themselves fighting one another for an ever smaller slice of the cake. Operating an open trade regime since 1989 and gradually liberalizing the financial sector, Hungary created very tough competitive conditions across the board. What could probably not have been attained by any antitrust agency was secured by foreign competition. Since Hungary liberalized its trade no major defenses against foreign competition could be sustained. This took care of all the shortcomings of Hungarian regulations.

Implementation of Programs. Economic reform in the Russian Federation has been characterized by a series of radical-sounding projects. From the 500-day program of Shatalin and Yavlinskii in 1990 to the Kiriyenko plans for achieving single-digit rates of inflation and a stable exchange rate in the economy, no Russian government could be accused of lack of ambition. Implementation, however, has been half-hearted or purely formal.

In Hungary, accommodating government language notwithstanding, tough economic measures were implemented in 1989, 1992, 1995, and 1998 (with the launching of the private pension scheme). Speaking softly while acting tough implies, however, very strong resistance by vested interests. It is hardly a coincidence that no reformist government could gain re-election over the past 10 years.

Conversely, the presidential regime in Russia allowed a degree of continuity that was useful for keeping the Russian Federation together as a federal state. It also allowed for political continuity under quite different economic policies, however, that has led to adhoc policymaking favoring expedient short-term actions such as granting a variety of hard-to-justify tax concessions over more thoughtful longer-term measures.

Capital Formation. In Hungary improvements to the regulatory environment—and perhaps even more important, the perception that additional improvements will be made—have been recognized by hundreds of thousands of economic actors inside and outside the country, increasing the level of both foreign and domestic investment.

Positive expectations create bullish business moods, in which investors see cheap asset prices, think big and long term, and invest in research and development and fixed assets. The relocation by both General Electric and Nokia of some of their research facilities to Hungary is just as telling as the spread of new hypermarket chains, which make sense only if purchasing power is likely to grow steadily in the medium to long run.

In the Russian Federation the low investment ratio reflects a vicious development cycle: the credibility-regulation-expectations chain is at work here, too, but it is functioning in the wrong direction. If there is no prospect of economic recovery and stabilization, capital flight remains the only realistic way out. At least for now, the central government has very limited leverage over Russian resources, including financial resources. A government-led recovery—even a mild Keynesian anti-depression cure—would require a qualitative jump in the administrative capabilities and implementing power of the Russian state.

Many of the popular ideas about curing the Russian decay assume that the state is—or should be—able to collect revenues and plan priorities in ways that private markets cannot. The trouble is that market failure in the Russian Federation is a consequence of state failure. Public authorities are expected to harness capital that is fleeing essentially because of the state's arbitrariness and expropriatory practices.

The Role of Path Dependency

The Soviet legacy and traditions left their mark on Russia's development path, the large share of military-related industries and technologies in Russian GDP has rendered any adjustment painful, and lengthy. Lack of meaningful reforms produced the possibility of gaining experience in such basic concepts as the size of information flow that can be centrally managed, the difference between rent-seeking and profit-seeking, and the benefits of free prices, not to mention the market valuation of assets.

The public perception of privatization as theft is only partly explained by the manner in which privatization was handled in Russia. Ties between banks and companies were close in South Korea and Japan, but capitalism there has certainly not earned the bad reputation it has in the Russian Federation. The perception of equity and of what is legitimately to be expected from public authorities does play a fundamental role in the way abstract economic concepts are translated into policy practice.

In Hungary years of exposure to reform helped form the public's perception of what is to be expected from the state, what role risk premiums on property play, what entrepreneurship means. It also increased the attractiveness of nonbureaucratic ca-
Russia’s New Economic Program: Does “Putinomics” Mean a Slimmed but Muscular State?

Earlier this year Russian President Vladimir Putin instructed a team of economists led by German Gref, the Minister of Economic Development and Trade, to draft a plan aimed at reducing poverty and achieving growth rates of up to 10 percent a year.

In a national address in early July, Putin stressed that only a strong centralized state could deliver a booming economy, social justice, and individual freedoms. “We have to recognize that the state itself was largely responsible for the growing strength of the unofficial, shadow economy, the spread of corruption, and the flow of great quantities of money abroad,” Putin noted. “Our economic policy is very clear: less regulation and more business competition. We should not be supporting a select group of businesses but private business on the whole.”

Reimposing the Rule of Law

Putin pledged a new social contract with Russia’s citizens and vowed to overthrow the dictatorship of the shadow economy that has plagued the country for years. Restoring strong central power was key to rebuilding Russia as a great power, said Putin, who defended his plans to grab back power from Russia’s often fractious regions. He accused regional bosses of favoritism and failure to follow fair business practices. “The President of Russia must have the right to establish order and be able to interfere should regional leaders break federal laws,” Putin said, in reference to his efforts to win the right to fire the heads of Russia’s 89 regions.

After years of corruption and crony capitalism, Putin is attempting to regain control of the Russian economy by imposing the rule of law. As of mid-July, the government had launched investigations or filed charges—ranging from fraud to tax evasion—against 13 major business leaders (oligarchs), whose companies include Media-MOST, LUKOil, and Gazprom.

On July 12 investigators from the Russian Federal Tax Police Service announced the launch of a criminal case against auto giant AvtoVAZ. The company had concealed hundreds of millions of dollars from taxation by producing multiple vehicles with the same serial number and then reporting the manufacture of a single automobile. The Media-MOST empire, which owns banking, broadcasting, satellite communications, and banking interests, has been raided repeatedly. Its head, Vladimir Gusinsky, accused of defrauding the government during a privatization deal, was jailed for four days in June. Gazprom, the country’s natural gas giant, and its director, Rem Vyakhirev, are under investigation for granting questionable loans to Media-MOST. Vagit Alekperov, the director of LUKOil, the country’s largest oil concern, has been charged with tax fraud.

Implementing a New Economic Reform Program

The new program, outlined by Gref at the end of June, consists of a list of priority measures to be implemented in the first 18 months. The plan, which has been approved by the government, is based on free market principles and calls for equal opportunities for all economic actors, guaranteed property rights, and the elimination of bureaucratic constraints hindering business activity. Specific features of the new program include the following:

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**Import liberalization.** Import duties will be cut to a minimum. Either a single rate or four separate rates applicable to large groups of commodities will be imposed. The reform will end the high tariff wall protecting domestic producers that, according to Deputy Prime Minister Aleksei Kudrin, "violates the rights of consumers and does not stimulate technological progress." The new openness will accelerate the demise of loss-generating production facilities and improve the investment climate by channeling resources into competitive plants and projects, according to Kudrin.

**Budgetary and tax reform.** Tax revenues are to be centralized, as announced in the Duma when the the 2001 budget proposal was introduced. Dividing tax revenues between the federal government and the provinces on a 50-50 basis will no longer be acceptable. Currently, 12 rich provinces provide 66 percent of all tax revenues collected in the Russian Federation's 89 regions. Previously, those provinces could claim at least a third of all taxes collected nationally. With the centralization of budgetary revenues—including 100 percent of VAT—those 12 regions stand to lose.

**Social reform.** The state will cut back on a wide range of social benefits that it cannot finance from the budget. Having consolidated the employment fund into the budget, the central government will no longer extend credits to enterprises to stimulate job creation. Direct and indirect state subsidies, including those on utility rates paid by companies, will be eliminated, the pension system modernized, housing reform carried out, and a long-term mortgage system developed.

**Deregulation.** The procedure for registering companies will be simplified. A single agency will be responsible for registration, and the list of activities subject to licensing will be cut significantly.

**Breakup of electricity, natural gas, and railway monopolies.** The transport and distribution divisions of Gazprom, the natural gas monopoly, will become financially independent. Electricity producers will be encouraged to join a wholesale electricity market. Nonpaying consumers will be cut off. Foreign companies will be able to compete in the railways, and passenger rail fares will be increased.

**Other items on the agenda.** The government also plans to create markets for land and buildings; improve bankruptcy procedures; increase the efficiency of state regulations; lift administrative curbs on the movement of goods, capital, and labor; introduce international accounting standards; and require companies to provide information about their business activities.

*Based on news agency reports and articles from the Russian dailies Rossiiskaya Gazeta, and Vedomosti.*

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**Joint Statement of Russian-U.S. Economists**

**New Agenda for Economic Reform in Russia**

**Russian and American economists, including several Russian academicians and U.S. Nobel laureates, recently issued a joint statement on a new agenda for economic reform in the Russian Federation. True to our longstanding editorial policy of providing information on views we do not necessarily fully share, we publish the full text of the statement, which appeared in the June 9 edition of the Moscow-based Nezavisimaya Gazeta.**

"Despite predictions of doom, the valuation of the Russian ruble and favorable conditions on the world market have stimulated Russian production. These are temporary phenomena, however, and the immense challenges of recovery, transition, and development remain. We, Russian and American economists, agree with Russia’s new President, Vladimir Putin, that the state must be strengthened in order to play a more active role in the economy. We would also emphasize that not only the quality of Russian life but also the prospects for economic recovery and growth depend on ensuring civil liberties, a free press, and a democratic system of government."

Economic reforms in Russia need a fresh start to create a more favorable environment both for entrepreneurs and employed labor, as well as for consolidating society and unleashing its energy. That is why we wish to propose a five-point economic reform agenda for the consideration of President Putin, the Russian government, the Federation Council, the State Duma, and the Central Bank:

1. **Institutional Infrastructure.**

   The government has a responsibility to eliminate deep distortions in the market mechanism and to establish and maintain the institutional infrastructure of a genuine market economy. It is imperative that the federal government, along with local governments in the 89 regions of Russia, rationalize property rights, reorienting large- and medium-size enterprises from asset stripping to net worth maximization, and introduce modern systems of accounting, finance, insurance, and other needed market functions. It should create conditions for banks that serve the role of channeling savings into investment and oversee private financial institutions in conjunction with the central bank.

   Doing away with the overdue mutual debts of all economic agents (including the gov-
ernment) is also of utmost importance for the proper functioning of the market mechanism.

2. Fight against Crime.

Criminals have filled the institutional vacuum with corrupt officials and Mafia control. As President Putin has emphasized, the rule of law must be solidified in order to increase allegiance to standards of ethical behavior and to provide a stable business climate that would stimulate investment and production. Extortion and bribery should be rigorously prosecuted, irrespective of the position or political views of the officials involved.

Penalties for extortion and bribery should be severe, and government policies should be tailored to mitigate economic causes of corruption, such as extremely low pay for public officials, a tremendous increase in transaction costs, and a Byzantine tax system, which deprives the production sphere of the stimuli for growth. It is urgent to upgrade the ability of the Russian government to fashion and implement economic policy. Measures should be taken to ensure proper standards of recruitment of government officials, as well to insulate government hiring and promotion from politics.


