

The Newsletter About Reforming Economies

# Beyond Transition

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*The study by Institute of Urban Economics in Moscow confirms that at-risk groups for poverty in Russia are households of nonworking retirees, large families, households with disabled members, poorly educated households, and those living in smaller cities.*

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## From the Managing Editor:



Many poor in the CEEC and the CIS have benefited from the high growth rates in recent years, but the impact on poverty varies substantially from country to country and from region to region. The pattern is neither new nor unique: one of the most striking features of global development is how even modest growth in some places has brought millions over the poverty line, while in others rapid growth has had little or no impact on the poor.

Given the political importance of linking growth to poverty alleviation, it is remarkable how little we know, conceptually and empirically, about what explains the variations. This issue of *Beyond Transition* takes as its starting point recent work by Timothy Besley, Robin Burgess, and David Donaldson examining the international evidence and the record of Indian states. We also bring in experiences from Poland, China, Russia and Latin America.

Of course, the differences in poverty impact reflect to some extent the differences in welfare systems. The effectiveness of redistribution mechanisms in reaching the poor varies greatly across countries, particularly within the CIS. In Russia, for example, more than half of benefits go to the richest 60 percent of the population. Alberto Alesina, in our interview, discusses differences in attitudes on redistribution and uses German reunification to show that attitudes change only slowly.

But as Besley, Burgess and Donaldson emphasize, the distribution of production opportunities may be more important than redistribution of income in understanding the impact of growth on poverty. The transition out of agriculture into the secondary and, in particular, the service sectors dwarfs most other factors in its effectiveness in fighting poverty. This perspective shifts attention to property rights and the quality of institutions protecting these rights.

A focus on access to production opportunities also brings out the importance of human capital development and access to finance. Besley et al. demonstrate that regulation, even when pro-poor, can have a negative impact on the opportunities open to the poor. Interestingly, openness to trade does not come out as a strong factor in their analysis. To shed more light on this point, this issue includes two articles examining the Chinese and Russian experiences from trade liberalization.

Perhaps the least understood channel between growth and poverty runs through politics. Besley et al. explore how issues of voice and accountability, for example, can affect the growth-poverty relationship. We also look at new comparative work on the role of different constituencies in bringing about important transitions, such as urban-rural migration or approaching the world technology frontier. Judging from Alvaro Garcia's article, the experience of Latin America is very different from that of Central and Eastern Europe, but perhaps not so different from that of Russia.

Sustaining the high growth rates of recent years is a major challenge for the countries of Central and Eastern Europe and the CIS, but ensuring that the poor benefit from this growth is an even greater one. The experience reported in this issue suggests that more emphasis should be put on the institutions crucial to the creation of production opportunities, as a complement to redistribution systems. In any case, attitudes on redistribution are likely to be determined by factors such as history and ethnic heterogeneity, which are hard to affect through policy.

What is required from the institutional environment will change, as countries move closer to the technology frontier and increasingly have to rely on their own innovative capacity. Another lesson is that regional variations in production technology and investment climate within countries may be at least as important as variations across countries. Large countries such as Russia may want to differentiate policies and experiment on a regional basis, in order better to understand impact.

*Beyond Transition* is continuing its own transformation. We are gradually introducing more interactive features, to engage our readers in important debates about institutional change and development. In particular, we are inviting reactions to previous features and contributions by policymakers and academics. We are also keen to increase content originating in the region.

In order to bring down costs and ensure speedier delivery, we are moving to electronic publishing. We will maintain a smaller hard-copy edition, but during the fall the *BT* web site will be upgraded and the electronic version of the publication will be enhanced with more features. We welcome suggestions from readers for how best to make use of this opportunity.

*Erik Berglof, Managing Editor*

# Global poverty reduction via expanding opportunities

Timothy Besley, Robin Burgess, and David Donaldson

**W**hich institutional and policy features have been successful at reducing poverty? We draw on data from international and subnational (Indian states) sources to identify the features of economies in which growth is particularly pro-poor. These features include well-protected property rights, accountable governments, access to education and finance, and unregulated business environments.

