CHAPTER 5

PROGRESS IN SYSTEMIC REFORMS IN THE CIS

Due to difficult circumstances, including unfavourable initial conditions, the road to a market economy has been problematic for most CIS countries. Economic and political transformation in this region has taken more time to get started than in eastern Europe, and CIS countries have advanced less in market reforms than most of their east European counterparts. Despite recent progress in some countries, the pace of systemic reforms has been uneven. Reforms such as liberalization of prices and foreign trade, the hardening of firms' budget constraints, and the change of ownership over productive assets have advanced most in Russia, but there is not much evidence of sustained liberalization in the CIS as a whole. Progress in other major reform areas such as establishing the rule of law and implementing competition policies, has been slow everywhere. As a result, even when based on private ownership, market structures in the region are marred by significant imperfections. In particular, the ownership structures that emerged as a result of rapid mass privatization programmes, which have often led to enterprises being controlled by management insiders, have had detrimental consequences for corporate governance and restructuring.

The experience of transition in some CIS countries shows that systemic reforms that are not grounded in suitable institutions – including an active and well-organized civil society – are unlikely to deliver successful outcomes. The choice and speed of reforms in individual countries appear to have been closely related to their national institutions, history, economic circumstances and political conditions. In some cases, the consequent failures to establish a system of political contestability and to institute an effective rule of law, have resulted in partial and stalled reforms, where those who gained from the initial wave of reforms block further progress.

5.1 Introduction: approaches to reform

More than a decade after the start of economic and political transformation in the formerly centrally planned economies there is a broad consensus that the countries of eastern Europe have made more progress in market reforms than most of the members of the Commonwealth of Independent States (CIS). While the most advanced reformers are already at the doorstep of the European Union, some CIS economies are still faced with major challenges on their long road towards establishing functioning market economies. This chapter takes a look at the process of economic and political transformation in the CIS and explores some of the factors behind the relatively slow pace of reform in these countries.

At the outset of the transition to market economies in the formerly centrally planned economies in the ECE region, there were different views and visions of transition paths and procedures. The dominant view held that central planning and a market economy define the starting and end-points of transition, while initial conditions and political opportunities shape the appropriate reform policies. The sequence of reforms was determined by the idea that a rapid liberalization of prices, hardening of firms' budget constraints – accompanied by effectual stabilization policies and the rapid privatization of productive assets by a simple change of ownership – would lead to a significant demand for – and the consequent creation of – the rule of law and other market supporting institutions. These, in turn, would induce new entrants to the market and the restructuring of the former, inefficient state owned enterprises, leading to the creation of a functioning market economy. This big bang approach to transition – rooted in the neoclassical economics paradigm – dominated the reform agenda in the early stages of transition with the active participation of the international financial institutions. Proponents of a more gradual approach stressed that liberalization and privatization should develop in line with institutional reforms, which were the key to a successful transition but not "automatically" driven by liberalization and privatization. Apart from a growing support in academia, this emphasis on the need for institution building has from the very start of transition been stressed by the UNECE.[336] Over time, the different views have tended to converge towards a consensus that "if anything, the experience of transition shows that policies of liberalization, stabilization and privatization that are not grounded in adequate institutions may not deliver successful outcomes."[337]

Independent of the reform path chosen, any assessment of the ultimate success of systemic reforms has to answer the basic question, whether and to what extent have the formerly centrally planned economies developed into *private ownership competitive market economies*? Or, equivalently, do voluntary private decisions in the market, exclusively guided by market prices, lead to transactions that represent welfare gains to society?[338] With that question in mind, the following sections differentiate between various elements of reform in the CIS economies: *basic reforms* (liberalization of prices and foreign trade, hardening of firms' budget constraints and the change of ownership of productive assets) set the rules of the game that define the degree to which transactions are indeed guided by market signals. In contrast, *structural reforms* – or market supporting institution building – lay the legal foundations for the exercise of ownership and control rights, and thus define the conditions that influence the degree to which the basic rules actually function; if structural reforms are successfully implemented, they should ensure that price-guided transactions in the market will lead to welfare gains.

On the basis of an account of these different reform elements across the economies of the CIS, later sections of this chapter explore the consequences of CIS reforms for two types of enterprise, namely, new market entrants and the privatized, formerly state owned enterprises. An overall assessment outlines some flaws in the systemic reforms in the CIS. Finally, remaining challenges are outlined, together with an account of the difficulties of implementing market reforms in the CIS – sometimes leading into outright "under-reform traps".[339] These often reflect the specific conditions prevailing in these countries: communist legacies were deeper rooted, the transformational recession was longer and more severe, and the development of democratic institutions, and not least of public governance, in the CIS countries proved more difficult than elsewhere.

Throughout the chapter, eastern Europe's experience with systemic reforms is taken as a point of reference, or benchmark, against which reform progress in the CIS is being assessed. This, however, has to be done with care, taking initial conditions into consideration. As this chapter argues, initial conditions have indeed been more detrimental in the CIS than in eastern Europe, where the reform effort was also supported by the early prospect of eventual EU membership. The bilateral political commitment to EU enlargement has greatly helped reform progress in eastern Europe, an impetus that was not present in the CIS. It is also important to recall that progress in reforms is not tantamount to success of reforms.

5.2 A short history of systemic reforms in the CIS

The start of systemic reforms in the CIS is closely linked to the dissolution of the Soviet Union in December 1991. Most former Soviet republics had already by then declared their independence and were quick to introduce initial reform programmes, accompanied by the substitution of new currencies for the old Soviet – henceforth Russian – rouble.

[336] UNECE, *Economic Survey of Europe in 1989-1990,* pp. 13-17, and "From plan to market: the transition process after 10 years", papers from the ECE Spring Seminar, May 2000, UNECE, *Economic Survey of Europe, 2000 No. 2/3*, pp. 41-145.

[337] G. Roland, "Ten years after … transition and economics", *IMF Staff Papers*, Vol. 48, Special Issue (Washington, D.C.), 2001, p. 30.

[338] K. Arrow, "Economic transition: speed and scope", *Journal of Institutional and Theoretical Economics*, Vol. 156, No. 1, March 2000, p. 11.

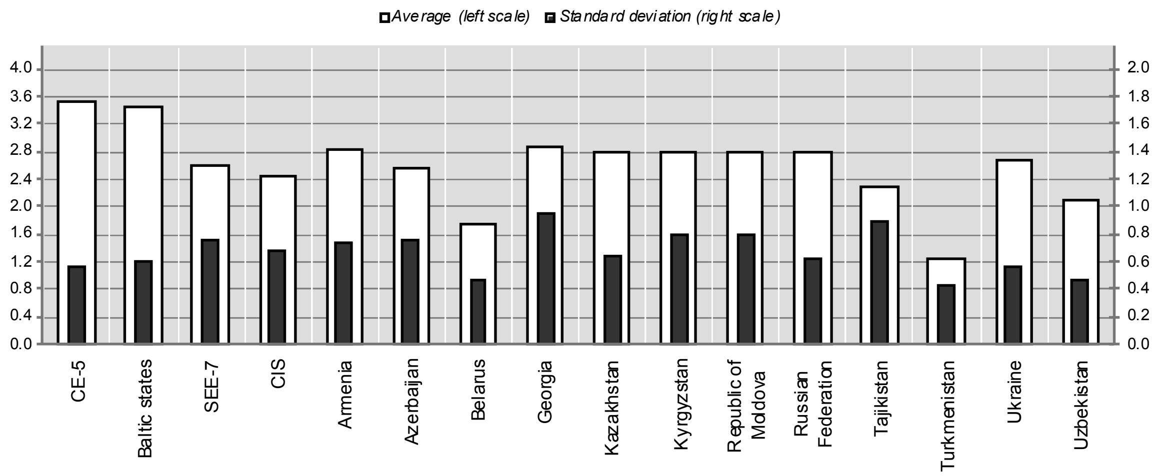
[339] Many CIS countries are considered to have fallen into partial or under-reform traps, where a mismatch between speedy liberalization and privatization, and slow economic and political institution building has enabled powerful interest groups to block further and balanced reform progress in order to safeguard early rents. This problem is discussed extensively in World Bank, *Transition, The First Ten Years. Analysis and Lessons for Eastern Europe and the Former Soviet Union* (Washington, D.C.), 2002.

During 1992, *Russia* implemented big bang reforms as outlined in the previous section: most consumer prices were deregulated and a mass privatization programme was initiated that featured a voucher scheme granting substantial privileges to the managers and workers of privatized industrial firms. This first wave was completed by mid-1994, and a second wave, mostly covering the commodities sectors and utilities, was implemented between 1995-1997. Since January 2000 the Russian government has broken with some of the stop-and-go policies of the past and has perceptibly accelerated the pace of systemic reforms. This led to a comprehensive agenda of legislative reform during 2001: there was a change in the tax code leading to more transparency and uniform treatment, approval of the land code, a pension reform and a significant reduction in the regulatory burden on the economy.

While liberalization and privatization were also the essential building blocks of the reform programmes in the other CIS countries, progress in systemic reform has been rather uneven. Both in Belarus and in the Republic of Moldova, the pace of reform slowed down during the second half of the 1990s; the centralized system of economic management in Belarus still preserves many elements of a centrally planned economy. The focus of recent reforms in Ukraine has been the withdrawal of the state from barter transactions, which eliminate price signals and distort the allocation of resources. Another important area of reform is agriculture, where a land code allowing for the private ownership of land in the medium term has recently been adopted by parliament. Also, parts of the shadow economy have been reintegrated into the official economy thanks to gradual improvements in the tax system and in regulatory policies. During the first half of the 1990s, the economies of the *Caucasian rim* suffered from violent conflict in the region (section 5.6(ii)). As a result, serious economic reforms in Azerbaijan started only in the mid-1990s. Recent structural and institutional reforms include the launching of a new privatization programme and a renewed attempt at deepening trade liberalization and improving the legal and regulatory environment for private sector development. Despite the difficult environment, Armenia and Georgia have a good record of systemic reform: the privatization of small and medium enterprises is by and large complete in both countries, and some large enterprises have been sold to foreign strategic investors. In addition, the Armenian government allowed a land market to develop as early as 1994.

CHART 5.2.1

Overall progress in systemic reforms, 2002



Source: EBRD, *Transition Report 2002* (London), 2002, pp. 20-21; UNECE secretariat calculations.

Note: For each country the chart presents the average and standard deviation of all measures of systemic reform (except infrastructure) as evaluated by the EBRD. This covers the liberalization of prices, foreign trade and access to foreign exchange, small and large-scale privatization, corporate governance and enterprise restructuring, competition policies, banking reform and interest rate liberalization and the liberalization of securities markets and non-bank financial institutions. Regional aggregates refer to simple averages over the respective countries. Measures are all normalized to lie within a range between 1 and 4+ (=4.33). In general, 1 represents no or little progress in a particular area of reform; 2 indicates important progress; 3 is substantial progress; 4 indicates comprehensive progress, while 4+ indicates countries have reached the standards and performance norms of advanced industrial countries.

In the economies of *central Asia*, dominated by natural resources, many reform initiatives have been continually threatened by resistance from vested interests (section 5.6(iii)). The presence of rents from natural resource extraction has reduced the incentives to introduce reforms that might in turn have limited the opportunities for direct rent appropriation.[340] However, Kazakhstan has made substantial progress in liberalizing prices and it maintains a relatively liberal trade regime; small-scale privatization is almost complete, and parts of the infrastructure have been privatized. After an impressive start with liberalization, the pace of systemic reform in Kyrgyzstan has slowed down somewhat since 1997. Tajikistan has made some progress in market reforms only in recent years, in particular with respect to tightening firms' budget constraints and some liberalization of trade since 1997. Small-scale privatization is almost complete, there have been steps towards large-scale privatization and land reform.[341] On the other hand, progress has been very slow so far in Uzbekistan and, especially, in Turkmenistan, the authorities in both countries still maintaining control of prices and the centralized allocation of resources. Privatization in Turkmenistan has been negligible, especially in resource extraction, agriculture and construction, financial intermediation is virtually non-existent and most investment is directly financed by the state.

Summing up, the pace of systemic reforms has been fairly uneven across the CIS economies and in some countries has even been reversed, mostly due to political upheavals, armed conflict, economic crises and vested interests. Chart 5.2.1 presents a tentative summary of reforms in the CIS by showing for each country the simple average of all the indicators of systemic reform as defined by the EBRD. The chart also shows the standard deviation of the indicators, in order to give an idea of both the speed and consistency of reforms. In a regional perspective, chart 5.2.1 makes the obvious point that transition in the central European and Baltic countries is indeed nearing completion, while on average both south-eastern Europe and the CIS still have a considerable way to go.

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[340] A. Esanov, M. Raiser and W. Buiter, *Nature's Blessing or Nature's Curse: The Political Economy of Transition in Resource-based Economies*, EBRD Working Paper, No. 65 (London), November 2001.

[341] About half of all agricultural land had been privatized by early 2000, but with little further progress since then.

None of the CIS economies are among the leading reformers in the ECE region as a whole. However, within the CIS, some countries exhibit both a higher average and a lower standard deviation over all measures of systemic reform than the region as a whole. Thus, a group of relatively fast and consistent reformers is comprised of the largest regional economies, Kazakhstan, Russia and Ukraine. Given the low average and variances of their respective reforms, systemic change in both Belarus and Turkmenistan has been consistently very slow. Systemic reforms have also remained rather slow in Uzbekistan and only slightly faster, but inconsistent, in Tajikistan. Kyrgyzstan, the Republic of Moldova and the three Caucasian rim economies appear to occupy a middle ground, with reforms being either slower or less consistent than for the CIS as a whole.

The following sections will elaborate this very general picture, and bring out the connections between the various elements of systemic reform in the different countries.