Growth of production and investment should be the primary goal of the government, rather than bringing inflation to near zero levels. Overly zealous monetary and fiscal restrictions are counterproductive. Concerted action should be taken against illegal capital flight. Within economically justified limits, the government should bolster purchasing power through payment of increased pensions and restoration of a portion of the savings that were lost as a result of sustained inflation and the financial collapse of 1998. It should pay more attention to rebuilding social overhead capital.

A substantial program to upgrade roads and other physical infrastructure would boost demand for Russian goods while enhancing the private sector’s competitive potential. Cleaning balance sheets of mutual overdue debts would greatly improve the financial position of the real sector. To increase investment in new facilities and technologies the government must help develop mortgages and create conditions for industrial firms to pursue the policy of accelerated depreciation. Judicious subsidizing of interest payments to help finance private investment would also increase the rate of growth.

4. Restructuring and Competition.

It is important not to interfere unduly with market discipline. Economic policy should encourage the growth of new competing enterprises, including those with local government participation and joint ventures drawing on foreign capital. However, government leadership is needed for Russia to realize its potential in the information economy, biotechnology, and some other high-tech spheres due to its scientists, research institutes, and some productive capacities. This implies careful elaboration and firm implementation of a realistic industrial policy. Until steady growth resumes, selected temporary import tariffs conditional on industrial performance could be introduced.

The government has to regulate the prices of basic commodities supplied under monopolistic conditions and ensure that regulated prices are market clearing. It is important prior to conducting privatization auctions to restructure enterprises and overhaul their finances. Privatizations that have been carried out in violation of the law should be reconsidered.

5. Social Contract.

Only the government can ensure that the benefits of the new economic order are shared. It is vital to improve the moral climate and to fortify respect for democracy and social justice. Among the expected steps in this direction could be implementation of a law on minimum subsistence, providing low-income households with necessary guarantees (including housing rent subsidies), while at the same time imposing substantial real estate taxes on personal residencies with high market-value. Pensions for the elderly are meager and must not be allowed to lag behind inflation. Health care, education, and public services should be allocated more resources. In order to reduce income differentiation and mitigate social tension, a well-enforced system of progressive taxation is needed. High taxes on extractive industries would ensure that the Russian people are the main beneficiaries of the export of natural resources.

The future of Russia depends on it having a realistic and balanced economic program. Responsible action on this five-point agenda would ensure a prosperous and equitable economy for Russia.*

This statement was signed by
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The Lure of the Authoritarian Temptation

by Pekka Sutela

President Putin, we now know, is not only a lawyer but also an educated economist, with a 1996 postgraduate degree from the St. Petersburg Mining University. In addition to its Presidential Economist, the Russian Federation also has a Governmentally Ratified Economic Future, a GREF, that is. This long-awaited economic program has been much applauded: it was written by Russians, not produced by foreigners; it was authored by the best liberal and other experts; it has been planned for 10 years; it emphasizes goals that had been absent from earlier programs; it is pragmatic, sober, and specific; and given the strong support enjoyed by Mr. Putin, it has a real chance of being implemented. Even if the program is imperfect, the inefficiencies of the economy are so huge that modest change in the right direction has enormous potential for improving outcomes in the Russian Federation.

Clearly, the GREF is a major statement. It ranges from cultural policies to monetary matters. The authors of the program even go lyrical and propose that the GREF be understood as a new social contract, the basic understanding between "state and society, state and business," defining their mutual responsibilities for the purpose of realizing human potential. This may be just the usual hubris induced by launching the GREF on Jean-Jacques Rousseau's birthday. Still, this is not the first social contract proposed in the Russian Federation. The latest one was in 1991, when Yeltsin sowed an anti-Gorbachev revolution and reaped deformed capitalism.

Thinking Strategically

Putin and the GREF promise social stability, consensual policies, normal conditions for business, and a law-based administration. The fight against poverty is the main task, Minister German Gref has announced. The Russian "subsidiary state" will help the poor, while the oligarchs will be guided toward economic development, job creation, and stability. The result will be to slash income differentials. Privatization will not be reconsidered if it was done according to legislation existing at the time, according to Prime Minister Mikhail Kasyanov. Cost recovery in housing and utilities will be reached gradually, as purchasing power rebounds. No one will suffer, as a continuously booming economy will facilitate improvements.

This is the message to the population. At long last, the Russian state is thinking strategically, and the future is, well, glorious, at least relative to what it is today. The growth projections of the GREF have been given much prominence in Russia.

Surely, this should give pause for thought. Is this not too good to be true? Have we not seen promises of a bright future before? After all, the near consensus of observers yesterday was that deformed capitalism is inevitable in the Russian Federation, given the heavy price of the past, the weakness of the state, and the underdevelopment of institutions and civil society; that Russia has a peculiar economic system, incapable of sustained high growth in the absence of further radical reform; that long-run trends of deterioration in infrastructure, provision of basic public goods, and economic structure threaten the cohesion of the state and society; that Russia risks becoming a failed state; and that the reform needed to avoid such failure is so radical that it is incompatible with social stability and political consensus.

Sources of Complacency

Now the new Russian complacency challenges such views. Such complacency has many roots: the unprecedented state of the macroeconomy, the youthful president, the current consensus on macroeconomic policies, the new prominence of the liberal economists, the mere tiredness with failure and decline. This is all understandable. But it also has another—and potentially, at least, more dangerous—root: the lure of the authoritarian temptation. Whether because of Russia's Marxist history, because of historical analogies and wishful thinking, or because of examples such as Pinochet and de Gaulle, all too many intelligent Russians tend to think that the weakness of the Russian state is an anomaly that has gone a long way toward causing the 20-year crisis of 1980-2000. Now a strengthening of the state will provide the stability guaranteeing normal capitalism. The bright future is at Russia's fingertips—once again.

This view has a number of problems. Putin's track record so far reveals as much about authoritarianism and arbitrariness as about consensus. He is neither Pinochet nor de Gaulle. The weakness of the state does not easily disappear. All earlier attempts at gradual sustained reform such as that proposed by the GREF have failed in the Russian Federation. The prospect of eternal improvements without the need for suffering has always been a technocratic dream. Reforms are more about privilege, power, and conflict than about social stability. And the main lesson that history has to offer is that authoritarian politics and liberal economics rarely go together. Usually, liberal economics have to give way, often when policies fail and the Leader feels threatened. One would wish to be wrong, as the stakes are high.

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Reversing the Brain Drain in Transition Economies

by Erik Berglöf (SITE and RECEP)

Unless transition economies can build critical mass in economics education and research, true capacity building could take decades. In the Russian Federation remarkable results have been achieved in a very short time.

The brain drain has been a ubiquitous feature of the early phases of transition in Central and Eastern Europe and the former Soviet Union. Many of the best and the brightest have left for educational programs and professional careers in the West. For a long time the hope was that young talent would return once their home countries had turned the corner. Sufficient time has passed to acknowledge that this has not happened. The return flow is, at best, a trickle.

Hundreds of Russian students are studying in Ph.D. programs in economics abroad, but as far as we know, only three Russians who received Ph.D.s from recognized institutions abroad have returned home. The situation is not very different in the Baltic states, and in Southeastern Europe, not to mention the rest of the CIS. Poland has had greater success than Russia, second only to that of RECEP. Other transition economies in repatriating students who studied abroad, but very few, if any, returning students are pursuing academic careers. Only a few institutions in the Czech Republic and Hungary have been able to repatriate substantial numbers of talented young people.

Local Capacity Is Still Lacking

The lack of domestic capacity in social sciences, education, and research generally, and in economics in particular, is very serious in the transition economies. The shortage is particularly noticeable in public policy, but it also exists in business and in academia, where future leaders are trained. Policymakers need the capacity to think independently and critically, analyze the consequences of reform programs, and understand the strengths and limitations of foreign advice and the theories underpinning it. The need to build environments that can generate such understanding is even more critical in the later stages of transition when political institutions have to be fine-tuned, the rule of law established and defended, and complex social reforms designed and implemented. Countries in the region need better universities, better research institutions, and better think tanks that can support the policy process.

Reversing the Brain Drain in the Russian Federation

In this article I want to share some experiences we have encountered trying to reverse the brain drain and build the economics profession in the Russian Federation. The most important lesson I learned from several years of policy advice in Russia is that only Russians can reform Russia. True reform requires local bearers of the reform message—not simply megaphones, but individuals with access to their own research capacity and experience. It is encouraging that for the first time such people are at the core of the Russian reform process.

Efforts to build capacity in economics in the former Eastern Bloc have met with mixed results. On the whole, the return on investment has been low. Vast sums have been wasted on programs attempting to reform existing institutions, with very little to show in terms of results. But there are also some success stories. The World Bank recently nominated six “centers of excellence” in education and research in economics. Three are in Moscow, one is in the Czech Republic, one is in Hungary, and one is in Ukraine.
The three Russian centers are the New Economic School (NES), a masters program in economics; the Russian-European Centre for Economic Policy (RECEP), the only academic think tank among the six centers of excellence singled out by the Bank; and the Economics Education and Research Consortium (EERC), a hands-on research grant program. The three Russian centers are highly complementary; taken together they provide most of the essential elements of a successful program in capacity building.

**Improving Graduate Education in Economics: The New Economic School (NES)**

None of the improvements in capacity building in the Russian Federation would have been possible without the establishment of the groundbreaking New Economic School and its high-quality graduate program (box 1). Russia’s premier graduate program in economics—recognized by President Clinton in his recent address to the Russian Duma—was started in 1994 with startup money from George Soros and a number of large primarily U.S. foundations. It is managed by Gur Ofer, of the Hebrew University, and Barry Ices, of Pennsylvania State University. NES now recruits about 60 students every year and graduates about 40 from its two-year program.

In the first few years of operation, most of the teaching at NES was done by Western academics, but in recent years Russians have taken over most of the teaching load. Every year NES sends about 15 of its top students to Ph.D. programs in the West, many of them to top 10 programs in the United States. NES is probably the only program in the world with such a record.

To combat the perception that NES is removed from policymaking, it engages its students in policy-relevant research projects and runs a large number of outreach programs to remote parts of the Russian Federation. Numerous NES graduates work in the government and the financial sector. One of them, Arcade Dvorkovich, is a major author of Russia’s new long-term economic program.

**Box 2. The Russian European Centre for Economic Policy (RECEP), Moscow**

- RECEP is the leading economics research institute in the Russian Federation today.
- It recruited the first three young Russian graduates of top Western Ph.D. programs to form a group of core Russian academic leaders.
- RECEP’s Russian economists continue training through coursework in Russia and abroad, participation in seminars and conferences, and cooperation with outside projects.
- RECEP has built a unique collection of data sets covering all major areas of the Russian economy.
- Through *Russian Economic Trends*, leading international source of information on the Russian economy, RECEP disseminates research results and information to a wider audience inside Russia and internationally. At monthly press conferences in Moscow, RECEP researchers and Russian policymakers shed light on key policy issues.
- RECEP staff participate in extensive outreach activities, including teaching and research collaboration with NES, EERC, and other Russian and Western institutions. It runs both internal and public seminar series and has hosted several large international conferences.

