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Prospects and Challenges for Russia: Davidson Institute Surveys 100 Leading Transition Economists

by Jan Svejnar

Russia's economic performance since the fall of communism has been dismal. Since 1989 gross domestic product has fallen almost 50 percent, foreign direct investment has remained miniscule, capital flight has reached dramatic proportions, creation and growth of new firms has been low, and income inequality has approached levels observed in Brazil and India. Yet the Russian Federation is one of the richest countries in terms of natural and human resources. With appropriate economic policies, it could become a rapidly growing economy that is attractive to foreign investors.

In view of the importance of the recent Russian presidential election for the future course of the Russian economy, the William Davidson Institute commissioned a survey of leading policy- and business-oriented academic economists working on transition economies. The survey obtained experts' views about the performance of the Russian economy and future prospects and challenges for Russia. The 100 respondents, many of whom are research fellows of the Davidson Institute, are almost equally divided among economists in North America, Western Europe, and the former Soviet Union. Their views, summarized below, thus constitute a balanced cross-section of opinions and expertise.

• **The dismal performance of the Russian economy during the 1990s was worse than expected.** Almost two-thirds of the respondents state that economic reform has proceeded worse or much worse than expected. For the vast majority of analysts surveyed, Russia's transition from plan to market has not fulfilled its potential.

• **In five years Russia's economy is expected to perform better than (or at least as well as) it is currently performing.** The experts are cautiously optimistic about Russia's future economic performance. About 53 percent of them expect

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debate on development policy. Governments were pressured into improving the economic environment, albeit fitfully. We now know that pressure from civil society is effective in improving government performance. Civil liberties, such as freedom of the press, for example, increase the return on public investment.

Creating an effective reform process is thus essentially synonymous with creating an effective knowledge discovery process. The core of such a process is experiment and competition. There needs to be sufficient institutional variation and institutional choice that some institutions are revealed to be better than others.

What Role Can Donors Play?

What does this imply for the donor role? Donors can do much to assist both policy reform and institutional reform. In terms of policy reform, they can help pro-reform constituencies, within the constraints of appropriate conduct. The international community can encourage standards of good practice for information disclosure. It can provide the analysis that shows the true effects of policy.

With respect to institutional reform, donors can show governments that there are a wide range of potentially viable options and stress that diversity and experiment are legitimate responses to uncertainty. They can finance pilot institutional reforms that, if successful, can be scaled up through imitation. However, the international community cannot supplant the role of the government. The government cannot abdicate responsibility for working out a development strategy. There are good reasons why this process should be a partnership between the government and the international community rather than an activity undertaken entirely by the government

Paul Collier is director of DECRG at the World Bank. This article is excerpted from his paper "Consensus-Building, Knowledge, and Conditionality."

Beyond the 'Grabbing Hand' of Government in Transition: Facing up to 'State Capture' by the Corporate Sector

by Joel Hellman, Geraint Jones, and Daniel Kaufmann

"I only want to draw your attention straightaway to the fact that you have yourselves formed this very state, to a large extent through political and quasi-political structures under your control, so perhaps what one should do least of all is blame the mirror." Vladimir Putin's to Russia's business leaders in their meeting in late July, reported in *Washington Post*, July 29th 2000, page A1.

"The oligarchs were so called because they had real power, state power. They wrote laws. They appointed ministers, often entire cabinets, and made sure that their interests were served. They corrupted the new governing, legislative and bureaucratic class of Russia, in the centre, in the regions and abroad.'... [The new regime under] Putin,... now much strengthened, is unlikely to face a coup soon. But if he is not to rely on the rule of wealth, on what rule is he to rely?" From article by John Lloyd in the *Financial Times*, August 5th, 2000, page I.

Corruption is conventionally defined as "the abuse of public office for private gain". Behind this definition lies an image of a predatory state seen as a large "grabbing hand", extorting firms for the benefit of politicians, high officials and bureaucrats. In this view, the conventional policy recommendation for addressing corruption and improving governance is simply to reduce the role of the state in the economy. In this article, based on a joint research project between EBRD and the World Bank on governance in transition, we shift the focus to the role of firms. This shift has significant implications for policy.