We begin by considering how changes to inequality and growth affect poverty reduction on a cross-country level, using World Bank household survey data. The growth effect is strong in every region of the world except Sub-Saharan Africa, but varies considerably between regions. The correlation between inequality and poverty is less pronounced, reflecting the fact that, historically, change to inequality has not been an important source of poverty reduction.

We also learn that the type of growth matters. “Structural change”, in which production shifts from primary to secondary and tertiary sectors, is correlated with growth but has an especially strong correlation with poverty reduction. The tertiary sector is, on average, most important to poverty reduction, and reallocations out of agriculture are important. Still, variations among regions persist.

Institutional and policy features shape growth and poverty reduction, but the impact of these features on growth is much better understood than their impact on poverty. We identify four ‘signposts’ from the cross-country analysis — factors that seem most important for reducing poverty: enforcement of property rights, especially in relation to land; governance, accountability and voice, in particular the flow of information and free media; access to productive opportunities, including human capital development, access to finance and bank availability; government regulation that impacts a country’s ‘business climate’, such as pro-labor regulation, barriers to entry, and restraints on international trade (though evidence of the effects of openness on poverty are less concrete).

We use these signposts to compare poverty reduction effects at the state level in India. We assess the links between growth, poverty and inequality in 16 major Indian states, accounting for more than 95% of the Indian population, over the period 1960-2000.

Throughout India, real agricultural output per capita has been relatively flat over the period. However, around the mid-1970s real non-agricultural output per capita began to accelerate, but this pattern varied highly across states. Some states, such as Assam, Bihar, Jammu and Kashmir, have seen limited structural changes and economic growth; others, such as Gujarat, Haryana, Kerala, Punjab and West Bengal, have seen impressive non-agricultural growth. The sources of this heterogeneity are

only beginning to be understood. More striking is how the poverty-reducing effects of growth vary markedly across Indian states. States such as Kerala have seen remarkable poverty reduction off of relatively weak growth; others, such as Haryana, have grown impressively but had much slower poverty reduction.

We find a number of correlations that may explain this heterogeneity in the extent to which growth is ‘pro-poor’. Structural change (as proxied by the share of non-agricultural output in total output) is associated with reductions in poverty. While inequality is not correlated with poverty, there is some evidence that lower inequality increases the poverty impact of economic growth.

But how much have the institutional and policy reforms adopted by different Indian states affected the extent to which economic growth influences poverty? Which are the most effective for reducing poverty? We can make use of the heterogeneity we found in our analysis to offer some tentative conclusions about the microeconomics of poverty reduction.

- *Property rights:* Institutions that protect property rights will be critical to encouraging investment, trade and exchange and to ensuring the participation of the poor in economic growth. States that have had more land reforms have tended to have more rapid rural poverty reduction.

- *Voice and accountability:* Mass media and democracy stand out. Newspaper circulation has had a critical bearing on the degree to which state governments respond to droughts and floods via food distribution and relief expenditures.

- *Access to finance:* States with more rapid bank branch expansion into un-banked areas have experienced faster rural poverty reduction and higher rates of non-agricultural economic growth. Increasing access to financial services in rural areas both increases the poverty-growth elasticity and encourages economic growth.

- *Human capital:* Investment in education has been central to reducing poverty both by increasing poverty-growth elasticities and by encouraging economic growth. States with more female literacy and labor force participation have done better at reducing poverty.

- *Regulation:* Labor regulation is a key part of the business climate in India. States with more pro-worker labor regulation have tended to have slower growth in manufacturing and higher rates of urban poverty.