**Building the Capacity for Research in Economics: The Russian-European Centre for Economic Policy (RECEP)**

NES has been vital to the success of the Russian-European Centre for Economic Policy, an EU-financed program managed by an international consortium led by the Stockholm Institute of Transition Economics (SITE) (box 2). During the past three years, RECEP has been transformed from a set of short-term policy advice projects run by Western economists to an independent think tank based on academic research undertaken primarily by Russians.

Shortly after it’s inauguration in 1995, RECEP attracted the first three Russians with Ph.D.s from abroad. The recruitment of Russians from abroad was a very important signal to young, aspiring students in Russian academia. RECEP has since consistently hired top students from NES. The center now employs some 25 Russian researchers, 4 resident Europeans, 10 staff, and 15 short-term Western experts.

The achievements of RECEP’s Russian researchers have been the major source of the center’s success. In less than three years these young economists have built the best research environment in economics in Russia. They publish more in leading international journals and have been awarded more research grants (from Russia and through international competitions) than economists from any other Russian institution. Last year RECEP’s Academic Director, Ekaterina Zhuravskaya, a Harvard graduate, won the Young Economists Competition, organized in connection with the Fifth Nobel Symposium in economics, dedicated to transition. The first two Excellence Awards awarded by EERC were won by RECEP staff.

In addition to their research activities, RECEP’s young researchers seek deep involvement in Russia’s reform process, participating in the drafting of policy memoranda for highly placed government officials, for example. The staff is young and fairly inexperienced in terms of policymaking, however, and the Russian bureaucracy lacks experience in how to put RECEP’s skills to work. In the difficult political and economic circumstances of the past three years, there has been very little demand for policy advice. This period has given RECEP’s researchers time to build their institution, but the policy impact of
RECEP has been limited until recently. The new government and its attempt to formulate a long-term economic program have opened up new opportunities for the center. Its research is suddenly in high demand, and it plays a role in channeling international research into the program process.

While NES has been vital to RECEP’s success, RECEP also contributes to the sustainability of NES, becoming the single largest employer of NES graduates. Almost all top students that do not leave Russia continue their training at RECEP, conducting policy-related research and offering policy advice. By bringing these young graduates into the policy process and providing them with supervision and high-quality data sets, RECEP also contributes to the legitimacy of NES. Through its policy-related activities, RECEP helps NES in its mission to break in modern economics as an academic discipline and tool for policymaking.

Creating a National Network for Russian Economists: The Economics Education and Research Consortium (EERC)

The symbiosis between NES and RECEP is complemented by the Economics Education and Research Consortium (EERC) (box 3). Funded by a Eurasia Foundation-led consortium, with the Swedish government as the major contributor, EERC is a nationwide network supporting research and the training of researchers. The consortium organizes competitions for research grants twice a year and has built a core of some 60-70 researchers from all over the Russian Federation.

EERC provides an important quality standard that serves as a benchmark for research at RECEP and NES. It involves many Western economists and reaches far beyond Moscow. Still, without NES and RECEP, EERC efforts would be much more difficult.

Box 3. Economics Education Research Consortium (EERC), Moscow

- EERC provides individual grants to researchers and runs research workshops and methodological seminars.
- EERC is building a network of more than 500 economists, extending from Khabarovsk to St. Petersburg. In 2000 it will open the network to other CIS countries, with funding from the Global Development Network.
- With funding from the Swedish Royal Ministry of Foreign Affairs, EERC is creating a governance structure for the selection and placement of the best Western-trained Russian economists in research and higher education in Russia.
- EERC is attracting leading international economists with long-standing interests in transition, who regularly participate in EERC’s research workshops, teach selected topics in applied economics and econometrics, and mentor research projects by young Russian scholars.
- EERC runs a working paper series for dissemination of new Russian research among libraries and institutions of higher learning across the Russian Federation and abroad. It hosts a regular series of policy roundtable meetings and a large annual conference that brings together academics and policymakers.

Several lessons emerge from the Russian experience:

- Building capacity in education and research is very complex and requires long-term commitment, but results can be obtained in a relatively short time, as the three Russian centers demonstrate.
- Investments should go primarily to new institutions. These institutions can be affiliated with existing institutions, although the experience with investments in old institutions has been discouraging.
- Capacity building should be thought of in terms of a system with many interrelated parts: education, research, outside quality control, outreach, and policy links. In making new investments, it is important to identify institutional gaps.
- Critical mass is extremely important. Efforts should initially focus on building a very small number of institutions, each with the necessary size to create a stimulating intellectual environment. The key is to reverse the brain drain by attracting people back from abroad.
- Academic excellence should not be compromised. There is no conflict between excellence and relevance. Quality is even more important for policy-related research than for basic research; policymaking should be based on high-standard, not low-level, research. Other objectives, such as developing contacts, should be dealt with separately.
- Any investment in capacity building must have a strong policy link, breaking in a discipline and a world view, not only individuals and institutions.
- The conditions for capacity building vary in different parts of the Russian Federation and across countries. It is critical to understand local conditions, which can be done by performing feasibility studies.
- Investments in building local capacity must combine teaching and research. Institutions that do not perform research will not be able to attract permanent faculty.
- Capacity building projects can be created relatively inexpensively and with the involvement of very few people. Initiatives that build critical mass and develop capacity for the long term may be the least expensive and highest-return investments that can be made in these countries.

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Creating a National Network for Russian Economists: The Economics Education and Research Consortium (EERC)
Why Russian Workers Do Not Move: Attachment of Workers through in-Kind Payments

by Guido Friebel (SITE and RECEP) and Sergei Guriev (RECEP and NES)

Reallocation of workers from declining sectors to more productive ones constitutes one of the most important challenges for all economies in transition. The challenge is particularly great in the Russian Federation, where, as a result of Stalinist industrialization policy, many regions have been dominated by a small number of large firms, which have proven to be unfit for the challenges posed by the transformation of the economic system.

One would expect workers to leave regions with weak job markets in order to find jobs in the flourishing metropolitan areas and in regions with better job prospects. In fact, the degree of interregional migration in the Russian Federation is very low. As a consequence, several geographically segmented labor markets have emerged. Unemployment and vacancy rates vary substantially across regions. In some regions, for instance, there is one job vacancy for four people seeking a job, while in others the ratio is 1 to 100. Remarkably, these ratios have been very stable over the last few years. Moreover, rather than converging, regions appear to be becoming more distinct. In some regional labor markets, profitable firms report a scarcity of qualified work force, particularly, skilled blue collar workers. At the same time, unprofitable companies in declining regions are hoarding workers with sought-after qualifications. The consequences are not only that profitable firms find it harder to fill vacancies but also that workers are forgoing promising job opportunities.

Why are workers not migrating across regions? While unqualified workers may lack outside options, it is surprising that highly qualified workers stay at their firms. Many firms have discontinued the payment of (monetary) wages, thus increasing the incentives for workers to migrate to more prosperous regions.

Our article provides a rationale for why workers stay at their firms and why firms appear to pay wages in kind and in the

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RECEP Working Papers 1999–2000

RECEP Working Papers can be obtained by writing to recep@recep.glasnet.ru or visiting RECEP’s Web site, at www.recep.org.

No. 2000/1. Privatization and Restructuring in Russia: New Evidence from Panel Data on Industrial Enterprises
J. D. Brown and J. S. Earle

No. 2000/2. Speed of Reform, Initial Conditions, Political Orientation, or What? Explaining Russian Regions’ Economic Performance
R. Ahrend

No. 2000/3. Capture of Bankruptcy: A Theory and Evidence from Russia
A. Lambert-Mogiliansky, C. Sonin, and E. Zhuravskaya

Kolenikov, I. Denisova, and K. Yudaeva

No. 1999/2. Dynamism and Inertia on the Russian Labour Market: A Model of Segmentation
Irena Grosfeld, Claudia Senik-Leygonie, Thierry Verdier, Stanislav Kolenikov, and Elena Paltseva

No. 1999/3. Barter in Russia: The Role of Market Power
Sergei Guriev and Dmitry Kvasov

Constantin Sonin

No. 1999/5. Why Russian Workers Do Not Move: Attachment of Workers through In-Kind Payments
Guido Friebel and Sergei Guriev
form of fringe benefits, such as housing, food, and health care, rather than in cash. We argue that the phenomena of slow labor reallocation, in-kind compensation, and wage arrears emerge as a consequence of firms’ strategies to attach wealth-constrained workers to the firms. Search costs of finding a new job are particularly high in the Russian Federation, because labor exchanges are inefficient and housing markets in the metropolitan areas of Moscow and St. Petersburg (where jobs opportunities are greatest) are poorly developed. Moreover, many cities limit geographical mobility by imposing additional administrative barriers to entry. By paying wages in kind and through fringe benefits rather than in cash, firms make it harder for workers to leave the region. Because most of the goods and services provided cannot be converted into cash, workers cannot raise the cash needed to finance the costs associated with moving to another region. They thus forgo opportunities to move to more rewarding jobs.

We argue that the phenomena of slow labor reallocation, in-kind compensation, and wage arrears emerge as a consequence of firms’ strategies to attach wealth-constrained workers to the firms. Search costs of finding a new job are particularly high in the Russian Federation, because labor exchanges are inefficient and housing markets in the metropolitan areas of Moscow and St. Petersburg (where jobs opportunities are greatest) are poorly developed. Moreover, many cities limit geographical mobility by imposing additional administrative barriers to entry. By paying wages in kind and through fringe benefits rather than in cash, firms make it harder for workers to leave the region. Because most of the goods and services provided cannot be converted into cash, workers cannot raise the cash needed to finance the costs associated with moving to another region. They thus forgo opportunities to move to more rewarding jobs.

We test our theory with data from the Russian Longitudinal Monitoring Survey, the largest Russian household survey. We find that workers who receive part of their salary in kind have a significantly lower probability of moving than workers who receive their wages in cash. We examine a number of policy implications of our analysis, in particular the importance of payment of wage arrears and the abolition of obstacles to migration.

Guido Friebel is assistant professor and Sergei Guriev is associate research fellow at SITE.

Does Foreign Ownership Matter? Russian Experience

by K. Yudaeva (RECEP), K. Kozlov (RECEP and NES), N. Melentieva (NES), and N. Ponomareva (NES)

This article compares the productivity of Russian firms that receive foreign direct investment with that of Russian firms that do not and analyses spillover effects from foreign-owned firms to domestic firms. Foreign firms are found to be more productive than domestic firms, but lack of adequate reform negatively hurts the productivity of foreign-owned firms. Spillovers between foreign-owned and domestic firms are most important at the local level and depend on the stock of human capital in the region.