The new evidence suggests that contrary to conventional notions of corruption as extortion of firms by bureaucrats (who can make it virtually impossible for the firm to operate), which we label as *administrative* (or bureaucratic) *corruption*, many firms in practice engage in high level corruption as a *choice strategy* and collude with state officials or politicians for their mutual benefit. This strategic choice decision, which we denominate as *state capture* (by the corporate sector), is becoming one of the enduring images of transition in

some countries—as illustrated by the opening quotes by the leader of one nation and by a noted observer of transition in an FT article.

In this article, we also summarize new evidence indicating that firms have powerful incentives to engage (and persist) in state capture, in contrast with administrative corruption. The private benefits derived by the 'captor' firm from state capture underscores the difficulty in addressing this type of corruption. We thus conclude with the rather different implications for action emanating from this shifting focus on state capture.

Measuring administrative corruption and state capture

To measure and analyze administrative corruption and state capture we use data from a specially designed Business Environment and Enterprise Performance Survey (BEEPS) carried out in mid-1999.¹ The survey, commissioned jointly by EBRD and the World Bank, provides firm-level data on obstacles in the business environment in 22 transition economies.

Administrative corruption is understood to be the illicit payments required from the firm in the (oft-distorted and arbitrary) *implementation* of existing regulations, policies and laws. Administrative corruption is measured as the proportion of annual revenues paid to public officials to “get things done” (last column in table 1 below). The results reveal considerable variation in the level of unofficial payments across transition economies, ranging from 1.1 percent of gross firm revenues in Croatia to almost 6 percent of gross receipts in Azerbaijan. Since this measure is a proportion of gross revenues rather than profits, in bribes end up accounting for a very substantial proportion of net profits in most countries.

The survey also allows for the first time to arrive at a proxy measure for *state capture*. In contrast with administrative corruption, state capture is defined as the capacity to affect the *formation of the basic rules of the game* (laws, rules, decrees, regulations) through private payments to public officials. A cross-country index of state capture (as seen in all its subcomponents in table 1) is constructed

as the extent to which the following forms of corruption (by themselves or others) have had a direct impact on firms' business:

- Sale of Parliamentary votes on laws to private interests.
- Sale of Presidential decrees to private interests.
- Mishandling of funds by the central bank.
- Sale of criminal court decisions.
- Sale of commercial court decisions
- Contributions paid by private interests to political parties and election campaigns.

The transition economies can be divided into *high* capture group versus those exhibiting a *low* (or ‘medium’) extent of capture, based on scores on the state capture index. By comparing the last few columns in Table 1, it is noteworthy that there is no necessary tight correspondence between administrative corruption and state capture at the country level (see for instance the gap between both forms of corruption for countries such as Bulgaria, Latvia, Russia, Croatia, Belarus and Uzbekistan), backstopping the importance of unbun-

dling corruption into its different key components.

Countries with low-to-medium prevalence of state capture include Albania, Armenia, Belarus, the Czech Republic, Estonia, Hungary, Kazakhstan, Lithuania, Poland, Slovenia, and Uzbekistan. This is an unusual group because it includes both advanced reformers and least reformed countries in the political and economic dimensions. In countries such as Belarus and Uzbekistan—where there has been minimal privatization, the private sector remains small, and important elements of the command system are still in operation—the capacity of private sector interests to capture the state might be expected to be low almost by definition, since the legacy of the past still suggests a state-led fusion. In contrast, the most reform-minded countries (such as Hungary and Poland) have achieved the most progress in liberalizing the economy, strengthening bureaucratic accountability, and promoting political contestability—all factors that might be expected to place limits on the capacity of powerful firms to capture the state.