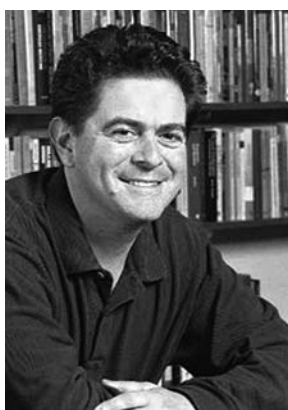
*The article is based on a presentation by Timothy Besley, Robin Burgess, and David Donaldson at a workshop in Stockholm in March 2005. Robin Burgess is reader in economics, Timothy Besley is professor of economics and political science, and David Donaldson is a doctoral candidate, all at the London School of Economics and Political Science. ■*

## Alberto Alesina: "I don't think that transition economies can afford the kind of welfare system that Western Europe has"

*Alberto Alesina is Nathaniel Ropes Professor of Political Economics and Chairman of the Department of Economics at Harvard University. He has authored several books, including Fighting Poverty in the US and Europe: A World of Difference, published by Oxford University Press in 2004 (with Edward Glaeser). Prof. Alesina answered questions during his recent visit to Moscow, where he delivered a series of lectures at the New Economic School.*

Looking back a few decades, can you say that the economists' understanding of poverty has changed? Have there been any myths on poverty that careful economic analysis has uncovered and refuted?

I'm not an expert on poverty in developing countries, but as for developed countries one issue that is now better understood is that a lot of programs meant to reduce poverty and inequality have instead created "pockets of privileges" for some people within the poor groups. For example, some labor laws, meant to protect labor against capital, in reality brought privileges for insiders and the unions and created barriers for entry for young people into the labor force. Very generous pension systems have been redistributing from the young to the old, with the old not being necessarily poorer, particularly as life expectancy has increased. What economists now better understand is that, when applied, certain redistributive policies in developed countries bring unintended effects, dividing the poor into insiders and outsiders and creating more inequality.



What policies, in your opinion, have worked well for the poor?

I think growth in general is always better for the poor. So the example of pro-poor policies would be maintaining market competition, avoiding barriers to entry, reducing regulation, avoiding monopolistic power, i.e. having policies that do not interfere with market forces, make markets work and are growth-enhancing. And a healthy growth in the economy makes taxing and redistributing feasible. However, if you have high taxes and market impediments, then you grow much slower and actually increase inequality, because insiders and those with connections get richer and richer. You get neither more equality, nor more growth. So my recipe would be: defend the market at all costs, leave a lot of market competition, and then you can afford to redistribute.

The approaches to fighting poverty in Europe and the US have been very different, as even the title of your recent book suggests, and this is despite similarities in economic fundamentals. Your research attributes these differences in welfare spending to political (institutional) and sociological/behavioral fac-

tors (e.g. racial fragmentation). Given Europe's historical electoral system and relative ethnic homogeneity, do you think European countries will ever move to a low-tax, smaller state and limited regulation system like in the US? What will it take?

I don't think that European countries will in any foreseeable future move in the direction that makes the structure of their welfare system any closer to the US. There will be some reforms, some trimmings here and there, pension systems will have to be adjusted because some countries are not solvent, but I don't foresee any major changes. One interesting aspect, though, is that Western Europe will become less homogeneous because of the wave of immigration. The European welfare state will face a pressure similar to that in the US from political parties arguing that the country cannot afford paying for welfare to immigrants, which will lead to discussions how not to incorporate immigrants in the welfare state. What is going to happen then is difficult to predict.

Let me then ask, should they change their welfare system? Is it too big?

Assuming we're talking about an efficient system (and everybody agrees that a welfare system should be as efficient as possible), the question of how much to redistribute is very much a political preference that is not "right" or "wrong". However, what I find somewhat irritating and not useful is the rhetoric in Europe: they claim that they would like to grow as fast as the US, be as powerful in foreign policy, and at the same time keep the European welfare state, meaning working fewer hours, having a much more regulated market, higher job security, a lot of redistribution, and early retirement. What I find not useful in this political debate is the lack of recognition that these goals are inconsistent. Choosing to have a European welfare system means that you should accept slower growth compared to the US, a smaller army, and therefore less power in foreign policy because you use all your taxes to redistribute. You should also accept that in 10-20 years countries like Korea, Chile and Mexico will have a higher income per capita because they are growing much faster. There is nothing wrong

with it. Western European countries are rich economies with low poverty levels, they can certainly afford not to grow very fast. But then they should stop talking about faster growth.