World Bank/IMF Agenda

G-7 Finance Ministers Agree on Reforming Development Banks

Finance Ministers of the leading seven industrial nations agreed on strengthening the international financial architecture during their pre-summit meeting in Japan, early July. Principle elements of the plan had been approved by the G-8 Summit in Okinawa. The proposal will be discussed during the IMF/World Bank Annual Meetings in late September.

- Multilateral development banks can make an important contribution to poverty reduction in emerging markets and middle-income countries.

- The Comprehensive Development Framework (CDF) and the Poverty Reduction Strategy Papers (see next news item) should become the basis for programs that have strong ownership by recipient countries.

- Development banks, especially the World Bank, should take the lead in facilitating the provision of global public goods (including fighting infectious diseases and tackling environmental problems).

- Loan pricing policy should be promptly and comprehensively reviewed.

- Separation of lending and nonlending services should be examined, to enable a wide range of countries to continue to benefit from the expertise of the development banks.

- While continuing to engage in healthy competition, the World Bank and some regional development banks should
strengthen collaboration and coordination in order to ensure efficient use of scarce aid resources. The CDF can be a useful tool for coordinating bilateral and multilateral donors.

- While the World Bank is the central institution for poverty reduction, macroeconomic stability—a key tool in reducing poverty and increasing growth—is the responsibility of the IMF. The two institutions should continue to work closely together to improve efficiency and exchange information.

- More progress is necessary in information disclosure, public participation, and accountability to shareholders.

IMF to Rely on Poverty Reduction Strategy Papers

Addressing a meeting of development policy experts in Berlin, IMF Deputy Managing Director Eduardo Aninat argued that in the future, the macroeconomic targets set by the IMF for poor countries will be tied explicitly to the improvement of social conditions. Familiar IMF prescriptions—reducing inflation, cutting deficits, and stabilizing the currency—will be laid down with an eye firmly cast on their potential benefits for the poor. The key rests with the concept of Poverty Reduction Strategy Papers, which must now be produced by poor nations seeking loans from the IMF, World Bank, and other donors. These economic and social policy blueprints will have the added advantage of acting as conduits for input from civil society groups and NGOs. The IMF will rely on the World Bank and other multilateral regional development banks for an assessment of the priorities included in these budgets and their costing. It will then help ensure that outlays are consistent with available financing, macroeconomic stability, and faster sustainable growth.

IFC Contributes to Private Enterprise Partnership

In mid-May IFC’s Board approved a three-year, $12.6 million contribution to the Private Enterprise Partnership for Armenia, Belarus, Georgia, the Russian Federation, and Ukraine. IFC expects to complement this contribution with an additional $45 million from donors. Before Board approval, the government of the Netherlands funded the feasibility study and development of the business plan.

The Private Enterprise Partnership consolidates IFC’s extensive technical assistance programs in the region. Since 1991 more than $89 million in grant funding has been raised for activities ranging from the privatization of small businesses to the creation of a leasing sector. The main donors include Canada, Denmark, Finland, Japan, the Netherlands, Norway, Sweden, the United Kingdom, and the United States. The partnership, led by Project Director Edward Nassim, currently employs 320 local and international staff and is implementing 11 projects. New projects will focus on the small and medium enterprise (SME) sector and foreign direct investment, the two most important sources of growth in the region.

Russian Expects $4-$5 Billion Foreign Loan Next Year

The Russian Federation will receive no more than $4-$5 billion in foreign credit in 2001, Duma Budget Committee Chief Alexander Zhukov said. The issue of attracting credits from the IMF is still on the agenda, he said. (The IMF suspended a $4.5 billion loan program to the Russian Federation last year, saying the government failed to implement structural reforms). Zhukov also announced that the Russian Federation would continue to attract credits from the World Bank in 2001 under credit lines that are already open. In addition, Russia may receive government credits from Germany and Japan.

World Bank Discusses Support for Russian Federation

The World Bank has sent a high-ranking team to the Russian Federation in mid-July to discuss its support of the government’s new economic program. According to Vice President for Europe and Central Asia Johannes Linn, the Bank is considering to lend about $1 billion to the Russian Federation to support economic reforms. The sum would be roughly equivalent to that of a Structural Adjustment Loan that was not fully paid out following the Russian ruble crisis in 1998. According to the Vice President, the Russian government may request the cancellation of the outstanding $1.1 billion under this Structural Adjustment Loan and seek its replacement with a new loan package.

Working Group Reviews Selection Process of World Bank President

The World Bank’s Board of Executive Directors has set up a working group, consisting of 10 Executive Directors, to review the selection process for the Bank’s president. The working group will review the Bank’s experience with the nomination, selection, and appointment of the president and make recommendations on possible improvements. After the working group presents its report to other executive directors, the Board will report the results to the Governors at the annual meetings in Prague. A similar review group was established at the IMF in early July. The two groups will exchange ideas.

Time Is Right for New World Bank Strategy in Ukraine

The World Bank and Ukraine should map out a new strategy of cooperation that will target the development of the social sectors and better governance. World Bank Vice President for Europe and Central Asia Johannes Linn said following his visit to Ukraine in early June. “The economic situation in Ukraine is stable. It is perhaps the first time in the last 10 years that Ukraine experiences a real and, for the moment, sustained economic growth. We see a government program supported by the president and the parliament. This is a signal for us to map out a new strategy,” Linn said. The Bank has been discussing with Ukrai-
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The private sector will be key to its success. Large projects. years. UNDP figures show that agricultural

The IFIs are ready to increase cooperation with Ukraine, especially by initiating new investment projects, according to World Bank Managing Director and IFC Executive Vice President Peter Woicke. Woicke's comments came after his recent meeting with Prime Minister Viktor Yuschenko in Kiev. IFC investments in Ukraine total $12.3 million. The corporation has invested $3.5 million in the venture fund Ukraine set up to finance small and medium-scale businesses.

World Bank Plans Worldwide Development Gateway Pilot

The World Bank wants to help link more than 50 countries electronically by 2003 through the Global Development Gateways. The prototype for www.worldbank.org/gateway was launched in late June. Clicking on a country will bring up all its vital economic statistics, the reforms it is undertaking, privatization, details of donor countries, as well as the latest newspaper reports. Schools, villages, aid agencies, charities, NGOs, companies, and private investors alike will find the site useful and are encouraged to participate. As the system develops, it will include chat rooms or bulletin boards on which people around the world can exchange ideas. The project, which will be facilitated by the World Bank, will operate as an independent nonprofit organization, governed by a board of directors. Partnerships with governments and the private sector will be key to its success. Large multinational companies, including Microsoft, IBM, Reuters, and Bloomberg have given support to the $20 million a year budget.

IMF Extends Standby Credit to Romania

The IMF has agreed to release $116 million to Romania. The funds represent part of a $535 million standby credit originally approved last August. Romania had drawn only $71 million of the available funds when the funds were halted, following a run on the country's largest bank, Banca Comerciala Romana, the closure of investment fund Fondul National de Investitii, and the decision by Banca Populara Romana to suspend payments to depositors. The release of the funds was sanctioned only after the IMF received commitments from the government that state spending would be reduced and salaries pegged and tied to performance. Stanley Fischer, the IMF's First Deputy Managing Director, suggested that regulation of the financial sector must be improved and fiscal discipline maintained.

The Romanian government remains unpopular with the electorate following three years of economic decline. In recent local elections, the PDSR, the former communist party, gained seats in crucial parts of the country, and it is leading opinion polls for this fall's presidential and parliamentary elections.

World Bank Supports Health System Reform in Bulgaria

The World Bank approved a $63.3 million equivalent loan for investment in Bulgaria's health system June 22. The project will help the government carry out a fundamental reform of its health sector designed to improve access to quality health services and ensure the financial and operational sustainability of the system. Special attention will be given to primary health care and to rural and remote communities. Since 1990, when Bulgaria joined the World Bank, it has received U.S.$1.44 billion for 23 projects.

Allegations against Former World Bank Official Dropped

An eight-month internal investigation has failed to substantiate allegations that a former senior member of the Russian Federation's World Bank mission in Washington passed confidential information to a Russian commercial bank in 1993. Leonid Grigoriev did violate Bank policy, however, by establishing a business relationship with now-defunct Inkombank while he was working in the Russian Executive Director's office, according to the Bank. Inkombank paid Grigoriev $13,000 for services and out-of-pocket expenses.

Grigoriev left the World Bank in 1997. The Bank said it would have no objection to his resuming his duties as General Director of the Bureau of Economic Analysis, a Moscow-based think tank funded mostly by the Bank.

South Korea to Back IMF, World Bank Membership for North Korea

South Korea will help North Korea join international financial organizations that could provide it with access to financial aid, Trade Minister Han Duck-Soo announced following the all-Korean summit. Joining the IMF and the World Bank could help North Korea develop its social infrastructure. The IMF said earlier this year that it could offer nonfinancial aid, such as training programs for Pyongyang economic planners, which would not require North Korea to join the Fund.

The government of North Korea asked the international community for $250 million in aid to revitalize the country's devastated agricultural sector and ensure adequate food supplies. The plea came during a meeting in Geneva in June, where the country's delegation discussed the conditions of an aid package with 22 donor countries. Two million people are estimated to have died of famine in the North Korea in recent years. UNDP figures show that agricultural production there plunged 70 percent in the past four years, while the country's GDP fell 50 percent.
World Bank Approves Environmental Loan to China

The World Bank will lend China $349 million for air pollution control and waste water management in Beijing. The loan will be used to help convert coal-fired boilers to natural gas and promote energy conservation heating systems. China will also use the credit to help provide waste water collection and treatment in the Liangshi River basin—which covers more than a quarter of the city—and strengthen environmental management in Beijing.

China’s reliance on low-quality coal, a recent surge in population, and a steep rise in the number of motor vehicles have taken a toll on the city’s air and water. To stop and reverse the environmental degradation, the Beijing municipal government has started a clean air program to convert all small scattered coal boilers and burners within the urban area to cleaner fuel, require all passenger cars to meet strict emission standards, and require the planting of vegetation to control dust. The Beijing environmental project will cost $1.26 billion. The World Bank’s Global Environment Facility will support the project with a $25 million grant.