Table 1 – State Capture and Administrative Corruption, by Country

Country	Parliamentary Legislation	Presidential decrees	Central Bank	Criminal Courts	Commercial Courts	Political Party Finance	Capture Index (avg)	Capture Index Class.	Administrative Corruption Level of bribery % of firm revenues	The high capture group includes Azerbaijan, Bulgaria, Croatia, Georgia, Kyrgyzstan, Latvia, Moldova, Romania, Russia, Slovakia, and Ukraine. Most of these countries could be considered partial reformers in both the political and economic transition. While they have made progress in the liberalization and privatization fronts, lesser advance is evident in the complementary institutional reforms to support a legal and regulatory framework for the emerging market. Furthermore, while most countries have adopted the basic rules of democratic elections, the evidence raises questions about the concentration of political power, limitations on political competition and constraints to full
Albania	12	7	8	22	20	25	16	Low	4.0	
Armenia	10	7	14	5	6	1	7	Low	4.6	
Azerbaijan	41	48	39	44	40	35	41	High	5.7	
Belarus	9	5	25	0	4	8	9	Low	1.3	
Bulgaria	28	26	28	28	19	42	28	High	2.1	
Croatia	18	24	30	29	29	30	27	High	1.1	
Czech Rep	18	11	12	9	9	6	11	Low	2.5	
Estonia	14	7	8	8	8	17	10	Low	1.6	
Georgia	29	24	32	18	20	21	24	High	4.3	
Hungary	12	7	8	5	5	4	7	Low	1.7	
Kazakhstan	13	10	19	14	14	6	12	Low	3.1	
Kyrgyzstan	18	16	59	26	30	27	29	High	5.3	
Latvia	40	49	8	21	26	35	30	High	1.4	
Lithuania	15	7	9	11	14	13	11	Low	2.8	
Moldova	43	30	40	33	34	42	37	High	4.0	
Poland	13	10	6	12	18	10	12	Low	1.6	
Romania	22	20	26	14	17	27	21	High	3.2	
Russia	35	32	47	24	27	24	32	High	2.8	
Slovakia	20	12	37	29	25	20	24	High	2.5	
Slovenia	8	5	4	6	6	11	7	Low	1.4	
Ukraine	44	37	37	21	26	29	32	High	4.4	
Uzbekistan	5	4	8	5	4	6	5	Low	4.4	
Overall	24	21	25	18	20	20	21	3.0		

participation by civil society in many countries. The data suggests that state capture appears to thrive in such an environment of only partial economic and political liberalization.

Indeed, as seen in Figure 1, in countries with a very low level of civil liberties (where the state retains substantial control over the economy), state capture is limited (virtually by definition). At the opposite extreme of the civil liberty spectrum where civil society is developed and active in monitoring and applying pressure on politicians and public officials, the capture economy is also rather small (for very different reasons). And in sharp contrast with both extremes, countries with only partial exhibit extensive state capture.

The incentives to engage in corruption

Needless to say, the problem of state capture also depends directly on the behavior of firms. Although the image of the powerful oligarch is the media face of state cap-

ture we find, somewhat surprisingly, that state capture is a strategy also associated with many *new entrants*. These firms engage in state capture in part to offset insecure property rights and competition from secure, powerful incumbents. State capture inter alia allows these firms to purchase security of property rights “a la carte” from the state. In countries with a *large capture economy*—that is, where there is a large segment of the economy affected by capture and with a large market for firms to purchase laws, regulations, or decrees from politicians and bureaucrats—it is also found that “captor” firms perform substantially better than other firms in terms of sales growth.

Moreover, these private benefits to captors are bought at substantial social cost, as seen in figure 2. As seen in the last pair of bars in the figure, on average the enterprise sector in the “Capture Economy” end up with much worse performance than enterprises on average in low capture economies, despite the specific private benefits

that the captor firms enjoys in the Capture Economy. Within the Capture Economy we also find the least secure property rights: state capture allows a few firms to create a zone of relative security, while increasing the overall level of insecurity for other firms. This fuels a vicious circle in which more firms have an incentive to resort to state capture to protect their rights and interests.

By contrast to the private benefits to capture by firms in the Capture Economy, in countries in which the capture economy is small, those few firms opting to captures exhibit worse performance in terms of sales growth than other firms (Figure 2). In low capture settings firms opting to capture as a strategy do not out-perform firms pursuing more market oriented strategies—and the adverse impact of their capture activities on the overall economic environment is more limited and less socially costly.