**Americans think the poor are lazy, Europeans think the poor are unfortunate. In your book you say that opinions and beliefs result from politics and institutions. Could one say that a belief in a strong state that should take care of its population, which seems to be widespread in transition countries, may change as institutions change?**

First of all, I would not say that institutions cause beliefs — it goes both ways. I think that ideology and beliefs matter in creating certain institutions, and then the institutions themselves cement those ideologies. In a paper with Nicola Fuchs-Schuendeln [see article on p. 6], where we compare the change in attitudes about the role of the state after the unification of Eastern and Western Germany, we find that attitudes do change, but not very quickly. It takes about a generation for the attitudes of former Eastern and Western Germans to become indistinguishable. So it will take quite a while for this belief about the role of the state in transition economies to change. First, as I said, because attitudes change slowly, and second, because transition has generated a big increase in inequality and those who have lost from transition create demand for state intervention.

What we say in our paper is that much has been said about short-run economic effects of the unification but perhaps a political shock — incorporation of 25% of the population strongly in favor of state intervention — will have a much deeper effect. So, for example, reforming the welfare state in Germany, which one might believe is important for achieving higher efficiency and growth, becomes much more difficult due to this political shock.

**Is there a message in your book to policymakers in transition countries?**

The book makes it very clear that we don't make any judgments, we don't say that the US system is good and the European one is bad, or vice versa. Our book is not prescriptive

at all. However, leaving aside the book, what transition politicians should learn from Western Europe, I think, is that if you build a system with excessive regulation, significant market intervention, high marginal tax rates, and generous pensions, then you may significantly interfere with growth, and in the long run what really eliminates poverty is more growth. I don't think that transition economies can afford the kind of welfare system that Western Europe has. The generosity of welfare systems in Western Europe increased tremendously in the 1960s, 1970s and early 1980s, when the level of per capita income was much higher than it is now in transition economies. My suggestion would be to reduce the most extreme manifestations of poverty using the smallest amount of resources possible and targeting them extremely well. In developing countries there is certainly a lot of mistargeting in poverty reduction programs. A lot of money is spent in cities on people who are reasonably well off, at least by developing countries' standards, while extreme poverty in the countryside is completely unaddressed by the central government. So, focus on extreme pockets of poverty and target very well, protect the free market, and let everybody take advantage of market capitalism.

**Going back to the book's results, which findings have surprised you most?**

When we finished the book I found myself believing much more than when I started how deep-down the differences are in the attitudes of Europeans and Americans towards poverty, ideology, and the role of Marxism, and how much these differences explain. When I started the book, I would have placed much more emphasis on economic factors, institutions or race, and I found surprising how important the attitudes were in explaining policies. It was surprising how prevalent Marxist thinking, communist and socialist ideology are in Western Europe. Even though nobody would call himself a communist or perhaps even a socialist any longer, these ideologies have had a profound impact on the ways Western Europeans think, much more so than in the US, where there has never been a significant socialist movement. These things may be obvious, but before starting the book I didn't realize how important they were. ■

Country	National poverty line		International poverty line		
	Survey year	Population below the poverty line, %	Survey year	Population below \$1 a day, %	Population below \$2 a day, %
China	1998	4.6	2001	16.6	46.7
Georgia	1997	11.1	2001	2.7	15.7
Hungary	1997	17.3	2002	<2	<2
India	1999-2000	28.6	1999-2000	35.3	80.6
Kazakhstan	1996	34.6	2003	<2	24.9
Russia	1994	30.9	2002	<2	7.5
Ukraine	1995	31.7	1999	2.9	45.7
Uzbekistan	2000	27.5	2000	17.3	71.7