OECD Meeting Fails to Agree to End Practice of Tying Aid to Goods Purchases

The drive to end the practice of tying development aid to the purchase of goods from donor countries suffered a severe setback after industrial countries failed to reach agreement in June. A three-day meeting at the OECD in Paris ended in deadlock, after Denmark, France, and Japan joined forces to block the deal. Despite earlier agreement to exclude food aid and technical cooperation from the proposal, the three countries continued to insist that they would be unfairly disadvantaged by a general reduction in tied aid. Denmark and France have large tied aid programs, while Japan is concerned that foreign companies would be able to benefit from Japanese technical advice. The three countries said other governments, especially those with smaller aid budgets, should do more for the least developed countries as part of any deal. World Bank Vice President for Europe Jean-François Rischard said the Bank is opposed to all forms of tied aid, which the Bank estimates increase the cost of projects by about a fifth.

Corruption Report Published in Slovakia

Corruption in Slovakia is more widespread than it was 10 years ago, according to a report prepared by the World Bank at the request of the Slovak government. The report, “Corruption in Slovakia: Results of Diagnostic Surveys,” was written by the World Bank’s James Anderson, with the collaboration of the U.S. Agency for International Development (USAID), the Slovak Center for Economic Development and Transparency International, and the Bratislava-based Focus Agency. The findings were based on polls conducted among households, businesses, and government agencies. Slovakia’s Prime Minister, Mikulas Dzurinda, presented the report at a June 20 press conference in Bratislava. He referred to the “widespread and es-

Percent of Slovak Enterprises that Encountered Bribery in 1998-99
(of those that interacted with the body or service)
especially burdensome corruption in the health and education sectors, the state privatization agency (the National Property Fund), the courts, customs, the police, and ministries (see chart on previous page). Regulatory and licensing agencies issuing import, export, and construction permits are especially prone to accepting bribes. Many entrepreneurs obtain state subsidies through bribery, contacts, or influence in political parties, according to the report. The 100-page document was put on the Internet in early July. Based on the report, the government will work out an anti-corruption action plan by mid-October.

**Between World Bank and EastWest Institute: Partnership for Reform in Russia**

The EastWest Institute and the World Bank have formed a partnership to build coalitions for reform in the Russian Federation. The partnership will combine the World Bank's comprehensive approach to the Russian Federation's economic reforms with the Institute's specific projects and capabilities in areas such as fiscal transparency and private sector development. The initial focus of the partnership will be on increasing the transparency of extrabudgetary funds in the Russian Federation; analyzing and improving the system of intergovernmental finance; promoting domestic and foreign investment, including better regional governance and accounting standards in the enterprise and banking sector; and using the EastWest Institute's regional network and parliamentary contacts to gather and disseminate information and develop a broad dialogue on these and other selected topics.

**Poland, World Bank Set Up Task Force to Tackle Rampant Graft**

The Polish government has set up a task force with the World Bank to develop laws to tackle growing corruption in state institutions. The Bank said earlier this year that Poland has a serious corruption problem at all levels of public administration and needs to curb graft in Parliament, ministries, and local authorities. The new task force is assessing draft laws and will propose legislative changes to clean up the awarding of state contracts, key jobs, and licenses for sought-after assets such as radio frequencies.

**Slovenia Prepares to Graduate from the World Bank**

Based on recommendations by the World Bank, Slovenia is prepared to initiate its graduation from the Bank. It will be the first transition economy to reach this milestone. Announcement of the move was made in mid-May, during the Bank's discussion of the Progress Report for the Country Assistance Strategy (CAS) for Slovenia. Johannes Linn, the World Bank's Vice President for the Europe and Central Asia Region, said, "We believe that Slovenia is ready and prepared to move from being a recipient of the Bank's financial and technical assistance to becoming a strong partner of the Bank that will generously share its experience and resources with other countries."

According to Roger Grawe, Country Director for the Czech Republic, Hungary, Moldova, Slovakia, and Slovenia, "A key factor in Slovenia's successful transition is that it focused its sights on EU membership early on. There was also a strong focus on achieving and maintaining macroeconomic stability. Thus the World Bank's financial support became less important than its technical inputs."

With its "A" credit rating, Slovenia has good access to international capital markets. However, the progress report highlighted a number of critical structural reforms, such as privatization of public utilities, telecommunications, and the remaining state-owned banks, that need to be successfully completed. In these areas the Bank remains prepared to provide policy advice and analytic services. By the end of 1999, the Bank's commitments in Slovenia totaled $151 million for four projects.
Conference Diary

For the Record

Third Meeting of the ECPD International Permanent Study Group on Transition and Privatization
November 26-27, 1999, Ohrid, FYR Macedonia

The meeting was organized by the European Center for Peace and Development (ECPD) of the University for Peace established by the United Nations and sponsored by the Macedonian government. The meeting was attended by government experts, the academia, and business managers. Over twenty papers were presented and discussed by the Group. The meeting reviewed recent comparable international experience of privatization in the transition economies, identified plus and minus of various forms of privatization, and evaluated what role institutions and government policies play in determining the quality of corporate governance.

In the discussion about the decade-old experience with privatization, opinions differed whether privatization on the whole was really successful. Many expressed the view that privatization had too often led to negative consequences for income distribution and social justice. Weakness of the institutional framework for adequate corporate governance was emphasized. The experience of investment funds as instrument of corporate governance in the mass privatization schemes of Poland and the Czech Republic was examined from that perspective. The conclusion, broadly shared by the Group as a whole, was that these funds had proved inadequate for the task, due to the absence of adequate incentives and the lack of strong institutions of accountability and control. This was found to be a serious impediment both to efficient restructuring of privatized enterprises and to effective corporate governance.

Information: Ms. Gordana Hofmann, ECPD, Terazije 41, Belgrade, Tel.: 381-11-3246-041, 3246-042, 3246-043, 3246-044, 3246-045; fax: 381-11-3240-673, 3234-082; email: ecpd@EUnet.yu

Good Governance and Administration in Europe's Integrated Market
July 3-14, 2000, Florence, Italy

Information: 11th Session on the Law of the European Union. Contact: Academy of European Law of the European University Institute, Florence. Tel./fax: (39.055) 468.5523; email: ciomei@datacomm.iue.it; Web site: http://www.iue.it

Improving Accountability, Efficiency and Responsiveness in Government: Ideas and Lessons for the New Millennium
July 10-13, 2000, Beijing, China

Information: Catherine Coninckx, IASIA, Brussels, Belgium. Tel./fax: (32.2) 537.97.02; e-mail: iasia@iasia.be. In Chinese, English, and French.

EACES conference on Financial Crises in Transition Countries: Recent Lessons and Problems yet to Solve
July 13-14, 2000, Halle (Saale), Germany

Information: Katrin Renneberg, Division of Central and Eastern Europe, Institute for Economic Research (IWH), Kleine Märkerstr. 8, D-06108 Halle (Saale); email: krb@iwh.uni-halle.de; Website: http://www.iwh.uni-halle.de/

Ethics and Responsibility
July 14-19, 2000, Tallinn, Estonia

Information: NISPAcee, Bratislava, Slovakia. Tel./fax: (42.7) 64.28.55.57; email: viera@nispa.sk; Web site: http://www.nispa.sk/In English.

Sixth ICCEES World Congress
July 29 - August 3, 2000, Tampere, Finland


Policing in Central and Eastern Europe: Ethics, Integrity and Human Rights
September 21-23, 2000, Ljubljana, Slovenia

Third Biennial International Conference

Information: Milan Pagon, College of Police and Security Studies, University of Ljubljana, Slovenia. Tel.: (386.61) 172.4678; fax: (386.61) 302.687; email: milanp@vpvs.uni-lj.si; Web site: http://www.vpvs.uni-lj.si/conf2000. In English.

China: Growth Sustainability in the 21st Century
September 9-10, 2000, Canberra, Australia

Organizers: China Economy and Business Program, Asia Pacific School of Economics and Management, Australian National University, and Association for Chinese Economic Studies (Australia). Topics: Macroeconomic stability during the transition to market economy; further integration into the global economy, including through trade liberalisation, accession to the WTO and liberalisation of the capital account; foreign direct investment and interactions among the Chinese economies of the mainland, Hong Kong, Taiwan and Macao; development of the capital market and reform of the financial sector; building an efficient labour market and the challenges of unemployment and income disparity problems; accelerating economic growth in the West; reform of the state-owned enterprises and rise of the
private enterprise sector; reform and re-building of the social security system; demo-graphic transition and economic growth; ur-banisation, the environment, the energy market and economic development; trans-formation of the rural economy and its im-plications for farming income and food security; and trends of factor supplies and changing sources of productivity growth.

Milestones of Transition

EBRD forecasts higher GDP growth for transition economies. The EBRD’s Transition Report Update 2000 revises its forecasts for GDP growth in Central and Eastern Europe. The new forecasts are much higher than the forecasts made last November. Relative to their 1989 levels, GDP figures for EU aspirants are much higher than those for CIS countries (table 1). GDP in countries actively purs-uing EU membership is close to or above the 1989 level. In contrast, GDP in the CIS countries averages about 60 percent of 1989 levels.

Table 1. GDP Growth Forecasts, 2000

<table>
<thead>
<tr>
<th>Country</th>
<th>Projected growth (percent)</th>
<th>GDP index (1989=100)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>3.5</td>
<td>70</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>2.0</td>
<td>95</td>
</tr>
<tr>
<td>Hungary</td>
<td>4.5</td>
<td>104</td>
</tr>
<tr>
<td>Poland</td>
<td>5.0</td>
<td>128</td>
</tr>
<tr>
<td>Romania</td>
<td>0.5</td>
<td>76</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>4.0</td>
<td>59</td>
</tr>
<tr>
<td>Ukraine</td>
<td>2.0</td>
<td>37</td>
</tr>
</tbody>
</table>

Source: EBRD estimates.

Poland’s economy expands, but un-employment remains high. The Central Statistical Office reported in June that Poland’s economy grew 6 percent in the first quarter of 2000. The figure repre-sented an improvement over last year’s 1.4 percent first-quarter growth, but it was slightly lower than the 6.2 percent regis-tered in the fourth quarter of 1999. Eco-nomic growth is expected to reach 5.2 percent in 2000, up from 4.1 percent last year. Meanwhile, unemployment stood at 13.5 percent in May, down from 13.7 percent in April. By the end of May, 2.45 mil-lion people were registered as jobless in Poland.

Polish Parliament passes mass privatization bill. In July Poland’s Parlia-ment, the Sejm, approved the so-called enfranchisement bill, which stipulates that every Polish adult receive a share of state assets. Tenants of municipal or coopera-
tive flats will be granted full or part own-ership rights to their homes. Others will receive coupons in special funds man-aging shares in companies undergoing privatization. The ruling Solidarity Elec-toral Action coalition sees the enfran-chisement bill as an act of historical justice for those who did not benefit from earlier legislative provisions granting free shares to workers of privatized companies. The Democratic Left Alliance and the liberal Freedom Union opposed the bill, claiming it would hurt public fi-nances.