5.3 Elements of systemic reform

(i) Liberalization: prices, wages and foreign trade

The unravelling of pre-reform distortions through the liberalization of prices, wages, foreign trade and access to foreign exchange was an easily acceptable and necessary ingredient of systemic reforms. However, some early reformers expected that liberalization – together with stabilization and the hardening of firms' budget constraints – would be sufficient to trigger structural change and greater efficiency in resource use despite a slow pace of institutional transformation.[342]

In line with such expectations, and in the context of an IMF-supported reform agenda, Russia liberalized most consumer prices,[343] introduced a VAT, lifted controls on foreign trade and abolished the state trading monopoly in early 1992. The exchange rate was unified in July 1992, substantial progress in foreign trade liberalization had been made by spring 1996 and was soon followed by the introduction of full current account convertibility. Currently, Russia's accession negotiations with the WTO are picking up speed. Its involvement in regional integration,[344] however, has so far been hampered by differences in the reform commitments of some of the partner countries (chapter 6.2).

The Russian pattern of price and foreign trade liberalization was broadly followed in other CIS countries: in Ukraine and Kazakhstan, most prices were liberalized by the end of 1994, and in Armenia and Azerbaijan by 1995.[345] Uzbekistan eased some price controls in 1995, and Turkmenistan did so in early 1996. However, there has been little sustained effort to liberalize prices in these two countries and in Belarus.

Most CIS countries, except for Belarus, Turkmenistan and Uzbekistan, have made progress in liberalizing trade and foreign exchange, especially with respect to trade with non-CIS countries.[346] Exchange rate unification was introduced in Azerbaijan in March 1995, in Belarus no earlier than in September 2000, and was formally announced in Turkmenistan in April 1998.[347] There is now full current account convertibility throughout the CIS, except in Azerbaijan, Belarus, Turkmenistan and Uzbekistan.[348] Many restrictions on trade, including strong non-tariff barriers such as quotas and licensing requirements, remain in place in Belarus and Turkmenistan. Uzbekistan abolished custom duties and licensing in 1997, but trade and foreign exchange restrictions continue to shelter

[342] A. Berg, "Does macroeconomic reform cause structural adjustment? Lessons from Poland", *Journal of Comparative Economics*, Vol. 18, No. 3, June 1994, pp. 376-409.

[343] An area where price liberalization – in Russia as well as elsewhere in the CIS – has, however, been long delayed is energy. Energy consumption is still subsidized and final user prices do not in general cover costs, which results in wastefully high energy intensity of economic activity, imposes a heavy toll on public finances and discourages investment in this sector. Furthermore, residential tariffs are substantially lower than industrial rates, although the relative costs of supplying both groups of energy consumers would suggest the opposite pricing rule. The problems associated with energy subsidization play an important part in the negotiations for WTO membership that many CIS countries are conducting.

[344] This concerns the Russian-Belarus union and the Eurasian Economic Community between Belarus, Kazakhstan, Kyrgyzstan, Russia and Tajikistan.

[345] Except for a few selected goods, such as petrol in Azerbaijan, there are no administered prices in either country outside the utilities sector.

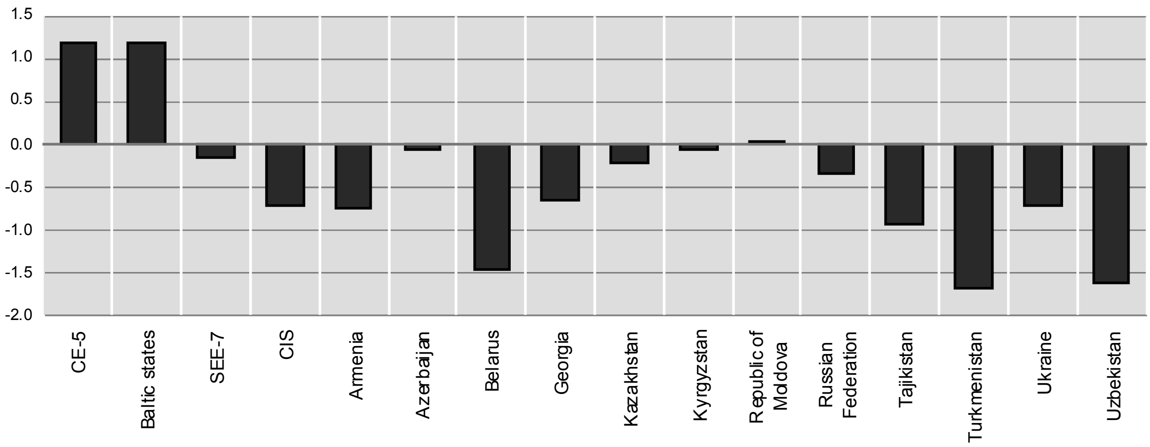
[346] Reform of intra-CIS trade has been slower and remains governed by a substantial amount of policy discretion (chap. 6.2).

[347] However, Turkmenistan continues to maintain de facto a multiple exchange rate regime.

[348] At present, Russia maintains some temporary restrictions on convertibility for current account purposes. These were reintroduced after the August 1998 crisis.

CHART 5.3.1

Indicators of openness in eastern Europe and the CIS, 1998



Source: J. Sachs, C. Zinnes and Y. Eilat, *Benchmarking Competitiveness in Transition Economies*, CAER II Discussion Paper 62, Harvard Institute for International Development (HIID), February 2000, p. 37, table 10.

Note: Openness is an ordinal measure that aims to capture the advantage taken of all the components linking a country to the global economy. These components are grouped into three categories, the regulatory environment, current account activity and capital account activity. They cover general regulations directly impacting commerce and foreign participation in the economy, trade flows and regulatory obstacles impeding them, aggregate financial in- and outflows, and foreign investment participation in the economy. Components are measured so as to ensure their positive correlation with openness, i.e. the ratio of tariff revenues to total imports enters negatively. Correspondingly, very high tariff-import ratios may result in negative openness indicators. SEE-7 in this chart does not include Bosnia and Herzegovina and Yugoslavia.

domestic industries and it still maintains a multiple exchange rate system.[349]

Foreign trade reforms have so far made WTO membership possible for only four countries in the region – Armenia, Georgia, Kyrgyzstan and the Republic of Moldova. Many CIS countries are still conducting their trade exclusively on the basis of bilateral agreements and are not yet parties to multinational arrangements. As of December 2002, seven CIS economies were still negotiating their accession to the WTO. Among them, Kazakhstan, the Russian Federation and Ukraine have reached a more advanced stage in the negotiation, while Azerbaijan, Belarus, Tajikistan and Uzbekistan are still lagging somewhat behind. Turkmenistan has not yet started negotiations. In a comparative perspective (chart 5.3.1), by 1998 the CIS economies had achieved significantly lower degrees of openness than the central European and Baltic countries.

Hardly anywhere in the CIS, however, has liberalization proceeded smoothly, and in some cases gains have even been reversed: six months after the outbreak of civil war in Tajikistan, the deregulation of prices was partially reversed in early 1993 and by the end of the year wage indexation was introduced. Belarus reintroduced price controls at the end of 1996, barely one and a half years after deregulation; the scope of administrative price controls were relaxed only in the spring of 2001. Most notably, in the wake of the Russian crisis of the summer of 1998 temporary restrictions of trade and foreign exchange were reintroduced in Kazakhstan, Russia and Ukraine (chapter 6.2(i)). Uzbekistan had already reverted to more rigid price, trade and foreign exchange controls in 1997.

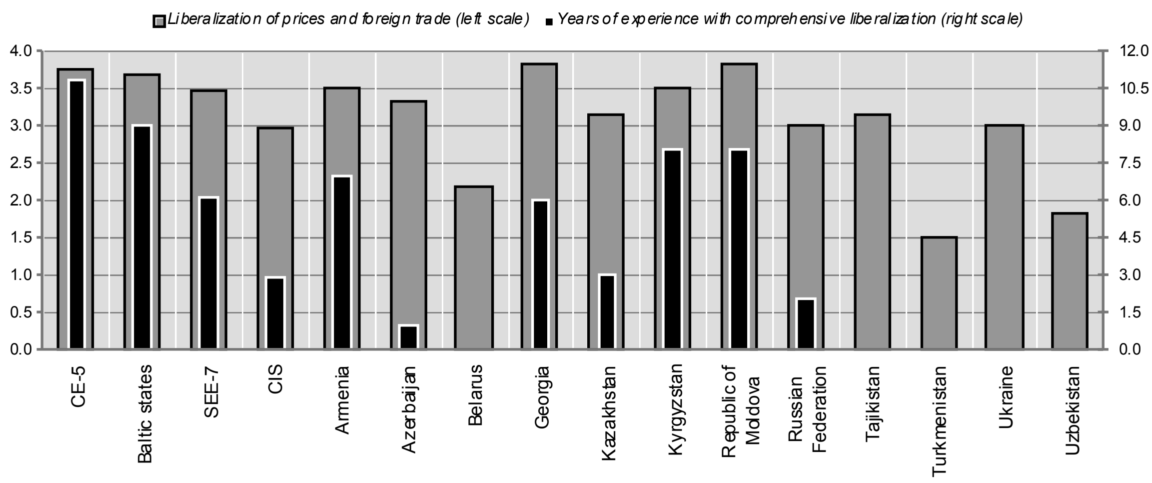
Consequently, as far as overall progress in price and foreign trade liberalization is concerned, chart 5.3.2 paints a disappointing picture for the CIS as a whole compared with the most advanced east European reformers. More than a full decade into transition, most CIS economies are still without truly comprehensive price and trade liberalization.[350]

[349] Currently, this comprises an official rate and a rate at which banks may buy hard currency from (but not sell to) their customers.

[350] Comprehensive liberalization of prices and trade is defined here as a score of at least 3- on the EBRD scale for price liberalization and at least 4- for foreign trade and exchange liberalization. This roughly corresponds to the average state of liberalization in the CIS as described above. In addition, this also requires the removal of all quantitative and administrative import and export restrictions and export tariffs, the absence of non-uniform customs duties for non-agricultural goods and services, and full current account convertibility.

CHART 5.3.2

Comprehensive liberalization of prices and foreign trade in eastern Europe and the CIS, 2002



Source: EBRD, *Transition Report 2002* (London), 2002, pp. 20-21; UNECE secretariat calculations.

Note: Liberalization of prices and foreign trade is measured by the average EBRD score for both categories. Comprehensive liberalization is defined as a score of at least 3- on the EBRD scale for price liberalization and at least 4- for foreign trade and exchange liberalization.

Chart 5.3.2 also shows the number of years for which each country has sustained comprehensive liberalization since 1989. The picture here is even less satisfactory. First, the difference between country groups is striking: 12 years of transition have resulted in almost 11 years of comprehensive liberalization in central Europe but, on average, barely three years in the CIS. Almost half of the 12 CIS economies have not had a single year of comprehensive liberalization. As there have recently been some reversals of liberalization in two of the relatively more advanced reformers, Kazakhstan and Russia, only four CIS economies qualify as featuring both sustained and comprehensive liberalization: Armenia, Georgia, Kyrgyzstan and the Republic of Moldova. This apparent lack of momentum in the liberalization of the CIS economies may have contributed to the delay in their structural reforms.

(ii) Taxes and subsidies: hardening budget constraints

The pre-reform tax system in the former centrally planned economies was deeply distortionary. Tax revenue came mostly from turnover, payroll and other taxes on enterprises. Transition has brought about systematic changes in the tax burden and the tax structure. The ultimate aim is to replace the old discretionary system of taxation with a more rules-based system, increasing the uniformity of treatment, reducing the subsidization of state owned enterprises and effectively hardening their budget constraints.[351]

Although a VAT was introduced already in 1992, a major tax reform was launched in Russia only in July 1998 and has been gradually implemented since then. It aims to lower the overall tax burden by reducing the number and discretionary nature of taxes and to broaden the tax base by minimizing the number of exemptions and improving tax administration.[352]

Elsewhere in the CIS, apart from the introduction of VAT, tax codes have also been slow to change. Exceptions are rare, and early attempts at tax reform are not necessarily evidence of a systematic or consistent approach: in the Republic of Moldova, a new tax code was introduced already in 1992, but major tax exemptions were removed only in summer 1998. Ukraine adopted an income tax law at the beginning of 1993 and introduced a new corporate profits tax two years later.[353] In the

[351] R. Dobrinsky, "Tax structures in transition economies: a comparative perspective vis-à-vis EU member states", paper presented at the East-West Conference on *Structural Challenges and the Search for an Adequate Policy Mix in the EU and in Central and Eastern Europe* (Vienna), 4-5 November 2002 [www2.oenb.at/tagung/ostwest2002/paper/dobrinsky-long.pdf].

[352] Thus, since January 2001 a flat personal income tax has been in place. Also, the destination principle for VAT on non-energy trade with CIS countries has been applied since July 2001.

[353] Broadening the tax base is currently on the agenda, together with simplification of both the corporate tax and VAT laws, under pressure from the large accumulation of overdue VAT refunds to exporters.

TABLE 5.3.1

Official budget subsidies to firms in eastern Europe and the CIS, 1992-2000

(Per cent of GDP)

	1992	*1994*	*1997*	*2000*
CE-5 [a]	4.08	3.84	3.46	4.18
Baltic states	..	1.10	2.13	2.00
SEE-7 [b]	6.28	2.26	1.00	1.12
CIS				
Armenia	..	12.8	0.6	..
Azerbaijan	11.2	5.4	0.7	0.2
Belarus	8.7	4.4	4.7	6.7[c]
Georgia	..	13.8	2.2	2[c]
Kazakhstan	..	3.2	1.8	0.7[c]
Kyrgyzstan	..	2.1	2.2	2.2[c]
Republic of Moldova	..	..	..	..
Russian Federation	..	..	8.5	5.3[c]
Tajikistan	10.9	10.9	1.1	0.7
Turkmenistan	..	1.6	0.6	..
Ukraine	..	13.3	5.0	..
Uzbekistan	10.7	2.7	3.2	..

Source: EBRD, *Transition Report 2001* (London), 2001.

a CE-5 aggregates contain 1993 (instead of 1992) data for the Czech Republic, and 1999 (instead of 2000) data for Hungary and Poland.

b SEE-7 aggregates contain 1999 (instead of 2000) data for Bosnia and

Caucasian rim, Georgia established both an income tax law and a new corporate profits tax already in 1992, but tax revenues remain among the lowest in the region. Armenia significantly simplified its tax law at the end of 2000 after a major tax reform in 1997. Progress in central Asia accelerated with the introduction of new tax codes in Kazakhstan in mid-1995 (further simplified in 2001), in Kyrgyzstan one year later, and the launching of a major tax reform in 1999 in Tajikistan. While Turkmenistan enacted a flat income tax rate in mid-1995, Uzbekistan introduced a new tax code in early 1998, but failed to eliminate differential treatment across sectors.