Source: The World Bank, World Development Report 2005

# Good-bye Lenin (or not)?

## The effect of communism on people's preferences for redistribution

Alberto Alesina and Nicola Fuchs-Schuendeln

**P**references for redistributive policies differ significantly across countries. Do regimes differ solely because of the populations' different initial preferences for redistribution? Or is there a feedback effect from the regime on preferences? Post-war Germany offers an opportunity to analyze the effect of Communism on preferences. Our empirical analysis, based on more than 18,000 year-person observations, reveals that the effects of Communism on attitudes towards the role of the government are large and long lasting. It will take one to two generations for the preferences of former East and West Germans to look alike.

From 1945 to 1990, Germany was split into two parts for reasons that had nothing to do with Germans' individual preferences, desire for separation, or diversity of visions. Because the political and economic systems have been the same in the eastern and western parts of Germany since reunification in 1990, and were the same before 1945, West Germans constitute a meaningful control group for East Germans. Therefore, comparing the differences in attitudes, beliefs and political preferences for market capitalism and the role of the state after the reunification can give us a clue on the effects of having lived for 45 years under a Communist regime.

For our analysis, we use data from the German Socio-Economic Panel, an annual household panel. We use the original sample established in West Germany in 1984 (11,400 year-person observations), and the sub-sample covering the territory of the former GDR (7,000 year-person observations) for two years, 1997 and 2002. In both years, respondents were asked about their preferences regarding the role of the state in different areas of social security, namely in providing financial security for families, the unemployed, elderly, sick, and people requiring long-term care. Two additional questions were designed to capture respondents' beliefs on the role of alternative driving forces for success in life: individual effort versus luck and/or social conditions.

The main explanatory variable is a dummy that takes on the value of 1 if the respondent lived in East Germany before reunification, regardless of current place of residence. We control for the age, gender, marital status, labor force status, and occupation of the respondent, the number of children, and the number of adults in the household, as well as annual household income.

### East Germans have stronger preferences for an active state role

Our analysis shows that an East German is significantly more likely to have preferences for state intervention than a West German, even after controlling for household income. In 1997, being from the East increased the probability of favoring state intervention by between 14 and 16 percentage points, compared to being from the West.

### 20-40 years needed for preferences to converge

However, East Germans are becoming less pro-state over time: Between 1997 and 2002, the probability of favoring state intervention for an East German declined by between 2.5 and 5.8 percentage points. Assuming that convergence is linear, we estimate that it will take roughly between 20 and 40 years, or one to two generations, for Eastern and Western preferences fully to converge.

- *Age effects.* In the West, the older are progressively less pro-state than the young, a pattern also observed in the US. However, in the East the exact opposite is true. The quantitative implications of the age effects are large. While an East German born after 1975 is only between 3 and 11 percentage points more likely to be in favor of government redistribution than a West German of the same age, the difference increases to between 21 and 49 percentage points for people born before 1945. The obvious interpretation of this strikingly different age pattern between East Germans and West Germans is that while age tends to make individuals less pro government in West Germany, this effect is more than compensated for by the fact that elderly East Germans have lived longer under communism.

- *Decomposition of change over time.* Is the above-mentioned decline in East Germans' preferences for redistribution between 1997 and 2002 simply a result of a shift in the cohort composition, or of changes in personal preferences? By including in the regression only individuals who answered the relevant questions in both 1997 and 2002, we are able to conclude that approximately two thirds of the convergence arises from an actual change in preferences, while approximately one third arises from a shift in the composition of the cohort.

- *The effect of Communism: poverty or preferences?* The poor tend to favor government intervention more than the rich. Yet the fact that East Germans have on average lower household income does not explain our results; they are robust to the inclusion of current household income, expected household income, and the share of household income currently coming from government sources. In addition to personal income, however, there might be an aggregate income effect; individuals living in regions poorer than average may prefer government intervention because of the active redistribution from richer to poorer regions. By including average per-capita income and unemployment rate of the state of residence, as well as transfers received or paid by the state, we find that up to one third of the "East effect" can be explained by the fact that the East became poorer during Communism and is now a net beneficiary of redistribution within Germany.