Gazprom board shaken up as pro-duction declines. The government and minority shareholders of Gazprom gained control of the company’s board at the annual meeting held June 30, ending the broad autonomy manage-ment at the giant gas company that had en-Joyed. Management lost control of two of the six seats it had held on the 11-person board, while minority shareholders gained two seats. The government, which owns 38 percent of Gazprom, re-tained five seats but stiffened its con-trol by installing Dmitry Medvedev, a top Kremlin aide, as chairman. Medvedev replaced Viktor Chernomyrdin, who of-ficially represented the state but was considered a closer ally of manage-ment.

Gazprom Chief Executive Rem Vyakhirev warned shareholders that 80 percent of the company’s gas production comes from old fields with declining production. Gazprom has the world’s largest gas reserves, but widespread nonpayment of bills and low gas charges set by the government have left the company with insufficient funds to invest in new fields. Production this year will decline by 20 billion cubic meters to 525 billion cubic meters, according to man-age-ment. At the beginning of the year, un-paid bills amounted to 151.7 billion rubles ($5.43 billion), roughly half of 1999 sales of 306 billion rubles and three times net profits of 46.6 billion rubles. (Jeanne Whalen, Wall Street Journal).

Health system in Russian Federation receives low WHO ranking. Russia's
Health system ranks 130th out of 191, according to a report by the World Health Organization (WHO) issued in June. The ranking places the Russian Federation in between Peru and Honduras (table 2). Of the former Soviet republics, only the Kyrgyz Republic, Tajikistan, and Turkmenistan ranked lower than the Russian Federation, which trailed significantly behind Kazakhstan (64th) and Belarus (72nd). France's health system ranked first in the world, followed by Italy's system. The United States ranked 37th. According to the Moscow Times, Health Ministry spokesman Aleksandr Zharov said the report was based on 1997 data and does not reflect the current state of the Russian healthcare system. WHO's assessment was based on five indicators: the overall level of population health, health inequalities (or disparities) within the population, the overall level of health system responsiveness (a combination of patient satisfaction and how well the system acts), the distribution of responsiveness within the population (how well people of varying economic status find that they are served by the health system), and the distribution of the health system's financial burden within the population (who pays the cost).

Ukraine

Ukrainian premier reports economic achievements. Prime Minister Viktor Yushchenko told parliament 15 July that GDP grew 5 percent during the first half of 2000. Budget revenues increased 10.5 percent during the first six months of the year, and almost all of revenues were collected in cash rather than through barter or offsets. Yushchenko noted that this year's growth had enabled the government to pay off debts to pensioners and cut back on unpaid wages to government workers, increasing real income 11.8 percent. Yushchenko said there is no immediate threat of a new financial crisis. Inflation is on the rise, however, increasing 1.7 percent in April, 2.1 percent in May, and 3.7 percent in June. The annual rate of inflation is expected to reach 18.7 percent by the end of the year. Tourism will continue to rise during the summer months, which could help hold back a rising current account deficit.

Slovenia

GDP could increase 4.75 percent in 2000, according to the governmental Institute for Macroeconomic Analysis and Development. The deputy director of the institute, Janez Sustersic, said the revision of the forecast from the original estimate of 4.0 reflects higher exports as a result of higher GDP growth in EU countries this year. He said GDP growth next year is expected to be 4.0-4.5 percent. Last year GDP rose 4.9 percent. Strong growth is expected in the EU, and improved growth is expected in Croatia and the Russian Federation. The EU accounts for some 67 percent of Slovenia's total exports, Croatia 7 percent, and Russia about 2 percent. The current account deficit is expected to remain unchanged from last year at about $600 million, or 3 percent of GDP. Due to the small FDI inflow, most of the deficit is financed from foreign loans.

Slovakia

OECD urges structural reforms. The Organization for Economic Cooperation and Development (OECD) said in a mid-May report that Slovakia needs to vigorously pursue structural reforms in the banking and financial sector and curb its fiscal deficit. The report identifies the need for deep restructuring of large enterprises as the "Gordian knot" of the Slovak economy and warns of the danger that widespread financial fragility in Slovakia's enterprise and financial sectors could put pressure on the state budget. The report acknowledges that the government has taken steps to recapitalize large state banks and transfer bad loans to state debt institutions but warned that failure to reform the corporate sphere would limit the benefits of financial restructuring. The report forecasts economic growth of 2.0 percent in 2000 and 3.0 percent in 2001, inflation of 10.0 percent in 2000 and 8.0 percent in 2001, and a registered unemployment rate of 18.5 percent this year and 16.0 percent next year in Slovakia.

The private sector makes up 75 percent of the country's GDP. The figure is 85 percent in Hungary 75 percent in the Czech Republic, and 65 percent in Poland.

Vietnam

U.S. and Vietnam Sign Trade Agreement. Vietnam signed a trade agreement with the United States July 14. The agreement reduces tariffs on a broad range of goods and allows foreign firms to participate in key businesses, including telecommunications and banking. The deal is likely to provide a huge boost to the country's apparel and manufacturing industries, increasing exports by $800 million a year and creating hundreds of thousands of new jobs, according to the World Bank. The unemployment rate in Vietnam is 7.4 percent, and every year 1.2 million new workers enter the job market.

Western donors toned down their criticism of Vietnam's slow pace of economic reform at the annual review meeting after Vietnam's economy grew 6 percent in the first half of 2000. But World Bank Country Director Andrew Steercautioned that trade liberalization and reform of state enterprises and the banking sector should make more progress in order to reverse the sharp decline in foreign investment. Foreign investment fell to $1.4 billion last year, after peaking at $8.6 billion in 1996, largely on fears that economic reform was stagnating.

In mid-July Vietnam opened its stock market, the Ho Chi Minh City Securities Trading Center. Four firms are listed on the exchange, on which trading takes place three days a week. Six brokerage houses will trade the stocks and bonds the government is planning to float.

We appreciate the contributions from Radio Free Europe/Radio Liberty.
World Health Report 2000: Ranking of Transition Economies

The World Health Organization (WHO) released on June 21 the World Health Report 2000—Health Systems Improving Performance. In the first ever analysis of the world's health systems, WHO used five indicators: overall level of population health; health inequalities (or disparities) within the population; overall level of health system responsiveness (a combination of patient satisfaction and how well the system acts); distribution of responsiveness within the population (how well people of varying economic status find that they are served by the health system); and the distribution of the health system's financial burden within the population (who pays the costs). The following table ranks the transition economies of Eastern Europe and Central Asia as well as the reforming economies of Asia based on this report. (For comparison, the ranking of the first three countries as well as that of the United States has been included.) The table also contains the latest data on life expectancies for both men and women as well as the proportion of those older than 60 years for each country.

<table>
<thead>
<tr>
<th>Performance</th>
<th>Life expectancy at birth (years)²</th>
<th>Percentage of population aged 60+ years²</th>
</tr>
</thead>
<tbody>
<tr>
<td>On level of health system performance</td>
<td>Males</td>
<td>Females</td>
</tr>
<tr>
<td>France</td>
<td>4</td>
<td>1</td>
</tr>
<tr>
<td>Italy</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>San Marino</td>
<td>5</td>
<td>3</td>
</tr>
<tr>
<td>United States of America</td>
<td>72</td>
<td>37</td>
</tr>
<tr>
<td>Slovenia</td>
<td>62</td>
<td>38</td>
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<tr>
<td>Cuba</td>
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<td>39</td>
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<tr>
<td>Croatia</td>
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<td>Czech Republic</td>
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<td>Albania</td>
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<td>Slovakia</td>
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<tr>
<td>Kazakhstan</td>
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<td>Hungary</td>
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<td>Belarus</td>
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<td>Lithuania</td>
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<td>Estonia</td>
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<td>FYR Macedonia</td>
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<td>Ukraine</td>
<td>101</td>
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<tr>
<td>Bosnia and Herzegovina</td>
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<td>China</td>
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<td>Mongolia</td>
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<td>Tajikistan</td>
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<td>Viet Nam</td>
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<td>Lao People's Democratic Republic</td>
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<td>165</td>
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<tr>
<td>Democratic People's Republic of Korea</td>
<td>153</td>
<td>167</td>
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<tr>
<td>Cambodia</td>
<td>157</td>
<td>174</td>
</tr>
</tbody>
</table>


a. As measured in 1999.
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Annual implicit subsidies in the form of nonpayments amount to 10 percent of GDP in the Russian Federation. These subsidies have stifled growth, contributed to the August 1998 macroeconomic crisis through their impact on public debt, and made at best a questionable contribution to equity. Hardening budgets requires that these nonpayments (or mutual arrears and noncash settlements among the government, the energy monopolies, and manufacturing firms) be eliminated with energy bills, taxes, and budgetary spending settled on time and in cash. (Editor’s note: See also “Nonpayments Cycle in Russia Suffocates Economic Growth: Proposal of World Bank Economists,” Transition, vol.10, no.6, December 1999, p.1.) To order: Helena Makarenko, room H4-304, tel.: 202-458-7832, fax: 202-522-2753, email: hmakarenko@worldbank.org. The authors may be contacted at bpinto2@worldbank.org, vdrebentsov@worldbank.org, or amorozov@worldbank.org.

Empirical results highlight the downside of imposing certain regulatory restrictions on commercial bank activities. Regulations that restrict banks' ability to engage in securities activities and to own nonfinancial firms are closely associated with increased instability in the banking sector. Keeping commercial banks from engaging in investment banking, insurance, and real estate activities does not appear to produce positive benefits. To order: Agnes Yaptenco, room MC3-446, tel.: 202-473-1823, fax: 202-522-1155, email: ayaptenco@worldbank.org. The authors may be contacted at jbarth@business.auburn.edu, gcaprio@worldbank.org, or rlevine@csom.umn.edu.


Only 1.5 percent of Latvian households receive social assistance, which represents 20 percent of income for those households. Because social assistance is locally financed, poor households in different parts of the country are treated unequally. Urban households outside Riga and households headed by adult men are systematically discriminated against.


The Russian Federation receives relatively little foreign direct investment (FDI), almost none of it of the newer, more efficient kind, involving state-of-the-art technology and world-class competitive production linked to dynamic global or regional markets. Why is this kind of FDI so low in Russia, and what should be done about it?

FDI in the Russian Federation is often based on producing exports that exploit cheap labor or natural resources or are aimed at penetrating protected local markets, not necessarily at world standards for price and quality. To improve FDI flows, Russia should phase out high tariffs and nontariff protection for the domestic market, most tax preferences for foreign investors (which do not increase FDI but do reduce fiscal revenues), and many restrictions on FDI. It should adopt a modern approach to FDI by:
• Amending the newly enacted FDI law so that it will grant nondiscriminatory national treatment to foreign investors, abolish provisions (such as local content restrictions) that are inconsistent with the World Trade Organization agreement on trade-related investment, and make inves-
tor-state dispute resolution mechanisms more efficient (giving foreign investors the chance to seek neutral binding international arbitration, for example).