However, even after these reforms, the overall tax burden and the contributions of different taxes differ considerably both among the CIS countries and in comparison with the east European and, especially, EU economies. The efficiency of tax collection in the CIS is also rather low by international standards.[354]

Of particular interest, however, is the effect of tax reform on the subsidization and the financial discipline of firms. Under the former system of central planning, state owned firms operated under soft budget constraints: guaranteed government bailouts implied by the total absence of a credible bankruptcy threat, and various sorts of subsidies and soft credits were readily available to enterprises.

Direct government subsidies from the budget were already comparatively low in central Europe at the beginning of the 1990s, but have not declined since then, as they have elsewhere (table 5.3.1). However, these official budget data significantly understate the true levels of government support:[355] data from the World Bank's 1999 Business Environment and Enterprise Performance Survey Project (BEEPS) reveal that in all CIS countries (except Belarus and Uzbekistan, with Turkmenistan not reporting) more than 10 per cent of firms assess overdue government taxes as "substantial".[356]

354 The average tax burden in the EU is about 41 per cent of GDP, while in eastern Europe it is around 33 per cent, but 22 per cent in the CIS. The degree of tax compliance and the level of per capita income are positively correlated over all these countries. With regard to the shift towards a higher direct taxation of individuals, the east European countries have made more progress than the CIS. R. Dobrinsky, op. cit., pp. 12 and 17.

355 State financial aid to ailing state owned firms may take various forms such as direct budgetary subsidies, debt forgiveness, subsidized government credit, accumulation of tax arrears and accumulation of credit arrears to state owned banks or other state owned firms, in particular utilities. In various combinations, all of these exist in transition economies.

356 In Georgia, this figure reached 28.1 per cent, whereas it was only 3.5 and 4.1 per cent in the Czech Republic and Hungary, respectively. Data are from the 1999 BEEPS Dataset, covering 4,000 firms in 24 transition countries over 1999-2000 [info.worldbank.org/governance/beeps/].

Table 5.3.2 shows a specific indicator of the incidence of soft budget constraints, namely individual firms' assessments of their tax arrears to central and local government, and their payments arrears to utilities. It should be noted that many other institutional weaknesses may add to the continuing softness of firms' budget constraints, such as the possibility of accumulating wage arrears and obtaining soft credits from banks under state influence. Also, the increase in barter transactions facilitates tax evasion. Consequently, the figures in table 5.3.2 provide only a limited assessment of the incidence of soft budget constraints.

To summarize, the data show that liberalization has not always been accompanied by the hardening of budget constraints:[357] the Caucasian countries that did relatively well in terms of price and trade liberalization, perform significantly worse than the rest of the CIS in imposing hard budgets on firms. Two other fast liberalizers, Kyrgyzstan and the Republic of Moldova, both rank at the bottom of their respective regional groupings with respect to the hardness of budget constraints. According to the data in the table, budget constraints appear to be relatively hard in Belarus and Uzbekistan, two of the less advanced liberalizers. This observation, however, needs some qualification: in Belarus firms receive substantial state aid in the form of soft credits, making it unnecessary for them to revert to tax and payments arrears (a substitution that may also be at work elsewhere).

(iii) Privatization: change of ownership

Transition to a market economy involves a fundamental reduction of the role of the state in the economy, especially with respect to the ownership and control of productive assets. The theoretical case for privatization lies in the nexus between incentives and efficiency in addition to the soft-budget problem discussed above.[358] Accordingly, privatization – in the simple sense of a change of ownership from state to private hands – was seen in the early days of transition as the most important way to separate the functions of the state from the activity of the enterprise sector in order to focus firm managers' incentives on profit and efficiency objectives.

Progress in privatization differs markedly across the CIS economies, all of which started out with insignificant private sectors in the early 1990s. The change in ownership has been greatest

TABLE 5.3.2

Soft budget constraints in eastern Europe and the CIS, 1999-2000

Regional measures of soft budget constraints	
CE-5 and Baltic states	0.14
SEE-7	0.18
Russian Federation	0.18
Other European CIS	0.15
Caucasian rim countries	0.31
Central Asian CIS countries	0.13
Individual country rankings	
CE-5	
Hungary	3
Poland	9
Slovakia	15
Slovenia	19
Czech Republic	20
Baltic states	
Estonia	1
Lithuania	5
Latvia	10
SEE-7	
The former Yugoslav Republic of Macedonia	2
Bulgaria	6
Albania	11
Bosnia and Herzegovina	13
Romania	13
Croatia	22
CIS	
Belarus	3
Uzbekistan	6
Kazakhstan	8
Kyrgyzstan	11
Republic of Moldova	15
Russian Federation	15
Ukraine	15
Armenia	21
Azerbaijan	23
Georgia	24

Source: W. Carlin, S. Fries, M. Schaffer and P. Seabright, *Competition and Enterprise Performance in Transition Economies: Evidence from a Cross-country Survey*, EBRD Working Paper, No. 63 (London), June 2001.

Note: Measures of soft budgets are based on the ratings by firms of

357 The same source also reveals that budget constraints were softer for old than for new firms, and that softness increases with firm size.

358 This link comes in two strands: first, the state may be unable to monitor the managers of state owned firms due to the lack of a credible threat of takeover or bankruptcy. The second stresses the danger of firm objectives being diverted from profit maximization by political interference.

in Armenia, Georgia, Kazakhstan, Russia and Ukraine. Very little progress has been made in Belarus and Turkmenistan (table 5.3.3). While small enterprises were often privatized in the early stages of transition, mostly through local auctions, their significance generally remains small (section 5.4(ii)).[359]

As part of the Russian reform, a mass privatization programme for medium and large enterprises, based on vouchers distributed to the population at large, was adopted in mid-1992.[360] Small- and large-scale privatization started in Ukraine as early as March 1992, but progress has since been drawn out. In the Republic of Moldova, most of the ownership changes were registered in 1995. Belarus formally introduced small-scale privatization in October 1990,[361] and a voucher scheme for privatization got underway in Spring 1994, but both programmes have had only limited success.

More successful privatization programmes were launched in the Caucasian rim: in Armenia, the privatization of small firms started in May 1991, and voucher privatization began in October 1994. A recent new programme aims to finalize privatization by 2003. Georgia's successful small-scale privatization started in March 1993,[362] large-scale privatization in mid-1995. After a comparatively late start in 1997, privatization in Azerbaijan virtually stopped in 1998-1999 and a new programme has only recently been approved.[363]

The change in ownership has been slower in central Asia. In Tajikistan, small-scale privatization started at the end of 1991, but progress has been slow, while for medium and large firms it gained moderate momentum only in 1996. Progress has also been moderate in Uzbekistan, where small- and large-scale privatization started in 1993 and 1994, respectively. Since adopting a privatization programme in 1994, Turkmenistan has so far made little progress. Kyrgyzstan made significant advances in large-scale privatization during 1994, but the programme was stopped in 1997 as a result of concerns over transparency and its effectiveness. Early in 2002 a new programme was adopted to privatize about 400 enterprises within two years. Kazakhstan's speedy and reasonably successful voucher scheme began in April 1994 and was completed two years later.

359 However, many small businesses in the CIS are likely to be in the informal sector and may thus not be reported in official data.

360 The Russian voucher scheme, however, was designed to resemble a management-employee buyout: it granted substantial privileges to firm insiders enabling them to obtain significant fractions of shares either for free or at significant discounts. For details see P. Hare and A. Muravyev, *Privatization in Russia*, Russian-European Centre for Economic Policy, Research Paper Series (Moscow), August 2002. By mid-1994, when the first programme ended, firm insiders held about 70 per cent of privatized shares, which in turn accounted for some 30 per cent of Russian industry. This rather concentrated ownership structure was also due to the emergence of a secondary market. Moreover, in the absence of any capital market regulation, secondary trading was probably far from being fair. While this first privatization phase arguably favoured the old Soviet *nomenklatura,* which held the managerial positions within former state owned firms, it was the second phase of privatization between 1995-1997 that did much to create the new Russian *oligarchy*, i.e. "… a small group of bankers and industrialists who received billions of state assets in exchange for help in re-electing President Yeltsin". K. Hoff and J. Stiglitz, "After the big bang? Obstacles to the emergence of the rule of law in post-communist societies", World Bank (Washington, D.C.), September 2002, mimeo, pp. 7-8.

361 So far less than half of small enterprises have been privatized.

362 About four fifths of all small- and medium-sized enterprises are now private.

363 However, foreign investment in the oil and gas sector has been attracted by production sharing agreements since 1994.

TABLE 5.3.3

Private sector shares of GDP (2002) and privatization methods in eastern Europe and the CIS

	Private sector share of GDP	*Primary method*			*Secondary method*		
		Direct sales	*Management-employee buyouts*	*Vouchers*	*Direct sales*	*Management-employee buyouts*	*Vouchers*
CE-5							
Czech Republic	80			+	+		
Hungary	80	+				+	
Slovakia	80	+					+
Poland	75	+				+	
Slovenia	65		+				+
Baltic states							
Estonia	80	+					+
Lithuania	75			+	+		
Latvia	70			+	+		
SEE-7							
Albania	75		+				+
Bulgaria	70	+					+
Romania	65		+		+		
Croatia	60		+				+
The former Yugoslav Republic of Macedonia	60		+		+		
Bosnia and Herzegovina	45						
Yugoslavia	40						
CIS							
Armenia	70			+		+	
Russian Federation	70			+	+		
Georgia	65			+	+		
Kazakhstan	65			+	+		
Ukraine	65			+		+	
Azerbaijan	60			+	+		
Kyrgyzstan	60			+		+	
Republic of Moldova	50			+	+		
Tajikistan	50		+				+

Table 5.3.3 reveals significant differences in privatization strategies as well as varying progress in privatisation across countries. Most significantly, in virtually no CIS country were direct sales of individual enterprises to strategic investors the primary method of privatization: they were secondary and mostly used in natural resource rich economies.

While direct sales have the disadvantage of being relatively slow, they generate both government revenue and outside investment for enterprise restructuring as well as facilitating the transfer of managerial know-how. Mass privatization, on the other hand, promises a quick change of ownership, either in the form of insider privatization (i.e. management or employee buyouts) or as give-away or voucher schemes to the citizenry at large. Compared with direct sales, however, these methods generate neither new investment nor government revenue, and are not accompanied by the transfer of managerial know-how. Table 5.3.3 confirms that most CIS countries opted for a quick change of ownership through management-employee buyouts or voucher schemes. The proponents of mass privatization had hoped that such an approach would eventually lead to a concentrated group of outside owners, as a result of their buying out the first post-privatization owners on the secondary market.[364] This hope did not turn out as expected, because the

[364] M. Boycko, A. Shleifer and R. Vishny, *Privatizing Russia* (Cambridge, MA, MIT Press, 1995).

most active participants on the secondary market were powerful insiders, especially managers. As a result, enterprises in the CIS are now mostly owned by a combination of dominant management insiders and dispersed worker-owners and

Box 5.3.1

Land reform in the CIS

Land reforms in the transition economies consist of three elements: the privatization of land (in the sense of a change of ownership), the breakup of large-scale state and collective farm land holdings into smaller units and the establishment of unrestricted transferability of land.[1] Land reform is important for developing property rights, improving the investment climate in general and for raising agricultural productivity, which is crucial for the largely agricultural economies of the Caucasian rim and central Asia. However, private land ownership and agricultural reforms have been slower to develop than the privatization of other assets.

In Russia, private land ownership was already guaranteed in the 1991 constitution. But it was only in 2001 that a new Land Code was adopted – enacted in January 2002 – that effectively regulated the ownership, transfer and collateralization of commercial and residential land, household plots and family farms. A separate law on the ownership and exchange of farm land was adopted in July 2002.

Throughout the 1990s, land and agricultural reform in Ukraine tended to follow developments in Russia with a lag. As in the Russian constitution, Ukrainian law foresaw the creation of private farms already in 1992, but it took until October 2001 for the Rada to adopt a Land Code providing for the sale and purchase of agricultural land from January 2005.

Elsewhere, progress has been even less impressive. In most countries, land reforms were decreed during the 1990s, in principle paving the way for private land ownership. However, the registration of private titles has been slow, with few exceptions: land reform in Armenia began in 1991, and trade in land was permitted in spring 1994. During 1995-1998, 90 per cent of the land in Azerbaijan was privatized. But, at the other end of the scale, the state has retained control over land in Uzbekistan.[2]

Agricultural land reform in the CIS has generally proceeded in two steps: first, state farms were transformed into collective farms, and then individuals received certificates entitling them to land in collective ownership. However, these certificates do not represent physical plots of land. Consequently, Russian and CIS land reforms have not resulted in clear property rights over individual plots of land. This is strikingly different from land reform in central Europe, where a variety of procedures, including restitution, voucher privatization, the leasing of state land and outright distribution to rural households, have led to relatively clear property rights over individual plots.[3]

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1 R. Cech et al., "Discussion on land privatization in Russia: the intersection of economic and political problems", *Economic Systems*, Vol. 26, No. 2, June 2002, p. 163. The link between plot size and efficiency is far from straightforward. Breaking down large farms into many small plots may not create the potential for higher efficiency despite the change in ownership. Consolidation of land ownership only via the market, however, may in the long run result in unintended large farm ownership patterns due to scale economies in production and in the access to finance and services. Setting up rural credit associations, for example, may provide an alternative approach.

outsiders. In many cases, the state has retained significant ownership stakes.[365]

Considering the information presented so far, it might be useful to return to the question posed in the introduction, namely, whether and to what degree basic reforms (i.e. the liberalization of prices

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365 The state share averages more than 15 per cent of privatized firms in Albania, Belarus, Georgia, Lithuania, Poland, Romania, Russia and Ukraine, and more than 30 per cent in Bulgaria, Croatia, Slovenia and Uzbekistan. J. Bennett, S. Estrin and J. Maw, *Mass Privatization and Partial State Ownership of Firms in Transition Economies*, CEPR Discussion Paper, No. 2895 (London), September 2001. In 37 per cent of firms the Russian state retained more than a 20 per cent share, and in 14 per cent of privatized firms it was more than 40 per cent. J. Earle and S. Estrin, *After Voucher Privatization: the Structure of Corporate Ownership in Russian Manufacturing Industry*, CEPR Discussion Paper, No. 1736 (London), December 1997.

and foreign trade, the hardening of firms' budget constraints and the change of ownership) have introduced market signals to guide voluntary transactions. The previous sections suggest that in this regard most progress within the CIS has been made in Russia and perhaps in Kazakhstan and Kyrgyzstan. However, basic systemic reforms in the CIS region have so far been generally far less consistent and successful than those in eastern Europe, and have not yet laid solid foundations for a market economy. No CIS economy is comprehensively liberalized, predominantly privately owned and populated by firms with hard budget constraints.