- *Migration and preferences.* East Germans are certainly not a homogeneous group: 7% of them in our sample have

migrated to the West. When checking for differences among East Germans, we find that East Germans living in the West favor government intervention more than "native" West Germans, although only half as much as East Germans who remained in the East. The latter could mean either a faster convergence of preferences of East Germans who moved to the West, or a self-selection — the group might have had lower preferences for state intervention to begin with. Note, e.g., that the average age of Eastern respondents who moved to the West is 34, while the average age of Eastern respondents who stayed in the East is 45. All the convergence in preferences between 1997 and 2002 is driven by East Germans who stayed in the East. The preferences of East Germans who moved to the West do not change significantly between 1997 and 2002. Again, there are several possible explanations for this phenomenon. It could be that the preferences of East Germans who moved to the West converged initially, but that they reached their new steady-state level by 2002. In this case, we should likewise not expect full convergence for East Germans staying in the East. On the other hand, it could be that those East Germans who moved to the West not only had different preferences at the time of migration, but that their preferences also exhibit different convergence patterns.

#### Why do former East Germans favor state intervention?

A possible answer to the question above is that East Germans are used to thinking, partly under the influence of Communist ideology, that it is "society's fault" if people are poor, unemployed or in need of help. Thus it is society's (i.e. the state's) obligation to take care of these problems.

The probability of believing in the importance of social conditions for individual fortunes is 10 percentage points higher for an East German than for a West German. Older East Germans are more likely to believe in social conditions as a major determinant of individual fortune than younger East Germans, which is an effect of having lived longer under the Communist regime. In the West, the age effect goes in the opposite direction, but is not significant. Moreover, East Germans believe less than West Germans in an important role of luck. In other words, East Germans seem to believe much more than West Germans that an individual's life is defined by social conditions, which is a basic tenet of the Marxist way of thinking. However, even after controlling for beliefs regarding social conditions, former East Germans believe in state intervention more than former West Germans.

#### Conclusions

Our analysis demonstrates that East Germans believe significantly more than West Germans that the state should be responsible for the financial security of various vulnerable social groups, namely the unemployed, the sick, the elderly, families, and people in need of care.

According to our results, it will take about one to two generations (20 to 40 years) for the average East German to have the same views on the role of the government as a West

German has. The differences in attitudes will disappear due to the combination of two forces:

- the death of the elderly and the coming of age of individuals born after reunification; this accounts for about one third of the convergence;
- real change in the preferences of individuals; this accounts for the remaining two thirds of the convergence.

We find that the difference in preferences between former East and West Germans is largely due to the direct effect of communism: ideological indoctrination, e.g. via public schools and TV, or an intrusive public sector, to which people became accustomed. An indirect effect of Communism lies in making former East Germany poorer than West Germany, and therefore more dependent on redistribution.

An implication of the above is that the 1990 political shock in Germany has had, perhaps, much deeper and longer lasting consequences than the widely studied economic shock associated with the reunification. A country like former West Germany, with an already generous welfare state, heavy labor and goods market regulations, etc., which many believe needs trimming, has received an influx equivalent to 25% of its population, composed of people inclined towards an even more extensive role for the state. This will make any political reforms aimed at trimming the welfare system especially difficult. Those who believe that Germany's economic outlook will look brighter if certain "structural reforms" are carried out should be especially concerned.