Furthermore, also in contrast with the private benefits to state capture in the Cap-

Figure 1. State Capture and Civil Liberties

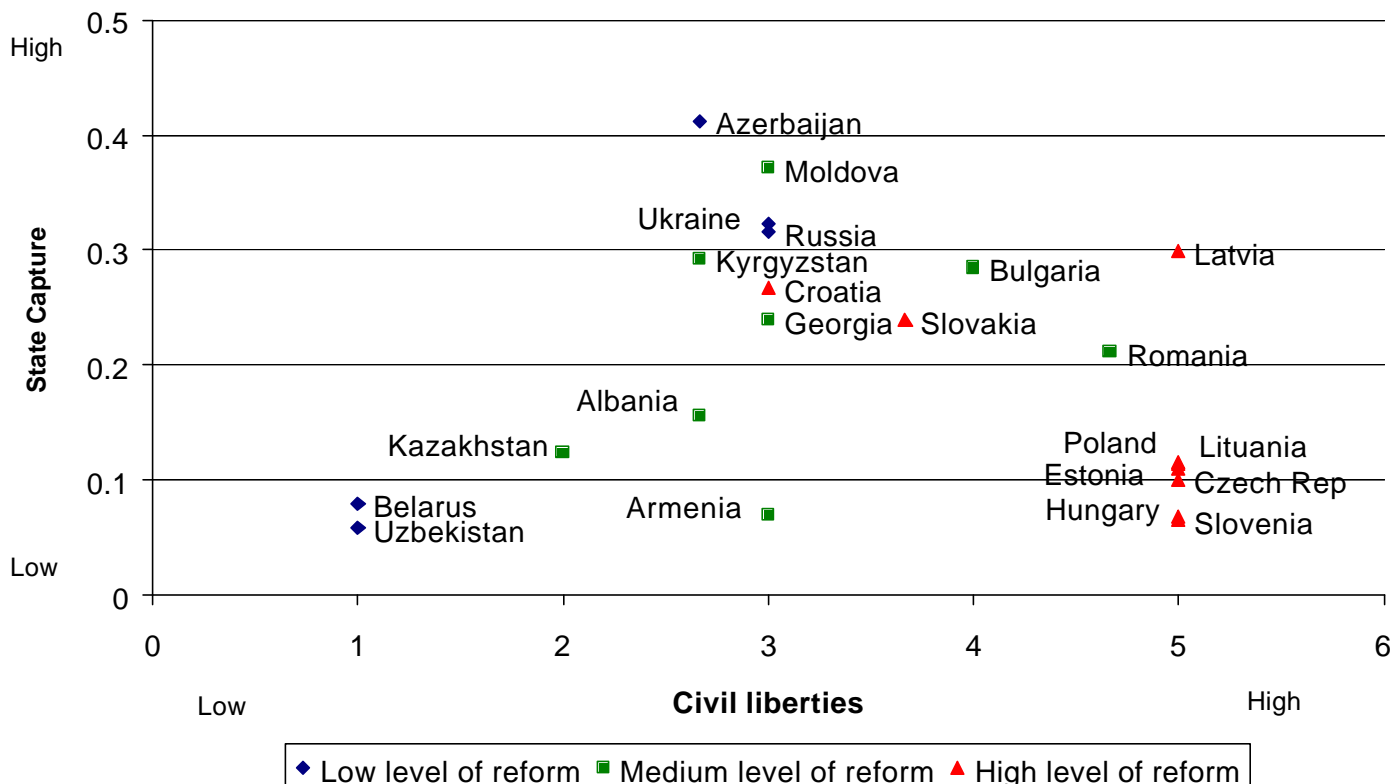
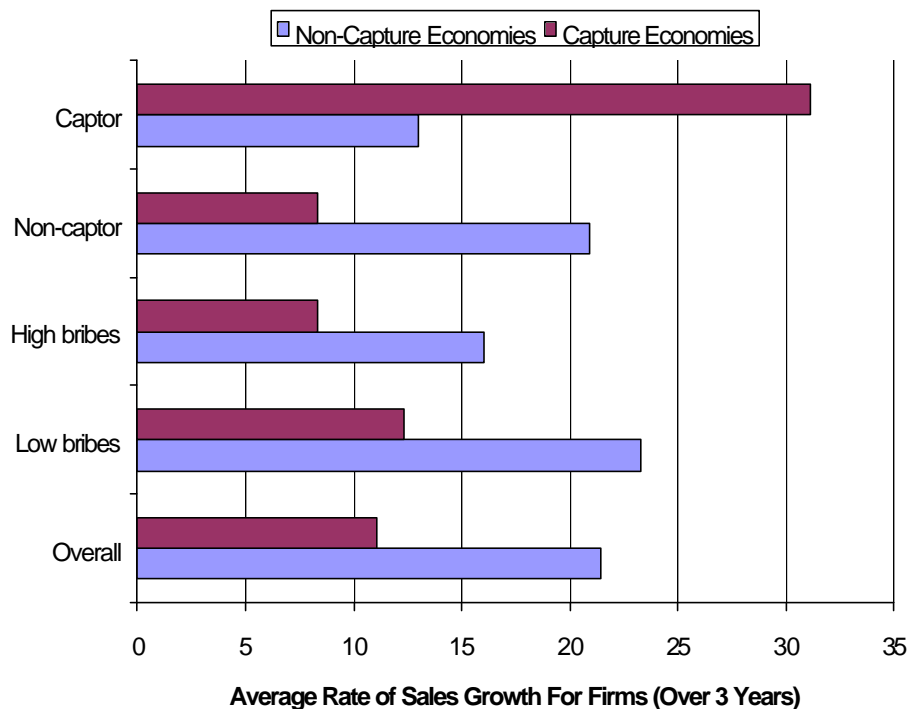