- Strengthening enforcement of property rights.
- Simplifying registration procedures for foreign investors to make them transparent and rules based.
- Extending guarantee schemes covering basic noncommercial risks.

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Using survey and other data, this article suggests that much of Russian industry is immune from robust competition because of heavy vertical integration, geographic segmentation, and the concentration of buyers and sellers in selected markets. Regulatory constraints protect incumbent firms from competition with new entrants, both domestic and foreign. Russia’s post-privatization program should aim at restructuring anti-competitive structures, reducing barriers to entry, increasing transparency, and improving accountability.

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Harry G. Broadman, Competition, Corporate Governance, and Regulation in Central Asia: Uzbekistan’s Structural Reform Challenges, WPS 2331, May 2000, 21 pp.

Like many Central Asian republics, Uzbekistan has adopted a gradual, cautious approach in its transition to a market economy. State enterprises are being changed into shareholding companies, and private enterprises account for 45 percent of all registered firms. But business decisions to set prices, output, and investment are often not market based or wholly within the purview of businesses, especially those in commercial manufacturing and services. Lines of authority for corporate governance—from state enterprises to private enterprises—are ill defined, so there is little discipline on corporate performance and little separation between government and business.

This article urges reform of the competition policy institutions and legal frameworks, including the establishment of an independent agency responsible for competition and regulatory policymaking. Infrastructure monopolies should be restructured and unbundled, competition should influence their price, output, and investment decisions. More transparency and accountability is needed toward the public.

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There is considerable scope for using economic instruments to reduce China’s industrial pollution problems.

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Hua Wang, Pollution Charges, Community Pressure, and Abatement Cost of Industrial Pollution in China, WPS 2337, May 2000, 27 pp.

Community pressure may be as strong an incentive for industrial firms to control pollution in China as pollution levies are.

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Multinationals have become increasingly important to the world economy. The value of overseas production by U.S. affiliates is three times that of U.S. exports, for example. Who is investing where, and where are the products being produced?

Investment in some transition regions, while still modest, grew rapidly in the 1990s. The value of U.S. affiliate production in Europe is seven times that of U.S. exports to Europe; that ratio drops to four for all industrial countries and to 1.6 for developing countries. Only 4 percent of U.S. affiliate production in the European Union is sold back to the United States. For the average developing country the figure is 18 percent, with Mexico leading the developing world at 40 percent. The major outward investors carry out much of their vertical investment close to home, in the European Union and in Central and Eastern Europe.

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As the trend toward decentralization accelerates, subnational entities in many countries—states, regions, provinces, counties, municipalities and the local utility companies they own—are now responsible for delivering services and investing in infrastructure. Infrastructure investments are growing rapidly to meet increasing urban demand. How should the World Bank help? Subnational debt markets can be a
powerful force in a country's development, although they remain embryonic in most developing and transition economies. It is critical to support the orderly and efficient emergence of such debt markets by reducing moral hazard, improving market transparency, strengthening market governance, establishing a level playing field, and developing local capacity for accounting, budgeting, and financial management. The World Bank should offer a variety of lending and guarantee instruments that encourage private investors to finance subnational entities.


Does private ownership improve corporate performance in a developing institutional environment? In Lithuania commercial transfer of state property to private owners has significantly improved enterprises' revenue and export performance.

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A higher share of income for the middle class and less ethnic polarization are empirically associated with higher income, higher growth, more education, better health, better infrastructure, better economic policies, less political instability, less civil war, more social “modernization,” and more democracy. A middle-class consensus distinguishes development successes from failures.

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How much advantage a developing country can take of technology transfer from foreign direct investment (FDI) depends partly on how well educated and well trained its workforce is, how much it is willing to invest in research and development, and how much protection it offers for intellectual property rights. This article surveys the literature on trade and FDI, especially wholly owned subsidiaries of multinational firms and international joint ventures, as channels for technology transfer. It also examines licensing and other arm’s-length channels of technology transfer. It concludes that:

- How trade encourages growth depends on whether knowledge spillover is national or international. Spillover is more likely to be national for developing countries than for industrial countries.
- Local policy often makes pure FDI infeasible, so that foreign firms choose licensing or joint ventures. The jury is still out on whether licensing or joint ventures lead to more learning by local firms.
- Policies designed to attract FDI are proliferating. Several plant-level studies have failed to find positive spillover from FDI to firms competing directly with subsidiaries of multinationals. (These studies treat FDI as exogenous and assume spillover to be horizontal; however, when it may be vertical.) All such studies find that subsidiaries of multinationals are more productive than domestic firms, suggesting that FDI does cause host countries to use resources more effectively.
- Absorptive capacity in the host country is essential for reaping significant benefits from FDI. Without adequate human capital or investments in research and development, spillover fails to materialize.
- A country's policy on protection of intellectual property rights affects the type of industry it attracts. Firms for which such rights are crucial (such as pharmaceutical firms) are unlikely to invest directly in countries in which such protections are weak. Policy on intellectual property rights also influences whether technology transfer comes through licensing, joint ventures, or the establishment of wholly owned subsidiaries.

( Editor's note: See the review of “Spillovers from Multinationals in Developing Countries: The Mechanisms at Work,” on page 8 of this issue.)

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This article estimates the costs and benefits of labor retrenchment in state-owned industrial enterprises in China. For the period reviewed (1994–97), low and stagnant labor productivity and low capital productivity characterized the state sector, while the private sector exhibited consistently higher productivity.

Simulation results for 1996 estimate that 43 percent of the workers in state enterprises and 70 percent of the capital are redundant. By itself, a transfer of labor from the public to the private sector at the current rate would generate increases in output of just 2 percent. A transfer of 10 percent of both capital and labor would achieve a greater efficiency gain than transferring the full 43 percent of redundant workers. This is partly because the private sector uses capital more efficiently than the public sector and partly because it needs capital to hire workers transferred from the public sector.

These results suggest that reform in state enterprises should concentrate more on the efficiency of capital allocation, not just on labor retrenchment. More efficient capital allocation would reduce the pressure on labor and would generate larger gains at a lower social cost.

The extent of corruption in a host country affects a foreign direct investor's choice of investing through a joint venture or through a wholly owned subsidiary. Corruption reduces foreign investment and shifts the ownership structure toward joint ventures.

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Discussion Papers


Hungary has been a pioneer in local government reform among transition economies. Through a series of legal reforms introduced since 1990, it has decentralized the state administration and re-established the full autonomy of local governments. Local governments have adjusted to the changing circumstances, but they are reaching the limit of their ability to adapt in the current framework.

To help Hungary continue to be successful in its transition and to help it accede to the EU, the World Bank partnered three units within the Europe and Central Asia region. This paper discusses key findings from the study of this partnership study, called the Hungary Subnational Development Program. It also proposes policies for modernizing the subnational government system, through fiscal decentralization, local capacity building, and development of a competitive credit market.


Over the past two decades, the World Bank has supported initiatives by the Chinese government to meet the growing and diverse needs of its energy sector. In an effort to meet the continuing demand of the power sector and ensure stability of fuel supply sources, the State Power Corporation asked for World Bank assistance to assess the viability of imported liquefied natural gas (LNG) as a fuel source for coastal provinces. In response to their request, the Bank undertook a detailed economic assessment of LNG as an alternative fuel source and reviewed the steps necessary to support its introduction.

Other World Bank Publications


All over the world, governments are reassessing their role in health service delivery. The reforms being undertaken by these governments are motivated in part by the inefficiency of existing public delivery systems, consumer dissatisfaction with the low quality of care, rising costs, and new theories on public sector management. This report argues that organizational reforms in the health sector are able to improve the performance of services provided through public sector institutions, reduce the level of government expenditure and the size of the core public sector, increase the accountability of public officials and the transparency of the process they control, and make public services more responsive and accessible to consumer choice.


The new competitive foreign investment environment has prompted analogies between competition among governments for foreign investment and competition among firms for market share. Given the similarities in the nature of the competition, it is not surprising that countries are adopting marketing strategies that parallel those of private companies. Some of the findings of research on company marketing programs can thus benefit countries trying to attract investment. Organizations seeking to develop competitive strategies for marketing activities can, to some extent, manipulate three variables in their overall marketing programs: product, price, and promotion. The focus of this report is on promotion.


Despite the billions of dollars spent on development assistance each year, very little is known about the impact of projects on the poor. This handbook tries to fill in this vacuum and provide project managers and policy analysts with helpful tools.

developing and applying a systematic ap- tion economies, which inherited a deep Publications

While the reaction of April 2000. higher foreign bank ownership involvement John Micklewright and Kitty Stewart, access to credit and jobs, and Early reorganization initiatives, flexible transfer of assets, investment in and access to the physical and social infrastructure, access to credit and jobs, and provision of safety nets.


This paper examines co-movements of financial markets across Europe’s transition economies. While the reaction of markets during the Asian and Czech crises was muted, the pattern of high-frequency spillovers during the Russian crisis looks very similar to that observed in other regions during turbulent times.


How can governments and civil society best encourage institutional change by developing and applying a systematic approach to measuring governance, its determinants, and its consequences? This paper presents new measurements and indicators of governance and corruption, summarizes salient results of the costs of misgovernment, and suggests new approaches to diagnose governance challenges within a country and help formulate concrete action programs.

Bank of Finland Institute for Economies in Transition (BOFIT) Discussion Papers

To order: Bank of Finland Institute for Economies in Transition, P.O. Box 160, FIN-0010 Helsinki, tel.: 3589-183-2268, fax: 3589-183-2294, email: bofit@bof.fi, Internet: http://www.bof.fi/bofit (papers are available in PDF format).


Early reorganization initiatives, flexible approaches to privatization, and liberal policies toward foreign banks’ involvement with domestic institutions helped build a relatively strong and increasingly efficient banking system in Hungary. Banks with higher foreign bank ownership involvement have been more efficient than other banks.


This paper provides a psychological foundation for the assumption that the decision to evade taxes depends upon the perceived fairness of the tax system. Hayek’s theory of human behavior as a process of rule-following would suggest that taxpayers are more compliant with tax laws to which they can in principle give their full consent. A social contract as a basis of tax policy may provide a potent means to combat tax evasion, particularly in transition economies, which inherited a deep mistrust of the government from their socialist past.


Using panel data from 25 transition economies, the author finds that price liberalization has a positive impact on fiscal performance, while privatization and restructuring negatively affect fiscal balances (because of their effect on unemployment). These findings contrast somewhat with earlier empirical work and theoretical transition economics, which suggest that fiscal pressures are most severe in fast-reforming countries. The analysis suggests that countries with better fiscal positions may have benefited from favorable initial conditions.