*Alberto Alesina is Nathaniel Ropes Professor of political economics and Chairman of the Department of Economics at Harvard University. Nicola Fuchs-Schuendeln is assistant professor of economics at Harvard University. The full text of the paper is to be published at the end of June as a Harvard Institute of Economic Research Discussion Paper. ■*



## Economic growth, income distribution and poverty in Poland during transition

Pierella Paci, Marcin J. Sasin, and Jos Verbeek

**T**he beginning of Poland's transition in 1990 was marked by exceptionally difficult macroeconomic conditions, which included high inflation, a massive external debt, and a large segment of "value-subtracting" enterprises. Many predicted a crisis, arguing that enterprises would not be able to cope with market conditions, bringing mass bankruptcy and social upheaval. This did not happen. On the contrary, Poland turned out to be unique among the large transition countries in having an unbroken record of growth once it resumed after the initial output collapse. However, despite positive economic growth, Poland has struggled to reduce poverty. In analyzing linkages between macroeconomic and economic growth variables, and their impact on poverty and income distribution, we recommend that Poland reduce its deficit and the size of the government budget.

While many factors can account for Poland's record of growth, the main economic factor has been that the state has managed the macro-micro policy linkages well. At its core, this meant maintaining a combination of hard budget constraints for enterprises, a competitive real exchange rate, and a post-privatization governance structure that allowed businesses, in particular small and medium-size enterprises, to flourish. By reducing fiscal deficits and managing public debt, Poland achieved a macroeconomic environment that was conducive to growth and that allowed a gradual decline in inflation.

The macroeconomic environment, however, deteriorated progressively at the end of the last decade. While monetary policy tightened during the second half of 2000, fiscal policy eased considerably during 2001. This "tight monetary and loose fiscal" policy mix has also crowded out investment and moderated the potentially expansionary effect of fiscal policy.

The loss of export markets in the East as a consequence of the Russian crisis in 1998, which cost Poland around 3 percentage points of GDP, triggered a new round of enterprise restructuring to curtail falling profitability. The resulting improvements in productivity were brought about in large part by reducing employment. This reduction, together with the increasing number of newcomers to the labor market owing to the baby boom of the early 1980s, led to significant increases in unemployment. In December 2002, more than 3.3 million people (20% of the labor force) were unemployed.

### Did poverty respond to growth?

High growth rates from the mid-1990s to 1998 (at 5% or above) facilitated a decline in poverty in Poland, which suggests a high responsiveness of poverty to economic growth.

From 1999 onward, however, this responsiveness appeared to weaken; poverty began to increase even though growth remained at 4% for 1999 and 2000 and was modestly positive (1%) thereafter.

Inequality also rose steadily throughout the second half of the 1990s. In 2002, the Gini coefficient for consumption inequality was 0.28, which was moderately high compared to other CEE countries.

When decomposing changes in poverty for Poland into their growth and inequality components, it is evident that economic growth was a main driving force in poverty reduction. Two periods are readily distinguishable. During Poland's high-growth years of 1994-1998, the economic growth effect (5%) far outweighed the negative effect of the increase in inequality (-1%), resulting in a cumulative decline in poverty of about 4 percentage points. During the subsequent period of 1998-2002, a decline in mean consumption, the lack of growth (a meager 1%) and increased inequality jointly resulted in a cumulative increase in poverty of about 3 percentage points.

### What is behind the increase in consumption inequality?

To fully evaluate the role of growth in poverty reduction, it is important to note that household consumption — as captured by the Polish Central Statistical Office's annual Household Budget Survey (HBS) — performed much worse than the national accounts would suggest. This is not a phenomenon unique to Poland and may be explained by the unusually high investment accumulation over the 1990s, as well as by the country's relatively high export rate.

Changes in consumption inequality may result from a number of factors. Four important factors include: changes in the distribution of original income; changes in the progressiveness of the tax and benefit system; changes in the distribution of savings (not analyzed here due to limited data); and changes in the relative prices of the basket of goods bought by households at different points along the income distribution.

*Changes in the distribution of original income* (income before taxation and benefits other than old-age pensions). From 1994 to 2002, inequality in original income, as measured by the Gini coefficient, increased by around 7%, from 0.38 in 1994 to 0.41 in 2002, and accounted for just over half of the increase in the Gini coefficient for consumption (13%). The increase was surprisingly moderate, considering the degree of transformation the country experienced. The main force behind this increase has been the growth of inequality in labor income.