(iv) Legal reform

(a) Instituting the rule of law

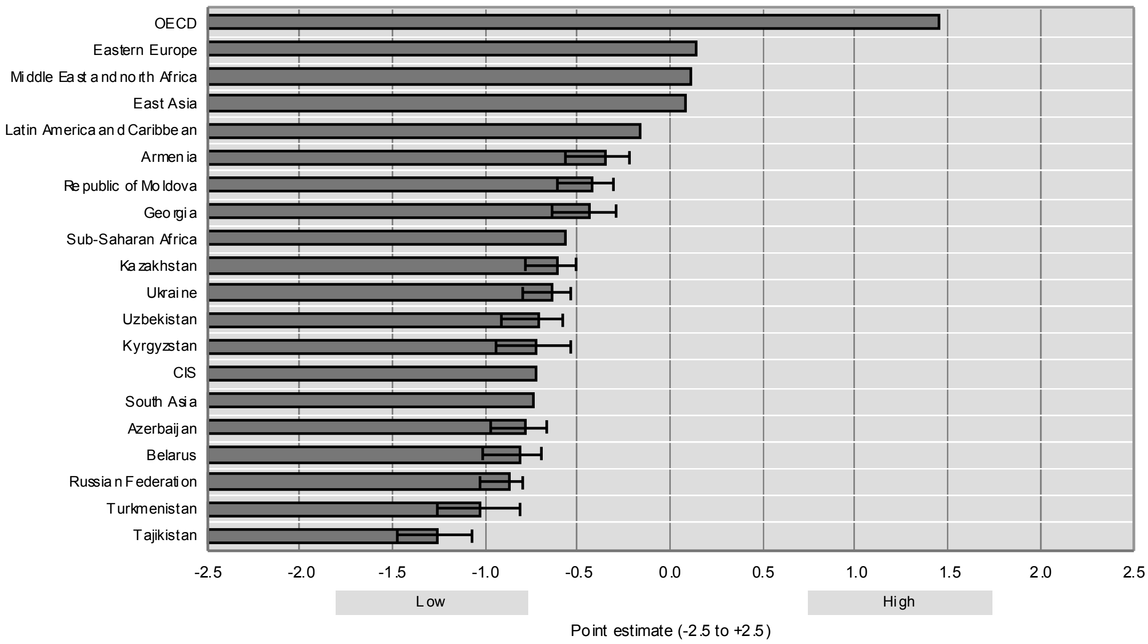
The original approach to reform, based on the neoclassical economics paradigm, foresaw that the basic reforms outlined in sections 5.3(i)-(iii) would in due course induce the creation of market-supporting institutions, including the rule of law. Rapid privatization was initially thought to be the best approach in this respect, as it was assumed that "granting individuals the *control* of property would create a political constituency for the rule of law, where there is *protection* for private property rights".[366] However, in virtually all transition economies, including eastern Europe, progress in establishing legal systems to support the development of a market economy and especially to protect private property rights has been slow.[367] Basically, the general underestimation and even neglect of the importance of adequate institution building for the general success of the transition process was a major weakness of the reform efforts in the early stages of transition.

[366] K. Hoff and J. Stiglitz, op. cit., p. 1.

[367] The apparent lack of a market-oriented legal structure has been described as the "Achilles heel" of the first dozen years of transition. J. Svejnar, "Transition economies: performance and challenges", *Journal of Economic Perspectives*, Vol. 16, No. 1, Winter 2002, p. 7.

CHART 5.3.3

The rule of law in selected regions, eastern Europe and the CIS, 2000-2001



Source: World Bank Institute, 2001 Governance Indicators, Interactive Governance Web Tool [info.worldbank.org/governance].

Note: The rule of law is measured by the extent to which agents have confidence in and abide by the rules of society. These include perceptions of the incidence of both violent and non-violent crime, the effectiveness and predictability of the judiciary and the enforceability of contracts. Together, these indicators measure the success of a society in developing an environment in which fair and predictable rules form the basis for economic and social interactions. Higher point estimates imply better ratings (subject to a margin of error; the 90 per cent confidence level is indicated by a thin black line). The data reflect the perceptions of a large number of survey respondents in industrial and developing countries, as well as non-governmental organizations, commercial risk rating agencies and think-tanks during 2000 and (up to mid-) 2001.

Chart 5.3.3 gives a rather gloomy picture of the development of the rule of law in the CIS, and especially in Russia, as compared with other regions in the world. Interpreting the rule of law as the existence of well-defined and enforceable property rights, including broad access to such rights, and predictable rules for resolving disputes, it is obvious that there are a number of obstacles to the institution of the rule of law in post-communist societies.[368] On the "supply" side, governments may simply be unable to collect enough taxes to finance a market-supporting legal system or to guarantee effective judicial enforcement of legal rules. Sustaining demand for the rule of law over time may also be problematic, because short-term losses from reform may turn part of the electorate against reform in general, and the institution of law in particular, while short-term winners may be tempted to block further institutional reform in order to safeguard newly acquired rents. Strong pressure from interest groups might emerge from the reform process itself:[369] as section 5.4(i) demonstrates, the modalities of privatization in the CIS have tended to favour asset stripping rather than productive investment and enterprise restructuring by the new owners. This probably holds even more strongly in economies – such as many in the CIS – that are dominated by non-renewable natural resources rather than by manufacturing industry.[370]

The initial faith in market-driven institutional development has not been supported by experience. The prevailing expectation now is that the early post-privatization asset strippers will

[368] As discussed in K. Hoff and J. Stiglitz, op. cit.

[369] See the contributions in "Creating a supportive environment for business enterprise and economic growth: institutional reform and governance", papers from the ECE Spring Seminar, May 2001, UNECE, *Economic Survey of Europe, 2001 No. 2,* Part Two, pp. 49-147.

[370] The interdependence between resource intensity and reform progress is discussed in more detail in sect. 5.6(iii). Expanding the natural resource concept to "commodity-intensive economies" shows the pervasiveness of these problems for all CIS economies except Belarus and the Republic of Moldova, see chap. 6.2.

turn to supporting the establishment of the rule of law in order to secure public protection of their gains.[371] However, this view could also be flawed if successful asset strippers prefer to buy occasional discretionary treatment rather than submit to the consistent application of the rule of law, which would hamper further predatory opportunities. Nor should the damage already done to society's view of fairness and moral credibility, without which a rule of law is not sustainable, be underestimated.

(b) Commercial law and competition policy

Often motivated by preparations for membership in international organizations, such as the WTO or the Council of Europe, most CIS countries have made progress in recent years in reforming their commercial legal environment. The main problem with the development of *commercial law* in the region is a serious shortfall in implementation and enforcement. This is often the result of laws, norms and standards not being sufficiently clear or accessible, or not receiving adequate administrative and judicial support. Sometimes it is due to outright corruption. This enforcement gap erodes confidence in the legal system, especially insofar as it affects market agents' perception of its ability to guarantee contracts and property rights. As a result, the quality of commercial laws and their enforcement in the CIS economies are in general well below internationally acceptable standards, which has a discouraging effect on investment.

However, there are significant differences across CIS countries: relatively more progress has been achieved in countries such as Kazakhstan, the Republic of Moldova and Russia. The former probably has assumed a leading role within the CIS in terms of the modernization of commercial and financial law. The least developed countries, where the legal and regulatory framework fails to provide clear and transparent rules in support of effective markets are Armenia, Azerbaijan, Tajikistan and Turkmenistan.

Across all the transition economies, progress in introducing *competition policies* also varies substantially.[372] While central European and Baltic countries have reduced significantly entry barriers and have introduced some measures to prevent the abuse of market power, south-eastern Europe and the CIS lag far behind in this respect. In general, the CIS economies have hardly passed the legislation and set up the institutions for effectual competition policy. The enforcement of legislation against the abuse of market power is in its infancy at best. The slow progress in this area is rather general among the CIS economies, with Russia and Ukraine slightly ahead of the others, although Turkmenistan appears to be the only country not to have made any progress at all so far.

5.4 Effects of systemic reform on old and new firms

(i) Privatization and restructuring

According to the neoclassical conceptual framework embodied in most of the early reform programmes, privatization – in the sense of change of ownership of productive assets – had been expected to lead quickly to enterprise restructuring by the new owners. However, especially in the cases of insider and mass privatization, leading to dispersed ownership and weak corporate control, rather than restructuring the firm, new manager-owners or majority shareholders often ended up appropriating profits or even stripping assets at the expense of minority shareholders.

Various arguments were soon offered to explain the lack of effective firm restructuring after privatization in the CIS, such as a lack of competition and openness, political pressure and so on.[373] The general neglect of corporate governance and the distorted governance structures that emerged in the wake of privatization helped to encourage asset stripping and impede the process of enterprise restructuring. In addition, in most CIS economies, market structures are usually dominated by a small number of large companies that play a special role in the economy as a whole. Consequently, they may avoid restructuring since the market exit of insolvent firms is not enforced and soft budget constraints are still in place (table 5.3.2). Finally, the continuing presence of the state as a residual owner does not always encourage the restructuring of privatized enterprises.

[371] See the discussion in C. Freeland, *Sale of the Century: Russia's Wild Ride from Communism to Capitalism*, (New York, Random House, 2000).

[372] EBRD, *Transition Report 2002* (London), 2002, p. 20.

[373] S. Guriev and B. Ickes, "Growth through restructuring", *EERC Research in Transition Newsletter on Institutional Development and Economic Growth in Russia*, No. 5 (Moscow), December 1999.

There are significant regional differences in governance and enterprise restructuring among the transition economies: central Europe and, to a slightly lesser extent, the Baltic states have been making significant and sustained efforts towards effective corporate governance, assisted by hardened budget constraints. In this regard the CIS countries are somewhat behind: in general they have made limited progress in strengthening corporate governance and in enforcing supporting measures in the areas of credit and subsidy policies, bankruptcy legislation and increasing competition.[374] While CIS countries as a whole show little difference in their corporate governance and restructuring achievements, recent developments in Russia have been more notable:[375] together with Armenia, Russia has made the most progress in this area, while firms in Belarus and Turkmenistan appear to have done virtually nothing to restructure the enterprise sector.

It is now widely accepted that a change in the ownership of productive assets does not by itself bring about (microeconomic) firm restructuring or (macroeconomic) GDP growth. Such positive effects require privatization to be accompanied by other basic and structural reforms, such as the imposition of hard budget constraints, market-oriented competition policy and corporate governance, and development of the financial sector.[376]

There are, however, some nuances in findings on the interplay between the simple change of ownership and other reforms: empirical studies of the effect of privatization and supporting reforms on *firm performance* in general conclude that there is a discernible positive impact of ownership change, which, however, is significantly stronger in eastern Europe than in the CIS.[377] This conclusion raises the question as to whether there is a systematic interdependence between different privatization methods and subsequent restructuring effects: as shown above (table 5.3.3) dominant management-insider and diffused worker and outsider patterns of ownership are more common in the CIS than in eastern Europe. However, such patterns of ownership have had different effects on enterprise restructuring in the various regions.[378] Research suggests that change of ownership, hard budget constraints and product market competition, especially foreign competition, have all had a significantly positive impact on enterprise restructuring in eastern Europe, but have all been less effective in the CIS. Accordingly, both the different structures of ownership and the level of supporting reforms may help to explain the significant differences in post-privatization restructuring between the CIS and eastern Europe.

Empirical work has found it harder to identify a discernible positive impact of privatization on the *macroeconomic performance* of transition economies. Deep, supporting institutional reforms seem to be a necessary prerequisite for positive effects from privatization, and the more comprehensive the supporting institutional reforms, the greater the impact of the ownership change on macroeconomic performance.[379] Privatization may even have a negative impact on macroeconomic performance if the supporting institutional reforms fail to reach a certain "threshold" level.[380] Again, there appear to be significant regional differences: in general, the scale of supporting institutional development in eastern Europe was sufficient for privatization to have a

[374] EBRD, op. cit., pp. 20-21.

[375] A new corporate governance law, together with current revisions to the bankruptcy law, have improved shareholder protection, creditor rights and information disclosure.

[376] This view is now supported by a substantial amount of research: J. Svejnar, "Transition economies: performance and challenges", *Journal of Economic Perspectives*, Vol. 16, No. 1, Winter 2002, pp. 3-28; S. Djankov and P. Murrell, "Enterprise restructuring in transition: a quantitative survey", *The Journal of Economic Literature*, Vol. 40, No. 3, September 2002, pp. 739-792, summarizing the conclusions from more than 100 empirical studies; C. Zinnes, Y. Eilat and J. Sachs, "The gains from privatization in transition economies: is 'change of ownership' enough?", *IMF Staff Papers*, Vol. 48, Special Issue (Washington, D.C.), 2001, pp. 146-170; W. Carlin, S. Fries, M. Schaffer and P. Seabright, *Competition and Enterprise Performance in Transition Economies: Evidence from a Cross-Country Survey*, EBRD Working Paper, No. 63 (London), June 2001.

[377] S. Djankov and P. Murrell, loc. cit.

[378] Especially, S. Djankov and P. Murell, loc. cit., find that privatization to outsiders has had the largest positive impact on enterprise restructuring, both in eastern Europe and in the CIS, albeit to different degrees. Employee privatization has had no significant restructuring effect in eastern Europe, but has had negative effects in the CIS.