Figure 2. The private and social costs of state capture and administrative corruption



ture Economy, firms subject to high levels of administrative corruption do not accrue private benefits from such illicit payments (depicted in Figure 2 as well). These results on administrative ('pettier') forms of corruption are consistent with a "grabbing hand" notion of state-induced predation, one where the discretionary power of politicians and bureaucrats in the application of regulations dominates their relationship with the enterprise sector — and thus is closer to extortion from the state apparatus (in contrast with the much less frequent (but vastly more damaging) state capture, where the firm does face a strategic choice to collude or not to collude with politicians or bureaucrats in purchasing the laws and policies of the state).

Other forms of corruption and influence

While much of the focus on the research paper summarized here is on state capture in many transition economies, we also emphasize that this is not the only manner in which firms attempt to influence the state. Some firms, by dint of their power and connections, have the capacity to *influence* the state (and benefit accordingly)

without necessarily having to resort to overtly corrupt strategies. Indeed the privileged position of many older incumbent firms (such as many larger state enterprises where the directors may have colluded with politicians long ago to protect the position of such incumbents) do compel some new entrants to 'purchase' laws or regulations to enhance their competitiveness and property rights vis a vis such influentially protected incumbents. Indeed, it is found that there is a cadre of incumbent firms which are influential and do not have to engage in the purchase laws, policies or regulations.

Furthermore, our empirical research provides clear evidence of the importance of *public procurement corruption*, defined as efforts to secure public contracts through payment of kickbacks to officials, as an oft-used channel of influence as well. Across transition economies, we find that firms that choose rent-seeking strategies based on kickbacks for public procurement also show substantially greater gains than other firms. A companion paper stemming from this ongoing research project (summarized in the *July 2000 Transition* issue) ad-

resses the extent to which firms with *foreign direct investment and transnationals* are also involved in paying public procurement kickbacks and engaged in other forms of corruption.

How to Fight Corruption in the Capture Economy?

Policymakers need to focus on strategies for addressing state capture and corruption in large-scale procurement. The persistence of these problems is related to the strong incentives that firms have to engage in them. Conventional recommendations of economic and trade liberalization advocated to address administrative corruption will not suffice.

Where state capture has led to entrenched interests, breaking up monopolistic structures will be a particularly daunting challenge. Its success will of course depend on the role of the political leadership. At the same time it will be critical to implement strategies to deepen competition and entry policy, promoting the ability of new entrants to compete with powerful incumbents. This will entail improvement in the security of property rights faced by new entrants, and their ability to have competitive access to assets which are still being privatized (or being liquidated from moribund older firms). Over time, a new cadre of multiple 'smaller oligarchs' may emerge and through competition by a cadre of, say, thirty-to-fifty influential firms in a country the current policy and legal distortions (and in law making) brought about by state capture may be mitigated.