Innocenti Occasional Papers


Analysis of the transition period focuses on the differences in access and achievement associated with household income and geographic location. Disparities differ across the region. In some countries, such as the Russian Federation, there are grounds for serious concern, but no country has cause for complacency.

Central European University Press Publications
This report analyzes the geopolitical links among the Russian Federation, Ukraine, and the three bordering central European states, Hungary, Poland, and Slovakia. The focus is on economic, political, and security issues.


Modern Russia has been shaped by Peter the Great's sudden attempt to transform it into a European country. Two hundred years after Peter's forceful westernization, during its second crucial transformation, in 1917, Russia witnessed the decay of classic realism and positivism and the rise of irrational philosophies, psychoanalysis, artistic experimentation, Marxism, and the birth of the new genre of film. This volume emphasizes the metamorphic nature of Russia, noting the futility of attempting to understand it—let alone predict its future—without considering the intellectual, social, and emotional reasons for its restlessness.


This book compares social structure, mobility, inequality, lifestyle, and economic stratification in Bulgaria, the Czech Republic, Hungary, Poland, the Russian Federation, and Slovakia.


Centre for the Study of Democracy Publications

To order: Centre for the Study of Democracy, 1 Lazar Stanev St., 1113 Sofia, Bulgaria, fax: (3592) 971 22 33, email: csd@online.bg, Internet: http://www.csd.bg.


Illicit trafficking was a major source feeding Bulgaria's shadow economy throughout the 1990s. The practice was helped by the weakening of the post-communist state and the spread of collusion among state officials (police, customs officials, senior civil servants, politicians) on the one hand and semi-criminal groups and local mafia on the other. Curbing illegal trafficking and corruption is closely connected to public sector reform and anti-corruption initiatives.


This report analyzes data collected from a quantitative sociological survey of 52 Bulgarian enterprises privatized before 1996. It concludes that as soon as possible, Bulgaria should introduce contemporary standards of corporate governance and procedures that could guarantee responsibility and accountability, transparency in the economy, and control mechanisms within private companies.

Institute for International Economics Publications


Electronic commerce and related activities can be the engines that improve domestic economic well-being through liberalization of domestic services, more rapid integration into globalization of production, and leapfrogging of technology. Electronic commerce integrates domestic and global markets from its very inception. Negotiating on trade issues related to electronic commerce will demand inspection of key domestic policies, particularly in telecommunications, financial services, and distribution and delivery. Rather than view the explosive development of e-commerce with alarm, countries should encourage it as a positive force that engenders deeper liberalization and deregulation throughout the economy.

Lithuanian Free Market Institute Publications

To order: Lithuanian Free Market Institute, Birutes St. 56, 2004 Vilnius, Lithuania, tel.: 370-2-722584, fax: 370-2-721279.


Since the beginning of the transition a decade ago, political and economic reforms in Lithuania have radically changed public policymaking and the functioning of the economy. The importance of foreign trade has increased (exports represent about 45 percent of GDP, imports more than 50 percent), and there has been a significant shift in trade from Eastern to Western markets, particularly the EU. The share of the EU in Lithuania's total trade increased from several percent at the beginning of reforms to about 50 percent in 1999. Over the same period, the share of CIS countries decreased from about 85 to about 20 percent. Preliminary estimates seem to
indicate that the economic effect of EU membership on Lithuania's trade with the Russian Federation is likely to be insignificant. However, the effect will depend on such factors as Russia's accession to the WTO and EU policy toward Russia, especially the implementation of a free trade agreement between Russia and the EU. [The impact of adopting the common external tariff on specific imported products from the Russian Federation to Lithuania and the status of the Kaliningrad region inside the enlarged EU deserve further study.]


Lithuania's securities market was established in 1993 with the adoption of regulatory acts of law and the establishment of agencies essential for the functioning of the market. Market capitalization and turnover have since risen, as have the number of financial intermediaries. With the bourse trading system and its legal basis undergoing constant improvements, the market increasingly attracts the interest of local and foreign investors. Companies still have great difficulty raising funds through securities issues, however, with most ventures finding it impossible to do. Only six stocks are listed on the blue-chip Official List and 47 issues on the Current List of the National Stock Exchange. The main problems of the capital market stem from the absence of institutional investors and petty regulatory constraints on market participants.

Romanian Academic Society Working Papers

Established in 1995, the Romanian Academic Society (SAR) is an independent public policy institute aimed at increasing the participation of Romanian intellectuals in the country's political life and fostering modernization and European integration. The institute's main interests are ethnic relations, local government, the social cost of transition, and education. Address: 15 Petofi Sandor St., Sect. 1, Bucharest, Romania, tel. 401-222-1405, fax: 401-222-1868, email: sar@starnets.ro, Internet: http://sar.org.ro.


This study explores the way Romanian mayors reacted to major reforms in local administration initiated by the government in 1998–99. It is based on a survey of 430 local governments and three previous case studies of local budgets. The study analyzes the factors that can explain variations in six institutional performance indicators (innovation, policy effectiveness, privatization, human resources, communication ability, and attitude toward corruption). It finds that the age, education, and experience of the mayor do not affect performance on any indicator. Party affiliation does not appear to be correlated with performance, although rightist mayors seem less tolerant of corruption.

The regional political culture (the "Transylvanian effect") improves only the "soft" aspects of performance, such as communication capability, and procedural effectiveness. On the "hard" issues, such as budgets, privatization, and, surprisingly, corruption, there are no differences associated with the region. The type of locality matters, but the biggest difference is not between urban and rural areas but between small towns and large cities. Rural local governments appear to be no less able than others to perform their duties effectively. The real problems lie at the level of small towns, some of which have been severely hit by the effects of decentralization, including decreases in revenues, ballooning social obligations (which come on top of already high unemployment), poor infrastructure, and lack of economies of scale of local utilities.


For the unemployed, finding a job in the gray sector is extremely difficult, at least in such regions as Piatra Neamt, where few alternatives exist even for the relatively young, skilled, and entrepreneurial. While in Bucharest the job market is tight and unemployment largely voluntary (or even benefit-induced), in Piatra Neamt about 30 percent of unemployment is caused by the recession and affects people who are more dynamic and flexible than the business environment (small wonder that they work in the underground economy).

Rural Development Institute Publications


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**Other Publications**


In the early 1990s “things can only get better” was the prevailing feeling surrounding the dismantling of the state socialist system and the construction of the new parliametary democracy. From the very early years of transition, however, Hungarians faced large-scale and unexpected hardships in their changing lives, which made them one of the most disappointed nations in Eastern Europe by 1993. In the second half of the 1990s, the policies of the Socialist-Liberal coalition—particularly the positive developments in the enlargement process of the EU and membership in NATO—restored the belief in rapid and successful accession to the major Western economic and security organizations. But, the author warns, further stumbling blocks are expected on the road toward EU accession.


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Papers included in the volume deal with a wide range of topics related to Cuba’s economy and society, including the current economic and political situation, macroeconomics, monetary and fiscal issues, economic reforms, intellectual property and the Internet, transition issues, politics, the role of the private sector in agriculture, public opinion, sugar and agriculture, civil society and transition, tourism, legal issues, and sectoral economic studies.

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To order: LICOS, Centre for Transition Economics, Katholieke Universiteit Leuven, Deberiotstraat 34, 3000 Leuwen, Belgium, fax: (32)1632-6599, email: conny.schuermans@econ.kuleuven.ac.be, or Daniel Piazolo, Kiel Institute of World Economics, Duesternbrooker Weg 120, 24105 Kiel, Germany, fax: (49)431-8814-500, email: dpiazolo@ifw.uni-kiel.de.


The late Mancur Olson summed up his life's work in this short but remarkably insightful book, in which he applies familiar themes from his past work to the late communist world, to the transition from communism to markets, and to the poverty of developing countries. There is first of all the theme of the importance of the "all-encompassing interest" of those in power in the prosperity of the economy. In an insightful metaphor he used in earlier work, a "stationary bandit" is better than a "roving bandit." A roving bandit will take everything; a stationary bandit will have an interest in the continuing prosperity of his victims and so will take less than 100 percent. By the same token, an unstable autocracy will loot more than a stable autocracy, because the stable regime has a longer horizon and thus a more encompassing interest in future prosperity. Olson cites empirical work on developing countries that seems to support his hypothesis that long-lived autocracies perform better than short-lived ones. He devotes a lot of space to one notorious stationary bandit, Joseph Stalin, who offset the disincentives to future wealth creation by engaging in state-led investment. Olson goes into interesting detail on how fiendishly clever Stalin's system of state terror was combined with production incentives. His insights help us understand how Stalinist communism lasted as long as it did.

But even a stable autocracy is not safe for prosperity, because all autocrats die and create succession crises. In the old days, they tried to solve this problem with the heir to the throne approach, although the royal couple was not always sufficiently fertile and younger brothers didn't always go along. Autocrats also have the unfortunate habit of trying to expand their revenues by preying on their neighbors. Democracies do not go to war with each other, as others have pointed out. Most important, democracies that handle the succession problem in a legally stable manner create a more encompassing interest in future prosperity. Such democracies do not appropriate investments or break contracts. Olson points out that virtually all of the richest countries are democracies with legally stable succession processes.

The second theme Olson develops is his now famous insight into the logic of collective action. The most original application of his work in this book is the explanation of the collapse of the Soviet Union and its difficult transition to a market economy. Communism suffered from the same sclerosis Olson noted in industrial countries in his earlier work. That is, over time, interest groups organized and diverted resources from the productive economy into their own hands. In the Soviet Union this took the form of state enterprise managers colluding with both their superiors and other managers to divert resources into their own pockets. The scale of corruption grew so great that the center eventually ran out of resources and imploded.

What about the difficult transition to the market economy? Olson draws an interesting contrast between the collapses of fascism in Germany and Japan after World War II and communism. In the case of the fascist collapse, the victorious Allies swept away all the old collective interest groups and imposed constitutional democracy. In the case of the communist collapse, the collective interest groups of state enterprise managers remained in place. They either slowed privatization or retained control of the "privatized" enterprises, continuing to divert productive resources to themselves.

If there is a problem with this book, it is that its two themes are somewhat contradictory. Stable, long-established democracy is good for prosperity because it creates a more encompassing interest in future prosperity. But long-term stability is bad for prosperity because it leads to interest group sclerosis. This leads to an ambiguous prediction for the long-run future of stable democracies. Olson offers one ray of light in saying that the progress of knowledge could slowly educate the public and break the hold of the interest groups. But for the tragedy of his untimely death, I am sure he would still be educating all of those who have long admired his many insights into power and prosperity.

William Easterly is lead economist, DECRG, World Bank.

*Brain Drain*

From the magazine *Business in Russia*.
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