[379] The macroeconomic variables in this context are GDP recovery, foreign direct investment and exports. C. Zinnes et al., op. cit.

[380] Negative impacts might result from privatization simply substituting weak private corporate governance without appropriate institutional structures for inefficient public governance.

TABLE 5.4.1

Bureaucratic barriers to market entry in eastern Europe and the CIS, 1999

	Number of procedures for entry [a]	*Time for entry* [b] *(days)*	*Cost of entry* [c] *(percentage of GDP per capita)*
CE-5			
Czech Republic	10	65	34.2
Slovenia	9	47	39.8
Poland	11	58	48.7
Slovakia	12	89	50.1
Hungary	8	39	100.0
Baltic states			
Lithuania	10	46	23.9
Latvia	7	23	51.5
South-east Europe			
Bulgaria	10	27	25.2
Romania	16	97	54.1
Croatia	12	38	60.2
CIS			
Armenia	11	55	34.7
Ukraine	13	30	37.7
Kyrgyzstan	9	32	38.1
Kazakhstan	12	42	64.3
Georgia	13	69	88.1
Russian Federation	20	57	227.0
Western market economies			
United States	4	4	1.7
United Kingdom	5	4	3.0
Germany	10	42	32.5

Source: S. Djankov, R. La Porta, F. Lopez de Silanes and A. Shleifer, "The regulation of entry", World Bank (Washington, D.C.), third draft, June 2001, mimeo.

positive effect on macroeconomic performance, but this was not the case in the CIS.[381]

The results of this research imply a fundamental qualification of the original reform design: mass privatization – implemented for the sake of speed and also for political and ideological reasons – might backfire and induce counterproductive, negative performance results, as long as budget constraints remain soft, firm objectives remain politicized, and legal and regulatory institutions do not function, as was especially the case in the CIS. Ownership matters, but so do institutions and structural reform. This is especially important, as it cannot be assumed a priori (section 5.3(iv)) that the creation of private ownership will automatically induce the establishment of the institutional infrastructure required to make a market economy work.

(ii) Market entry and exit

Empirical research indicates that new firms in the transition economies perform significantly better than old firms in terms of sales, exports, investment and employment. Also, value added per worker is significantly higher in small firms (employing fewer than 50 employees, a category often used as a proxy for new firms) than in larger enterprises.[382] This evidence supports the original idea that growth in the transition period should be based on a resource transfer from large, capital-intensive and inefficient enterprises to small, more efficient firms.[383] However, this transfer must be actively encouraged by policies which harden budget constraints, provide appropriate exit mechanisms for old firms and encourage the entry of new firms. Most CIS countries now have bankruptcy laws that, at least in principle, can order the liquidation of insolvent firms in order to satisfy the claims of creditors. Enforcement, however, is another matter, as this relies on the existence of hard budget constraints on the one hand, and on the efficiency of the legal process on the other. Consequently, the effective organization of firm exit has so far been a major problem.

Although there are substantial differences among countries, barriers to entry in economies in transition are often considerably higher than in developed market economies (table 5.4.1). These barriers include bureaucratic hurdles as well as complex and unpredictable business regulations and tax regimes. The sparse data available do not allow for any general conclusion about relative entry costs in eastern Europe and the CIS, but they do appear to be surprisingly high in parts of eastern Europe and prohibitively so in Russia.[384]

However, the data in table 5.4.1 – informative as they are – do not cover other important barriers

[381] C. Zinnes et al., op. cit., p. 166, table 6.

[382] P. Mitra and M. Selowsky, "Lessons from a decade of transition in eastern Europe and the former Soviet Union", *Finance and Development*, Vol. 39, No. 2, June 2002.

[383] See especially K. Arrow, loc. cit. and A. Berg, loc. cit.

[384] Not surprisingly, the same source finds that entry costs are correlated with a higher incidence of corruption, larger unofficial sectors of the economy and less democratic government.

to entry that relate to the contestability of incumbents' positions, such as access to credit and other resources, and even political connections that guarantee easy access to energy and transport subsidies, which create prohibitive barriers to competition and new entry. The Russian economy, for example, continues to be dominated by a small number of large companies, mainly in infrastructure and natural resources, which often oppose reforms that might enhance competition and market entry. This situation is sometimes sustained by regional and local governments where the existence of numerous administrative restrictions breeds corruption.[385] Consequently, there are strong incentives for small and medium enterprises (SMEs) to move into the shadow economy (chart 5.6.3), while official market entry in Russia, as elsewhere in the CIS, has so far remained disappointingly slow: World Bank data suggest that the share of employment in small enterprises in Belarus, Kazakhstan, Russia and Ukraine has been stagnant and has not yet reached 20 per cent of the total.[386] At the same time, during the 1990s, their share almost doubled in Poland and is now between 45 and 55 per cent in most of the central European and Baltic economies, where SMEs are considered to be one of the engines of growth.

5.5 Assessing systemic reforms in the CIS: disappointing results and the need for explanations

The discussion in sections 5.3-5.4 highlights some specific aspects of reform in the CIS. *Basic reforms* have been most advanced in Russia, and perhaps in Kazakhstan and Kyrgyzstan, but there is little evidence of sustained liberalization in the CIS as a whole. In Belarus, Turkmenistan and Uzbekistan, transactions are not at all guided by market signals. Progress in *structural reforms* has been slow in all countries, with significantly less intercountry variance than in the case of liberalization: this raises doubts as to whether price-guided transactions, even in the more liberalized CIS markets, actually increase welfare for their populations. The generally slow progress in developing the legal environment has consequences on market structures: even when based on private ownership, workable competition has not yet emerged as the dominant market structure across the economy at large in any CIS country. However, recent reform efforts suggest that Russia is getting close to becoming a functioning market economy.[387] Overall, however, systemic reforms in the CIS have so far been disappointing, especially when compared with the transition process elsewhere.

There has been less substitutability between reform measures than initially expected: for example, privatization alone is unable to induce firm restructuring without hard budget constraints, effective competition policies and legal reform. Complementarity therefore appears to be crucial. This holds for market supporting institutions and their relevance for restructuring as well as for the role of SMEs as potential engines of growth.

Most importantly, the rule of law has a key role in systemic reforms: the quality of legal institutions and the framework of law determine whether economic activities will be "productive" rather than "predatory" and predominantly rent-seeking. Consequently, the institution of the rule of law emerges as the necessary prerequisite for the restructuring of formally privatized firms, for investment, for efficient market entry and exit, and thus for the long-run growth prospects of the economy. The institution of the rule of law, however, is not guaranteed by the reforms in other sectors of the economy.

The generally slow progress of structural reform is only partly due to a lack of "liberalization momentum", as there has been more

[385] Bureaucrats may extract bribes both "from those wishing to set up new businesses, or from those wishing to keep out new competitors". J. Odling-Smee and P. Thomsen, "Putin at mid-term: where should economic reforms go from here? A commentary", *Vedomosti*, 15 April 2002. However, recently there has been some progress in Russia in removing administrative barriers: hundreds of regulations were scrapped in the first half of 2001. "Can Russia be a regional growth engine?", UNECE, *Economic Survey of Europe, 2002 No. 1*, chap. 3.1(iv).

[386] This often reflects the fact that old firms have been protected by subsidized credit and foreign exchange allocations implying relatively higher costs for new firms. P. Mitra and M. Selowsky, loc. cit.

[387] In the light of this discussion, the fact that the EU and the United States granted market economy status to Russia in 2002 is both encouraging and supportive, but for the time being this has special implications only for potential anti-dumping investigations. From now on, "instead of using proxy costs and prices from a third country, Russian companies' own costs and prices will be used for the purpose of calculating dumping margins". "EU formally recognizes Russia as a market economy country" (Brussels), 7 November 2002 [europa.ei.int/comm/trade/bilateral/russia/pr071102_en.htm].

variation in rates of liberalization across the CIS than in structural reform. It may therefore be useful to look at other aspects of transformation, namely, the process of democratization and the establishment of proper public governance, as well as the role of initial conditions, which may help to further explain the slow pace of systemic reforms in the CIS.

5.6 Explaining the sluggishness of systemic reform: public governance and initial conditions

As shown above, transition, or the process of moving from a system of governance based on one-party rule and central planning to one in which democracy, market forces and widespread private ownership dominate, has been very slow in the CIS. Remarkably, many CIS countries have yet to define the ultimate goal of their reforms, an essential prerequisite of systemic change. Some countries have made modest progress in conducting fair presidential or parliamentary elections, introducing some market reforms and partially opening their economies. Overall, however, and relative to the EU accession candidates, both systemic reform and political change in the CIS region have been sluggish.[388] In some CIS countries, reforms have not been introduced because they threatened the continued appropriation of resource rents by the ruling elites. In others, elected legislators or policy makers questioned the overall direction of reforms and contributed to policy reversals.

Overall, the nature and speed of reform in individual CIS countries appears to be closely related to their national institutions, history and economic circumstances. Political conditions have also played an important role in determining the direction of reform. While it is difficult to identify a common theme in the reform efforts across the CIS – since reform policies are inherently embedded in national institutions – the view that governments will undertake reforms as long as they increase societal welfare is generally not borne out. In addition, the experience of transition shows that liberalization and structural reforms that are not grounded in suitable institutions – including an active and well-organized civil society – are unlikely to deliver successful outcomes.

In particular, the failure to establish vigorous democratic institutions has meant that many countries in the CIS continue to be run by the old socialist elites.[389] In the absence of institutional checks and balances to restrain the arbitrary use of power, the elites – along with some newly emerged local entrepreneurs – have been able to abuse their political power and to use it largely for their own benefit. As a result, many CIS countries are trapped in situations of partial reform, where the early beneficiaries of structural change effectively block further progress. This phenomenon of "state capture" – where a minority unduly influences government policies in its own interest – is evident in many transition economies and has probably played a major role in slowing down the push for systemic change.

Finally, the entire process of transition depends critically on political developments.[390] Systemic reforms originate in and are inherently constrained by complex political dynamics. In practical terms, the "optimal" reform path is often replaced by less than ideal but more politically feasible (or sustainable) reforms while the actual choice of the "desirable" reform path may be debatable.[391] In theory, however, progressive democratic political processes, if they are present,

[388] For central and eastern European countries the fall of communism was seen as a geopolitical opportunity to move away from being satellites of the Soviet bloc to being strongly anchored in western Europe. In contrast, in the CIS countries the transition has been seen, to some extent, as a loss: the loss of superpower status and the increased uncertainty of millions of individuals who ceased being Soviet citizens and became "foreigners" in what used to be their homeland. G. Roland, "Ten years after …", op. cit. For these reasons, comparing the two regions is not entirely appropriate. Nevertheless, the transition experience of central and eastern European countries provides a useful benchmark.

[389] In contrast, east European countries, at the outset of transition, were able to establish vibrant political and economic competition by taking advantage of their better developed institutions and stronger civil societies.

[390] It has been argued that "differences in initial conditions are what determine the intensity of political constraints, and thus the initial choice of political institutions, and hence the initial choice of policies". G. Roland, "The political economy of transition", *Journal of Economic Perspectives*, Vol. 16, No. 1, Winter 2002, p. 46.

[391] Conversely, the course of reform – in particular its speed – may also influence political developments. "Shock therapies" – or rapid and wide-ranging systemic reforms – may increase the risk of political instability if benefits are not forthcoming quickly enough, while a slower rate of reforms may lead either to their "capture" by interest groups or their termination by those opposing change.

should mobilize and channel public opinion and thus provide the foundations for a successful implementation of reforms.

Throughout the post-communist world, the more radical and comprehensive economic reforms have been associated with fundamental political changes. The more mature political systems have usually undertaken the more radical market reforms, while the more autocratic regimes have introduced little substantive reform. In most east European countries the political transition to democracy was peaceful, swift and decisive and, simultaneously, these countries became transition leaders and are now about to join the EU. In contrast, democracy has been slow to take root in the CIS region. On public participation, the accountability of politicians and public servants, as well as the introduction of transparent rules and the effective flow of information – the three pillars on which modern democracies rest – little headway has been made. In this light, systemic change in the CIS mirrors the region's democratic evolution.

(i) State building

In eastern Europe, after four decades of (mostly) one-party rule accompanied by endemic shortages, slow technical change and the low quality of consumer goods, there was a broad understanding of the need for a radical shift towards political freedom and a modern market economy. There was also a widespread agreement on the objective of closer political and economic integration with western Europe. Consequently, communism in these countries collapsed without violence and largely as a result of collective, organized and broad-based civic action. In general, in most of these countries, state building was not an issue.

In contrast, these factors were largely absent in the CIS. As a result, the challenges of transition have been colossal and, to some extent, underestimated. In brief, the CIS countries were faced with the unprecedented challenge of simultaneously building new political and economic orders (i.e. states and markets). In the successor states of the former Soviet Union a new political order had to be created after 70 years of communist rule (about 50 years in the Baltic states and the Republic of Moldova) and with only limited experience of a democratic system prior to 1917. Moreover, many of the newly independent states had either never been sovereign before and/or had complex history that placed them at additional disadvantage.[392] Many republics also became independent states "by default" when Russia left the Soviet Union. Most importantly – from the perspective of systemic reform – the collapse of communism in many CIS countries was driven by nationalist aspirations, mostly of the governing elites and not of the populations at large.[393] Tellingly, in the national referendum of 1991 the citizens of the Soviet Union overwhelmingly rejected the breakup of the country (table 5.6.1).

In the countries of the former Soviet Union, a new economic order also had to be created and not returned to. The economic order in the USSR was already firmly established in the first "five-year-plan" of the 1920s and its basic principles remained essentially unchanged until the country's breakup. The negative consequences of following these principles for many decades have continued to affect the CIS and their capacity for systemic reforms to this day.[394]

[392] The Republic of Moldova, for example, was part of Romania before the Second World War, a Soviet republic after, and an independent country only after the breakup of the USSR. This complicated past was made worse by a unilateral secession by Transdniestria, which split the country along ethnic lines during the country's first year of independence.