The focus of reform options ought to shift some to addressing the channels through which firms interact with the state. For providing a set of checks and balances to make such relationship more transparent and conducive to economy-wide gains it will be key to support the development and deepening of societal "voice". Further, the social cost of state capture needs to be made transparent to the population, reform groups, and NGOs. In this context,

the implementation of in-depth surveys of citizens, firms and public officials and their wide dissemination can help empower and mobilize civil society and reformists in the executive and legislative bodies.

Policymakers should also consider introducing transparency reforms already prevalent in many countries in Latin America and OECD, such as public hearings to determine the "rules of the game" in large procurement contracts and NGO monitoring of the public procurement bidding process. Introduction of periodic mandatory public declarations of assets and income sources by government officials and their dependents would also help.

The ongoing revolution in internet and knowledge-based services can foster the emergence of a new cadre of potentially powerful entrepreneurs. The internet revolution also allows for the wide dissemination of data on corruption and state capture,

helping to expose the extent of the problem and mobilizing public opinion. The internet should also permit the quick and broad codification and public dissemination of parliamentary votes, thereby enhancing disclosure on potential conflict of interest between lawmakers and the corporate elite.

The internet also offers revolutionary new ways to increase transparency and reduce corruption and costs in public procurement. Local NGOs could conduct and disseminate periodic in-depth diagnostic surveys on state capture and public procurement corruption, detailing the extent and manifestations of such practices in different institutions and by different industrial groups.

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ence held in April in Washington, DC) entitled "Seize the State, Seize the Day: State Capture in Transition". The joint research project on governance by EBRD and the World Bank Institute is led by J. Hellman and D. Kaufmann, and also serves as an input to the forthcoming report "Anticorruption in Transition" to be presented at the Annual Meetings in Prague. For the research papers, visit <http://worldbank.org/wbi/governance/>

¹ Survey data were collected through face-to-face interviews with firm managers or owners in site visits conducted between June and August 1999. In most countries, 125–150 firms were interviewed, except for the larger samples used in Poland (250), Russia (550), and Ukraine (250). Sampling did account for the domestic structure of the enterprise sector, with quotas placed on size, sector, location, and export orientation. (see *Transition*, December 1999, p. 6, and "Measuring Governance, State Capture and Corruption", PRWPaper 2312 at <http://worldbank.org/wbi/governance/>).

China's Future Depends on Further Reforms

by Chi Fulin

Today, as China's economy struggles and social conflicts are on the rise, system innovation through reform is becoming vital and urgent. In fact, with its accession to the WTO likely, China has no alternative to reform if it wants to reap the benefits of economic globalization. Benefiting from globalization will demand that China relinquish administrative control, phase out sectoral monopoly, and provide enough leeway for the effective functioning of market mechanisms while creating a level playing field for all market participants. Consequently, if we want China to meet the challenges of WTO accession, we should encourage the involvement of the nonstate economy in such sectors as finance, telecommunications, civil aviation, and education. Accelerating reform is necessary to facilitate economic growth and maintain social stability.

China's economic reform has come to a critical crossroad; now is the time for substantial breakthroughs. China was supposed to establish a socialist market system by the end of the 20th century. It is fair to say that significant breakthroughs in the strategic restructuring of the state economy, in the establishment of a new income distribution system, and in the shift in the government's role are yet to come.

Relative surpluses and relative shortages coexist in China. The supply of commodities and manufactured products exceeds demand, while financial, housing, educa-

tion, and health care services—sectors considered off limits to nonstate investors—are unable to keep up with demand. As a result, in recent years prices of many industrial products continued to fall, while service fees increased more than 10 percent a year on average.

Stimulating Demand

The government's efforts to counter deflation in the past two years by invigorating the economy were less than successful, because of fundamental systemic constraints and barriers. As I pointed out in an

earlier article (*Transition*, February 2000, p. 13), China has great investment potential, with savings deposits of enterprises and the public amounting to nearly 7,000 billion yuan. This huge pool, however, has remained practically frozen, as the government's expansive fiscal policy has failed to stimulate investments by enterprises or individuals. In 1998 fixed asset investment by the state grew 19.6 percent, while private investment increased only 6.1 percent and fixed asset investment by town and village enterprises dropped 3.5 percent. The situation remained much the same in the first quarter of 2000.