[393] While opposition movements existed to a limited extent in the former USSR, the drive towards independence was spearheaded and accomplished by the political or economic leaders. The elite's – or *nomenklatura's* – rationale for independence was motivated by their keen ambition to shift the center of power and decision-making (in particular control over local resources) from Moscow to the republican capitals.

[394] The early discussions on economic reform indicate considerable confusion over the goals and course of these reforms. World Bank, IMF, OECD and EBRD, *A Study of the Soviet Economy*, Vol. 1, March 1991, pp. 63-81.

TABLE 5.6.1

Referendum on the future of the USSR, 1991

Question	*Country*	*Yes (per cent)*
1. " Do you consider it necessary to preserve the Union of Soviet Socialist Republics as a renewed federation ofequal sovereign republics, in which human rights and the freedoms of all nationalities will be fully guaranteed?"	Azerbaijan	93
	Belarus	83
	Kyrgyzstan	95
	Tajikistan	96
	Turkmenistan	98
2. " Do you consider it necessary to preserve the Union of Soviet Socialist Republics as a union of sovereign states?"	Kazakhstan	94
3. " Do you want Ukraine (Uzbekistan) to be part of a Union of Soviet Sovereign States on the basis of its declaration of sovereignty?"	Ukraine	80 (74)[a]
	Uzbekistan	80 (74)[a]
4. " Do you want direct elections to Russia's presidency?"	Russia	70 (71)[a]
Refused to hold the referendum	Armenia	
	Georgia[b]	
	Republic of Moldova	

Source: *The Economist* (London), 23 March 1991, as quoted in *Reuters Business Briefing* [www.rbb.reuters]

The Soviet economic system suppressed virtually all elements of a market economy resulting in generations of its citizens having neither direct experience nor the memory of markets and the institutions that allow a market-based economy to work.[395] This legacy of unfamiliarity with the market mechanism and market-supporting institutions has clearly had a significant impact on the process of reform. Almost overnight, CIS citizens moved from a society where for generations voluntary exchange transactions had been viewed as "economic crimes" to an environment where they were rewarded. Clearly, the magnitude of the task and the time required to change from the mentality of "from cradle to death" welfare provided by the state to an environment of competition, instability and uncertainty should not be underestimated.[396]

Nevertheless, neither the challenge of state building nor the novelty of emerging market capitalism were the only impediments to systemic change in the CIS.

(ii) Violent conflicts

Apart from dealing with the legacies of the past, the newly independent states that emerged from the breakup of the Soviet Union had to establish and maintain sovereignty and respond to emerging complex geopolitical issues. Simultaneously, the collapse of communism and its state institutions created opportunities for an unprecedented redistribution of power and influence. The combination of long suppressed internal divisions (e.g. ethnic diversity), the end of repression and immature democratic structures (which did not allow grievances to be contained and mediated) resulted in several wars and violent challenges to territorial integrity.[397] In addition, many internal power struggles, which partly reflected the weakness of the state, led to violent confrontations to determine who had the right to make binding decisions on behalf of the

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395 While the east European economies utilized essentially the same control and command principles, the Soviet Union was the undisputable leader in the extreme application of the central planning principles and state ownership. In other centrally planned economies, some private activities were allowed to continue albeit on a very limited scale and agriculture was collectivized everywhere except Poland and Yugoslavia. Moreover, market reforms were easier to carry out in countries where market economy traditions prevailed during the interwar period and which undertook some market reforms under communism.

396 For example, in 2001, almost three quarters of Russians still had a positive attitude to the old communist regime and almost half would willingly accept a non-democratic, communist rule. The University of Strathclyde, Centre for the Study of Public Policy, *New Russian Barometer,* No. 10, June/July 2001, as cited in R. Rose, "Advancing into Europe: the contrasting goals of post-communist countries", *Nations in Transit 2002* [freedomhouse.org].

397 Many CIS conflicts erupted because these countries did not have the institutional framework to resolve internal and external disputes. As a result, the new "institutional hiatus" inevitably brought about social conflict. R. Kozul-Wright and P. Rayment, "The institutional hiatus in economies in transition and its policy consequences", *Cambridge Journal of Economics*, Vol. 21, Issue 5, September 1997, pp. 641-661.

TABLE 5.6.2

Ethnic population and conflicts in the CIS countries

CIS country	Year	External or internal conflict	Ethnic population (per cent)	
Armenia	1992-1994	War with Azerbaijan over Nagorny Karabakh	Armenian	93
			Azeri	3
			Kurd and Russian	2
Azerbaijan	1992-1994	War with Armenia	Azeri	91
			Russian and Armenian	3
			Lezghin	2
Belarus	–	–	Belarusian	78
			Russian	13
			Polish	4
Georgia	1989-1994	Separatists' claims in South Ossetia and Abkhazia	Georgian	70
			Russian	6
			Armenian	8
			Azeri	6
Kazakhstan	–	–	Kazakh	53
			Russian	30
			Ukrainian	4
Kyrgyzstan	1990	Ethnic violence in Osh	Kyrgyz	60
			Russian	16
			Uzbek	14
Republic of Moldova	1992	The Transdniestr region declares unilateral independence	Moldovan	65
			Ukrainian	14
			Russian	13
Russian Federation	1992	Violence between the Inqush and the North Ossetians on the Russian territory	Russian	82
			Tatar	4
			Ukrainian	3
	1993	War in Chechnya		
Tajikistan	1992-1997	Civil war between regional and ideological groups	Tajik	65
			Uzbek	25
			Russian	4

community.[398] The territorial conflicts ranged from war between neighbouring countries to unilateral secessionist movements by break-away regions (table 5.6.2). Armenia, Azerbaijan, Georgia, the Republic of Moldova and Tajikistan faced violence or civic strife either before or immediately after the declarations of independence.

The inter-ethnic and separatist conflicts inflicted considerable human costs. Hundreds of thousands of people were displaced,[399] suffering losses of assets, livelihoods and social networks along with other pervasive effects such as economic and legal insecurity extending far beyond the cessation of hostilities. They also imposed substantial costs on governments.[400] By 2002 – more than a decade into transition – peace had appeared in most of the conflict prone areas, but the danger of a reignition of violence remains.

Wars and internal strife had a highly detrimental impact on various aspects of political, economic and social life. For example, Armenia's war with Azerbaijan has resulted in the loss of traditional trade routes with consequent cuts in Armenian exports and income. In turn, Azerbaijan could not receive international aid from the United States until 2001 due to the passing of the United States Freedom Support Act. This conflict is still unresolved, but the peace dividends for both countries are substantial not only in terms of increased economic growth but also as a result of decreasing uncertainty and freeing resources to focus on a sustained reform effort.[401]

The break-away regions in Georgia and the Republic of Moldova have also imposed large economic costs and obstructed reforms. Georgia's secessionist regions of Abkhazia and south Ossetia are believed to provide bases for smuggling, which lowers government revenues and thus weaken the state's ability to provide public goods such as reform. Similarly, the borders of the Republic of Moldova's break-away region of Transdniestria are

[398] For a detailed description of the power struggles between 1990-1993 see, P. Roeder, "Varieties of post-Soviet authoritarian regimes", *Post-Soviet Affairs*, Vol. 10, No. 1, 1994, pp. 61-101.

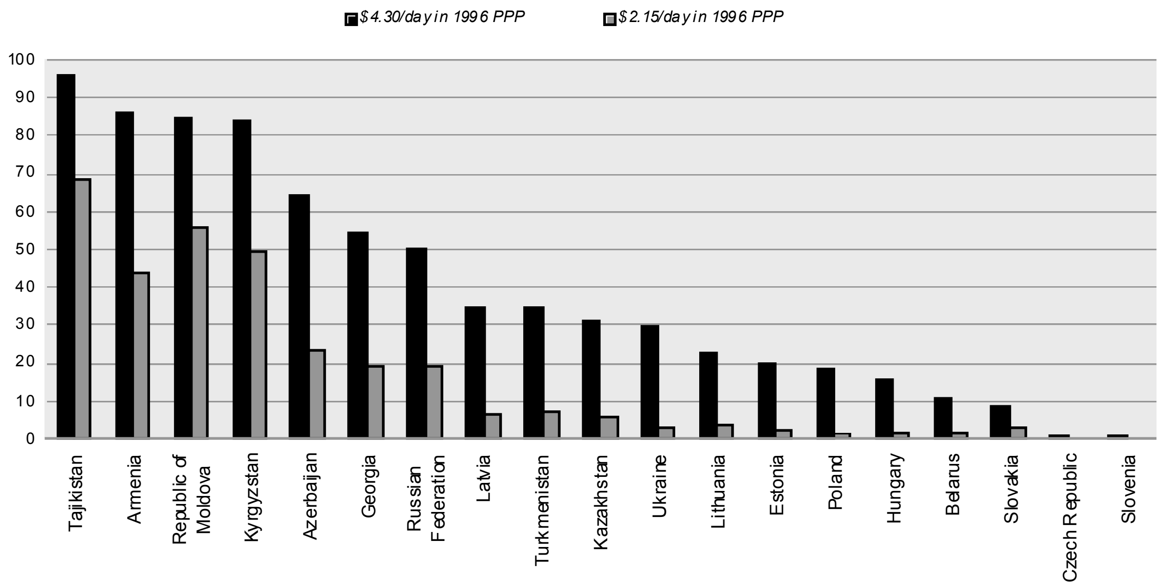
[399] Fighting over Nagorno-Karabakh uprooted at least 650,000 individuals; fighting in south Ossetia and Abkhazia resulted in the displacement of over 360,000 people; civil war in Tajikistan forced 600,000 people to flee their homes; communal violence in the Fergana Valley forced 90,000 individuals to flee; up to 50,000 Ingush people were forced to leave north Ossetia; and war in Chechnya displaced over 630,000 individuals. United Nations High Commission for Refugees (UNHCR), *The State of the World's Refugees 2000* (Oxford, Oxford University Press, 2000), pp. 185-209.

[400] In the 1990s, the Georgian government spent 20 per cent of its development budget assistance on people affected by conflicts. World Bank, *Making Transition Work For Everyone: Poverty and Inequality in Europe and Central Asia* (Washington, D.C.), June 2000, p. 51.

[401] According to one estimate, regional peace could double Armenia's exports, raise its GDP by 30 per cent and allow it to realize an annual $50 million savings due to cheaper energy imports. Azerbaijan could increase its exports by over 10 per cent leading to a 5 per cent increase in GDP. E. Polyakov, *Changing Trade Patterns after Conflict Resolution in the South Caucasus*, World Bank Policy Research Working Paper, No. 2593 (Washington, D.C.), April 2001.

CHART 5.6.1

Percentage of population living in absolute poverty, selected years, 1995-1999



Source: World Bank, *Making Transition Work for Everyone, Poverty and Inequality in Europe and Central Asia* (Washington, D.C.), 2000, p. 35.

reportedly used to generate profits through tax and duty avoidance (as well as the trafficking of drugs and arms).[402] Transdnietria, which represents about half of the industrial base of the Republic of Moldova, continues to be run on the basis of a Soviet style management; it is one of the main sources of the country's fiscal drain and a threat to its economic viability.[403]

Internal power struggles contributed to Russia's economic contraction in the early 1990s as the executive and legislature hesitated over the implementation of many of the basic foundations of a market economy. The sources of hesitation were complex, but frigid executive-legislative relations reflecting the lack of a wide social consensus on whether to proceed with market-oriented reforms were key. After the storming of the parliament building in Moscow in 1993, the Russian president relied mainly on decrees to govern.[404] Clearly, the subsequent "rule by decree" could not provide reforms with the same credibility or success as those implemented through a public process of design, consultation, debate and revision. Russia has also been engaged in a prolonged military conflict in Chechnya. Finally, despite five years of peace in Tajikistan where a brutal civil war lasted until 1997, a domestic authority exerting power across the whole country has yet to emerge.

In summary, institutional order cannot be established if military conflict, lawlessness, crime, violence and assassination are prevalent. Under these conditions, systemic reform is unlikely to be initiated, let alone to progress.[405] One cause of violence is poverty. Wars are more probable in

[402] "Moldova: OSCE plan for Transnistria is no quick fix", *Oxford Analytica Brief*, 16 September 2002.

[403] Transdniestria has repeatedly blocked railroads and gas pipelines, seriously disrupting trade and energy supplies to the rest of the Republic of Moldova. IMF and World Bank, *Poverty Reduction, Growth and Debt Sustainability in Low-Income CIS Countries*, 4 February 2002, p. 29.

[404] In September 1993, president Yeltsin dissolved the parliament and called for the election of a new legislature. Parliamentarians refused to step down, remaining with hundreds of armed supporters in the parliament building. Riots ensued in central Moscow, and on 4 October Yeltsin ordered the army to shell and occupy the parliament building and restore calm. A new bicameral federal assembly was elected on 12 December. In a constitutional referendum associated with the December election, Russians supported Yeltsin's draft constitution, which granted vast powers to the president and the executive organs.

[405] In general, the stability of a polity depends on three main factors: the legitimacy of a government's authority over its citizens; order, which refers to the agreed laws, rules, social norms and informal conventions that make up the structure of incentives to pursue acceptable forms of behaviour; and economic welfare, which by providing acceptable standards of living and a fair distribution of costs and benefits, sustains the system as a whole. P. Rayment, "The economic dimension of security with special reference to the UNECE region", United Nations Economic Commission for Europe, 2002, mimeo.

poor countries because the opportunity cost of violence is lower and governments of poor countries, which are usually dysfunctional and disrespectful of political rights, are often the least capable of defending themselves against rebellion. Civil wars, of course, exacerbate poverty through the destruction of infrastructure and productive assets and the loss of human and social capital. Wars also divert public resources from socially beneficial activities to the war effort, thereby undermining the capacity of the state to provide the most basic public goods. In the CIS, the economic and social dislocation associated with the breakup of the Soviet Union and the ensuing collapse in output has increased the number of poor many times over (chart 5.6.1).[406]

(iii) Initial conditions

Apart from the damaging effects of war and civil conflicts, there were also unfavourable economic factors that have made the reform process in the CIS more challenging. Specifically, at the outset of transition, and in contrast to other centrally planned economies, the Soviet Union faced greater macroeconomic distortions, such as its heavy dependence on internal trade and the greater inflation overhang.[407]

Economists have tried to estimate the effects of initial conditions and communist legacies on the transition process, but the results of these studies – apart from broad agreement that initial conditions matter – are equivocal.[408] For example, analysis of reform paths in the relatively similar central Asian CIS countries is obscured by significant differences in their external environment and the drawn-out nature of the transition process.[409] In general, therefore, the magnitude of the impact of initial conditions on output performance is difficult to assess. However, there is some agreement that they contribute more to transitional recessions than to the post-stabilization recovery. It has also been suggested that, in the course of transition, the importance of the initial conditions declines over time while the significance of policies increases.

In terms of systemic change, given that the effects of macroeconomic disequilibrium were likely to diminish over time, the CIS countries appeared to be firmly on the transition path in the early 1990s, although they lagged behind the fastest reformers. The sluggishness of the policy effort, in turn, was believed to be due to the magnitude of adjustment costs, the limited experience of reforms during the period of central planning, the delayed fall of communism in the Soviet Union, the greater extent of institutional breakdown and greater distance of the CIS from the markets of western Europe.[410]

In the political context, the size of adjustment costs in the CIS may have been one of the key factors explaining the slower pace of reform. The economies with more distorted structures at the beginning of transition were likely to suffer more severely when the adjustment began, and this, in turn, affected both the probability of success and the choice (and speed) of reforms.[411] Hence, governments and policy makers in the CIS were reluctant to accept the large, upfront costs of radical reforms in addition to the losses stemming from the dissolution of the old communist system.[412] The importance of the size of adjustment, in the context of systemic reform, has been tested empirically for most transition economies. It has been found that unfavourable

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406 Poverty is not only a cause and result of wars, but it also makes, *ceteris paribus*, citizens wary of accepting substantial short-term costs of reform in return for potential large gains in the future.

407 The level of development and overindustrialization (i.e. structural socialist distortions) was about the same as in east European countries except for the central Asian countries, Azerbaijan and the Republic of Moldova, which were poorer and less industrialized than the other CIS countries. M. de Melo, C. Denizer, A. Gelb and S. Tenev, *Circumstance and Choice: The Role of Initial Conditions and Policies in Transition Economies*, World Bank Policy Research Working Paper, No. 1866 (Washington, D.C.), October 1997, p. 19 and table 1.

408 M. de Melo et al., op. cit.; A. Berg, E. Borensztein, R. Sahay and J. Zettelmeyer, *The Evolution of Output in Transition Economies: Explaining the Differences*, IMF Working Paper WP/99/73 (Washington, D.C.), May 1999; O. Havrylyshyn and R. van Rooden, *Institutions Matter in Transition, but so do Policies*, IMF Working Paper WP/00/70 (Washington, D.C.), March 2000; E. Falcetti, M. Raiser and P. Sanfey, *Defying the Odds: Initial Conditions, Reforms and Growth in the First Decade of Transition*, EBRD Working Paper, No. 55 (London), July 2000; World Bank, *Transition: ...*, op. cit.

409 R. Pomfret, "Reform paths in central Asian transition economies", in G. Cornia and V. Popov (eds.), *Transition and Institutions: The Experience of Gradual and Late Reformers*, a study prepared for the World Institute for Development Economics Research of the United Nations University (UNU/WIDER) (Oxford University Press, 2002).

410 It has also been pointed out that the countries of the former Soviet Union may have lacked the necessary institutional, economic, cultural, social and political endowment to be on the same transition path as their counterparts in the ECE. In other words, without the minimum necessary initial conditions, the move from plan to market can be expected to be painfully slow and characterized by economic, social and political chaos. P. Murrell, "How far has the transition progressed?", *Journal of Economic Perspectives*, Vol. 10, No. 2, Spring 1996, pp. 25-44.

411 B. Ickes, "Comments on Åslund, Boone and Johnson", *Brookings Papers on Economic Activity,* 1 (Washington, D.C.), 1996, pp. 298-305.

412 Among the significant transitional adjustment costs were job losses, non-payment of salaries or pensions, hyperinflation, the related erosion of savings and a reduction in services previously provided free.

TABLE 5.6.3

Reported direct impact of state capture by the firm, 1999

(Per cent of firms)

	Parlia-mentary legislation	Presiden-tial decrees	Central bank	Criminal courts	Party finance	Overall capture index
Uzbekistan	5	4	8	5	4	6
Armenia	10	7	14	5	1	7
Belarus	9	5	25	–	4	8
Kazakhstan	13	10	19	14	6	12
Georgia	29	24	32	18	21	24
Kyrgyzstan	18	16	59	26	27	29
Russian Federation	35	32	47	24	24	32
Ukraine	44	37	37	21	29	32
Republic of Moldova	43	30	40	33	42	37
Azerbaijan	41	48	39	44	35	41

Source: J. Hellman, G. Jones and D. Kaufmann, *Seize the State, Seize*

initial conditions discourage reforms, but the effectiveness of reforms is not reduced once they are implemented.[413]

The availability of abundant natural resources, which might suggest favourable initial conditions, may have actually reduced the incentives to reform. It has been argued that slow systemic reform allows the incumbents to retain power and to protect their access to substantial resource rents.[414] In countries such as Turkmenistan and Uzbekistan, where the natural resource sector was well developed at the beginning of transition, very little structural change has occurred. In Azerbaijan and Kazakhstan, where foreign capital was needed to exploit natural resources and to develop the necessary infrastructure to export them, there was an initial phase of reforms to encourage foreign investment. Having ensured foreign interest, however, the reformist policy stance weakened. In contrast, the resource-poor CIS countries were more likely to rely on international integration through trade and investment flows. The corresponding financial transfers were conditional on structural reform, and thus more progress was expected in these countries.[415]

[413] Moreover, significant differences between the CIS and other transition economies in the nature of the response of output to policy have been observed. The immediate impact of reforms is negative in the CIS and positive in central Europe. World Bank, *Transition ...*, op. cit., p. 15.

[414] A. Esanov, M. Raiser and W. Buiter, op. cit.

[415] In addition, some CIS countries took advantage of financial transfers from Russia in the form of subsidies or mounting debt arrears.

(iv) Corruption

It has been argued that a partial reform strategy – as implemented in virtually all CIS countries – increases the likelihood that governments will be "captured" by narrow vested interests.[416] These interest or influential groups gain from market distortions and corrupt practices associated with partial reforms where, for example, the dismantling of the old command system occurred without the adequate development of functional, market-oriented institutions, including a strong judiciary system.[417]

As partial reforms have been common throughout the CIS, state capture – where individuals or groups act to influence the formation of laws or government policies to their advantage – is believed to have occurred and contributed to a slowing down in the pace of reforms. Governments in "high-capture" states tend to focus on providing specific advantages to influential firms and lobbies, while underproviding the institutions essential to improving national governance.[418] The policy challenge, in these cases, is to advance reform despite the efforts by the reform profiteers to preserve market distortions that produced their gains (table 5.6.3).

While state capture is a specific type of corruption where public officials act in the interest of a particular interest group, corruption, in general, is defined as "the abuse of public power for personal gain". The presence of corruption during transition, that is the period of building new political and economic institutions, is important because of its wide-ranging impacts on legitimacy and credibility. Corrupt governments, by definition, are not interested in reforms. While it is not possible to measure corruption directly,

[416] J. Hellman, "Winners take all, the politics of partial reform in post-communist transitions", *World Politics*, Vol. 50, January 1998, p. 223.

[417] A reflection of this phenomenon could be the fact that more than 90 per cent of those polled expressed their dissatisfaction with reforms in Russia and Ukraine in 2000. H. Harland, H. Nissen and W. Franzen, "On the development of democracy and a market economy in the central and east European countries", *Russian Politics and Law*, Vol. 40, No.2, March-April 2002, p. 36.

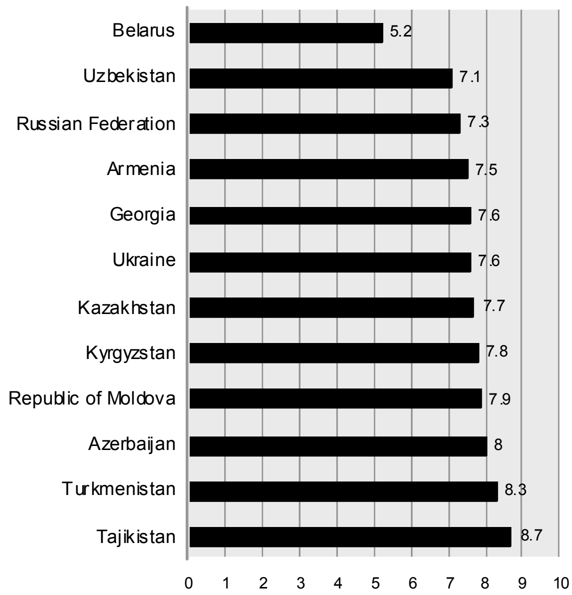
[418] EBRD, *Transition Report 1999* (London), 1999, chap. 6; J. Hellman, G. Jones and D. Kaufmann, "Seize the state, seize the day, an empirical analysis of state capture and corruption in transition", a paper prepared for the World Bank's ABCDE Conference (Washington, D.C), 13 April 2000.

Transparency International, an anti-corruption organization, conducts annual surveys to estimate "perceived corruption" (chart 5.6.2). Notably, most CIS countries are perceived to be very corrupt and appear at the bottom of the ranking of transition economies as well as of all surveyed countries.

From the systemic reform perspective, the presence of corruption in the CIS is a clear symptom of institutional malfunction. Corruption usually flourishes in an environment of excessive regulation and/or high discretion in economic policy. It is also present when governments rather than markets allocate scarce resources, or weak democratically unaccountable governments are in charge. In this respect, the CIS countries have inherited institutions that are inexperienced in regulating markets and, more importantly, have been shaped by decades of discretionary power and arbitrary justice. As a result, unaccountable public institutions and badly functioning legal systems are still characteristic of many CIS countries (section 5.3(iv)). In addition to being a result of institutional failure, the presence of corruption can simultaneously be a primary cause of reform failures.[419] Corruption destroys public confidence in democratic institutions and erodes the legitimacy of the state. Corruption also exacts heavy economic cost – just the opposite of the "grease the wheels" argument, which asserted that bribery was necessary to facilitate the operation of supply and demand.[420] Growing empirical evidence indicates that corruption has a strong negative effect on economic growth by distorting incentives, reducing investment and, most importantly in the context of reforms, undermining the fundamental role of the government.[421]

CHART 5.6.2

Transparency International Corruption Perceptions Index, 2002



Source: Transparency International, *Corruption Perceptions Index* 2002 [www.transparency.org]. For Tajikistan and Turkmenistan, 1997 data from G. Abed and H. Davoodi, *Corruption, Structural Reforms, and Economic Performance in the Transition Economies*, IMF Working Paper WP/00/132 (Washington, D.C.), July 2000, p. 13.

Note: The scale used is from 0 to 10 (highly corrupt=10, uncorrupt=0). Throughout the chapter, the original TI ratings have been inverted using the "10-x" formula. All data are for 2002, except 2000 data for Armenia and 1999

In the transition context, corruption is particularly damaging because it reduces public revenue and destroys the ability of public institutions to deliver essential services such as law and order.[422] In other words, it makes the state weak in the areas where it should be strong. In contrast, disproportionate and discretionary state control (combined with corruption) increases the costs of doing business. This increases unnecessarily the role of the state in areas where it should be limiting its functions to building the legal and regulatory foundations for competitive markets. This intrusiveness induces some private sector activities to move "underground". This rational response to higher costs and the unpredictability of government measures can be debilitating for a transition economy as a whole.

419 For a description of how Russian institutions and norms of political behaviour have provided the accommodating framework for a society where corruption is a principal means of acquiring wealth, see M. Levin and G. Satarov, "Corruption and institutions in Russia", *European Journal of Political Economy*, Vol. 16, 2000, pp. 113-132.

420 P. Bardhan, "Corruption and development: a review of issues", *Journal of Economic Literature*, Vol. 35, 1997, pp. 1320-1346; UNECE, *Economic Survey of Europe, 2001 No. 2,* pp. 49-147.

421 For an overview of corruption issues in transition economies, see K. Murphy and M. Hessel, "Stealing the state and everything else", *Project Syndicate Survey*, Winter 1999 [www.project-syndicate.cz].

422 According to some estimates Russian businessmen pay about $33.5 billion per year in bribes, which is about the amount of the state budget. Corruption effectively doubles the tax burden. "Russia: entrenched corruption stifles private sector", *Oxford Analytica Brief*, 3 October 2002.

As the size of the unofficial economy increases, more taxes go unpaid, further impairing the government's ability to provide public goods such as reform (chart 5.6.3). The state's inability to perform its basic functions, in turn, encourages more corruption.

This vicious circle is not uncommon. According to some studies, unfair taxes, relatively onerous regulations and poor public goods in the CIS countries are also associated with low growth and a high share of unofficial activity.[423] Similarly, countries with more corruption have higher shares of the unofficial economy.[424] These relationships have given rise to the concept of the economic and political "under-reform trap" into which many CIS countries are claimed to have fallen. Policies that aim at fostering increased economic and political competition – those that do away with economic and political monopolies – through the development of appropriate institutions are generally suggested as the way out of this trap. The development of these institutions, however, is dependent on the political demand for democracy and market institutions and it is still unclear if the desire for political and economic pluralism in the CIS countries is strong enough for that to happen.[425]

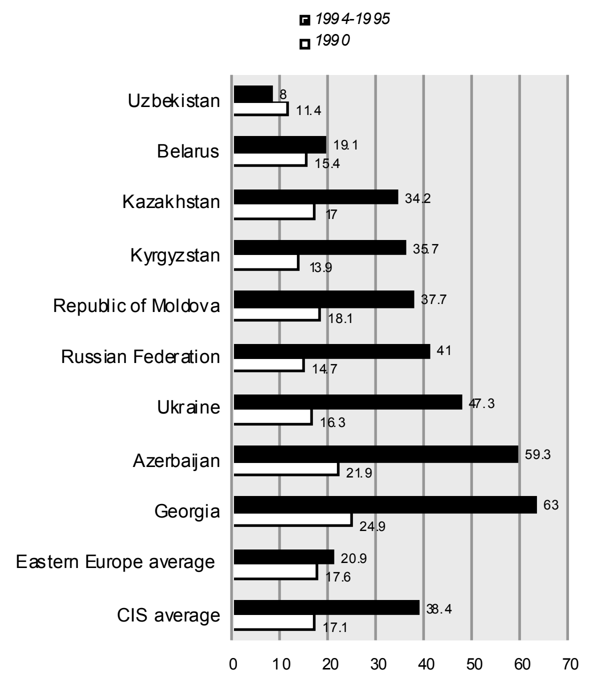
(v) Slowly emerging democratic institutions

Democracy and its system of effective "checks and balances" ensure that public governance (or "the exercise of political, economic and administrative authority to manage a nation's affairs")[426] reflects citizens' preferences,

CHART 5.6.3

Estimates of the size of the shadow economy in transition countries, 1990 and 1994-1995

(Per cent of GDP)



Source: F. Schneider and D. Enste, *Shadow Economies Around the World: Size, Causes, and Consequences*, IMF Working Paper WP/00/26 (Washington, D.C.), February 2000.

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423 S. Johnson, D. Kaufmann and A. Shleifer, "The unofficial economy in transition", *Brookings Papers on Economic Activity,* 2 (Washington, D.C.), 1997.

424 S. Johnson, D. Kaufmann and P. Zaido-Lobaton, "Regulatory discretion and the unofficial economy", *American Economic Review*, Vol. 88, No. 2, 1998, pp.387-392.

425 A. Åslund, P. Boone and S. Johnson, *Escaping the Under-Reform Trap*, *IMF Staff Papers*, Vol. 48, Special Issue (Washington, D.C.), 2001.

426 UNDP, *Reconceptualizing Governance*, Discussion Paper 2 (New York), January 1997, p. 9.

TABLE 5.6.4

Assessment of democratic elections in the CIS

CIS country	*Election type*	*Date*	*Major conclusions*	*Major problems to be addressed*	*Constitution, institutions and administration*
Armenia	Parliamentary	May 1999	Conducted in a generally peaceful and orderly manner.	The presence of unauthorized persons in polling stations, problems with the accuracy of voter lists, the transparency of the vote count and the tabulation procedures.	The president has considerable powers while the parliament is rela-tively weak; political system remains highly centralized with regional governors appointed by the president.
Azerbaijan	Parliamentary	January 2001	Did not meet international standards.	Ballot stuffing, turnout results manipulated, manipulation of result protocols, intimida-tion, unauthorized local officials controlling the process and influencing voters.	The president has wide-ranging powers. The constitution proclaims the principle of the separation of powers, but in practice no decision of consequence is taken without personal approval of the president.
Belarus	Presidential	September 2001	Fundamental flaws in the electoral process.	Need for strategies for the development of a fully functioning civil society and demo-cratic political structures.	The president enjoys sweeping powers as he appoints the prime minister, regional administrators, half the members of the Constitutional Court and the chair of the central bank.
Georgia	Presidential	April 2000	Considerable progress needed to fully meet com-mitments as a participating state of the OSCE.	Need for improvements in the legal frame-work, performance of the state media and the implementation of counting and tabulation procedures.	The president has extensive powers with an effective veto over all laws.
Kazakhstan	Parliamentary	October 1999	Marked a tentative step to democracy.	Illegal interference by executive authorities. Widespread violations during the vote count.	The president dictates major policies, even though policy implementation is the responsibility of the government and its ministries.
Kyrgyzstan	Presidential	October 2000	Failed to meet the OSCE commitments for democra-tic elections.	Serious violations of the tabulation of results and ballot stuffing.	Constitutional amendments have increased presidential powers at the expense of parliament.
Republic of Moldova	Parliamentary	February 2001	Met international standards for democratic elections.	Inaccuracy and incompleteness of voter lists. Lack of cooperation among Transdniestrian authorities.	Constitutional amendments have established a more parliamentary republic by granting parliament the right to elect the president directly.
Russian Federation	Presidential	March 2000	Marked further progress for the consolidation of demo-cratic development.	Need for impartiality of state and private media.	The president has sweeping execu-tive powers. Duma can only challenge the president when it is able to muster a two-thirds majority.
Tajikistan	Parliamentary	February 2000	Marked an improvement in the process of democratic development.	Need to improve the election process to meet the minimum democratic standards for equal, fair, free, secret, transparent and accountable elections.	The president is the most important center of political power with govern-ment and parliament subordinated to a large extent.
Turkmenistan .	Parliamentary	December	Electoral framework falls	A complete control over all activities by	The constitution vests executive

but the relationship between democracy, systemic reform and economic growth is not straightforward.[427] Some empirical research, however, supports the argument that political freedom facilitates rather than hinders the adoption of market-oriented reforms or that the two policies are complementary and self-reinforcing. Moreover, the presence of a vibrant civil society is one of the key variables influencing the adoption of systemic reforms.[428]

In general, the weakness of democratic institutions in the CIS countries is a critical drawback to systemic reforms and underscores their evolutionary nature. While the majority of these countries are now considerably more democratic and open than they were under communism, no CIS country has made sufficient progress in the creation of a pluralistic democratic society.[429] In some CIS countries, democracy has not even been put forward as a political goal. In others, the transition has been initiated and managed by small elites that have made choices about the political system and economic reforms with little if any participation by broader segments of society.[430] These elites frequently try to legitimize their power through pseudo reforms. In many CIS countries, competitive and regular elections have taken place but have been marred by various irregularities or are manipulated by political or economic elites (table 5.6.4).

In general, the political model adopted in the CIS features a strong role for the president and more limited power for the government and parliament.[431] Initially, in some of these countries, there was a decline in the power of their executives, but over time legal changes were made to increase presidential power as a counterbalance to the perceived loss of control over socio-economic development (table 5.6.4). As a result, leaders in many CIS countries appear more powerful than legitimate. They have frequently advocated the need to bring order to "chaotic" societies instead of proposing constructive and long-term coalition building. Typically, these leaders have extensive support from their constituents despite the relatively low level of civil liberties and political rights throughout the CIS (chart 5.6.4). For example, in Russia and Ukraine, over 80 per cent of individuals believe that a strong leader is more important than democracy, which is consistent with their views that democracy leads to chaos and anarchy, while a strong state personalized in a strong president can ensure peace and order.[432]

427 A. Przeworski and F. Limongi, "Political regimes and economic growth", *Journal of Economic Perspectives*, Vol. 7, No. 3, Summer 1993, pp. 51-69.

428 J. Dethier, H. Ghanen and E. Zoli, *Does Democracy Facilitate the Economic Transition? An Empirical Study of Central and Eastern Europe and the Former Soviet Union*, World Bank Policy Research Working Paper, No. 2194 (Washington, D.C.), October 1999.

429 According to Freedom House ratings, no CIS country is rated as a "consolidated democracy", nine CIS countries are defined as "transitional governments", while three are rated as "consolidated autocracies". Freedom House, *Nations in Transit 2002* [www.freedomhouse.org].

430 In contrast, much of the transition in eastern Europe was initiated by civil society and fundamentally shaped by a process of social consultation and consensus.

431 In eastern Europe, all countries have opted for parliamentary democracy with strong power vested in a government that is answerable to parliament and with a limited role for the president.

432 At the same time, a large majority of the citizens of Russia and Ukraine have little regard for and place no trust in state institutions such as the executive arm of the government, parliament and the judicial system. H. Harland et al., loc. cit., pp. 38-40.

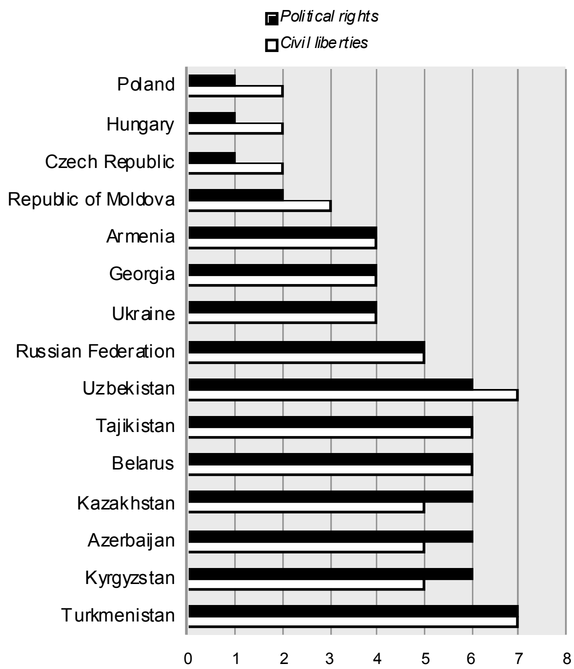
Other CIS countries, although democratic, are often marked by features such as non-existent checks on the power of the government, inequality before the law and disrespect for the rights of minorities. This indicates that free and fair democratic elections do not always produce democratic governments. This fact has generated a hypothesis that some newly democratizing countries (in particular in the CIS) give rise to governments that mix a substantial degree of democracy with a substantial degree of illiberalism.[433] Others disagree with this argument claiming that initially, a "young and inexperienced democracy" may produce adverse, divisive as well as grave side effects such as nationalism, ethnic conflict or war, but over time democracy helps instil habits of transparency, integrity, tolerance and accountability.[434] The need for such a transitional period is linked to the fact that "good governance" cannot be imposed upon a society, as it is the result of an evolutionary process that brings about incremental changes in political culture. While it requires formal institutions and rules, it also depends crucially on the norms of behaviour, informal conventions and self-imposed codes of conduct. These are complicated, not well understood and, above all, take a long time to develop.

5.7 Some conclusions and remaining challenges

As argued throughout this chapter, successful transition requires a consistent and sustained advance in systemic – i.e. basic and structural – reforms that depends to a large extent on both initial conditions and effective public governance. However, structural reforms in the CIS have so far not received sustained momentum from basic liberalization reforms, and progress is seriously hampered by corruption and by the slowness with which democratic institutions are emerging. Much of this is due to unfavourable initial conditions and the legacies of the communist past, sometimes exacerbated by political crises and armed conflicts. Consequently, the overall results of systemic reform in the CIS are disappointing, especially when compared to central Europe or the Baltic states. One of the negative features has been the emergence in some cases of under-reform traps, where a mismatch between liberalization or privatization, on the one hand, and economic and political institution building, on the other, has enabled powerful interest groups to block a balanced process of reform. Citizens might find authoritarian responses to these reform failures more appealing than liberal ones, an attitude which in turn could become a threat to the ongoing democratization of these societies.

CHART 5.6.4

Civil liberties and political rights, 2001-2002



Source: Freedom House, *Freedom in the World, Annual Global Survey of Political Rights and Civil Liberties, 2001-2002* [www.freedomhouse.org].

Note: The scale used is from 1 to 7 (1 – "the most free", 7 – "the least

The CIS countries are still faced with numerous reform challenges, which differ from country to country depending upon their achievements so far. First and foremost, the discussion in this chapter stresses that all the CIS countries need to institute more firmly the rule of law in order to establish trust both between the state and its citizens and among all market participants. This requires reducing the existing gap between legal implementation and enforcement, as this has turned out to be one of the major obstacles to foreign and domestic investment, enterprise restructuring and effective competition. In the CIS, as much as elsewhere, the legal transition must match progress in economic

[433] F. Zakaria, "The rise of illiberal democracy", *Foreign Affairs*, November/December 1997.

[434] C. Kupchan, "Democracy first", *Foreign Affairs*, May/June 1998.

and democratic transformation. All three areas reinforce each other: consequently, improvements in a legally safe investment climate will support further progress in economic, as well as political and legal reforms.

Second, the need for a stronger rule of law holds *a fortiori* for the natural resource-abundant CIS economies. While an initial reform phase helped to develop natural resources in Azerbaijan and Kazakhstan, there is a tendency for interest group pressure in the commodity exporting countries to hold back further structural reforms. This calls for economic diversification, which in turn requires above all positive and stable conditions for private investment, i.e. lower barriers to entry, and well developed competition and tax policies, all based on the rule of law.

Third, for the overly slow reformers, Belarus, Turkmenistan and Uzbekistan, the obvious challenge is to get started with a serious commitment to basic reforms, including wide-ranging liberalization policies and an acceleration of privatization. In most other CIS countries, there is a general need for a more consistent approach as well as for a consolidation of reform, e.g. by the finalization of privatization programmes (including key public monopolies). Especially in many Caucasian and central Asian economies, low levels of tax collection require a successful integration of the shadow economy.

Finally, the relatively more advanced reformers, Kazakhstan, Kyrgyzstan and Russia, still face important challenges in implementing the structural and institutional reforms that are essential for the efficient functioning of a market economy. Enterprise restructuring requires a more focused approach: bankruptcy procedures are weak, and corruption, administrative and tax barriers against new private enterprises, as well as regulatory uncertainty, limit the gains from other reforms. Also, governments still have to prove that they will not as a rule reverse the process of liberalization in response to economic crises.

While there is an undisputed need to accelerate systemic reform everywhere in the CIS, it has to be explicitly recognized that – throughout the world – political, economic and social reforms are always “works in progress”. Their design, implementation, timing, and ultimately their success, is never certain. Although there have been delays in systemic reforms in the CIS, progress has been made and in some cases quite considerable, especially when measured against the unfavourable initial conditions. Despite the pitfalls, the achievements should not be underestimated and success needs to be encouraged. Moreover, in recent years reforms have accelerated in some countries, especially in Russia and Kazakhstan. After years of painful failures, Russia’s reform progress is particularly encouraging, and may also have an important role to play in shaping attitudes to reforms and reform policies in the rest of the CIS. In consequence, the example of Russia as a successfully reforming economy could serve as an engine for the reform progress in other CIS countries. Promoting further trade liberalization within the CIS (chapter 6) will no doubt assist in spreading overall reform progress across countries, up to the point when it becomes mutually reinforcing. Thus the recent experience of successful reform efforts in some countries raises the hopes that the next phases of economic transformation in the CIS will be more successful than the first decade.