*The role of taxes and social benefits* (which may affect the distribution of households' disposable income). The concentra-

tion index for taxes increased by 32.8% in 1994-2002, which suggests that the tax burden has become more concentrated. At the same time, the social benefits system evolved more strongly toward the poor.

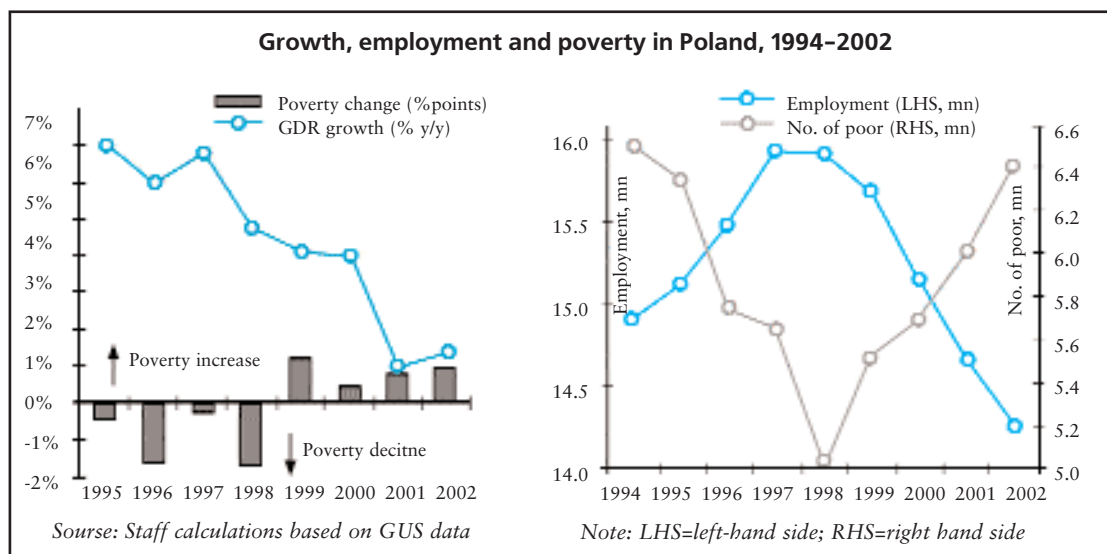
This implies that since the mid-1990s changes in the tax and benefit system have counteracted the increased inequality in original income, leading to a much smaller growth of inequality in disposable income (from 0.308 to 0.316). However, the number of people relying on social transfers to close their poverty gap increased steadily after 1998, approaching 20% in 2002. This means that headcount poverty would have been 20 percentage points higher if social assistance had not been available as a safety net. Even though social transfers (excluding old age pensions) have a direct poverty reducing effect, the system is extremely costly and inefficient. Less than half of social transfers serve to bring household consumption up to the poverty line level. A major portion of these resources (56%) does not go to the most needy.

*Inflation and exchange rate movements and expenditure composition.* The composition of food and non-food expenditures changed between 1998 and 2002, with every income group spending less of its consumption on food in 2002 compared to 1998. During this period the food price index changed 15 percentage points less than the overall CPI, indicating that less of one's income needed to be used to provide for one's daily bread and butter. Appreciation of the zloty during the latter part of the period induced all expenditure groups to spend less on tradable goods and more on non-tradable goods, indicating that the income effect dominates the substitution effect.

### Policy recommendations

- Macroeconomic stability is a key component of a growth-promoting environment and is therefore a foundation for any successful poverty reduction strategy. To prevent the re-emergence of economic imbalances, fiscal consolidation and the reduction of overall deficits are needed to complement the monetary easing in place since 2000. A parallel reduction in the size of the government budget would provide greater space for private sector development.

- In order for growth to be poverty-reducing, the link between economic development and labor market improvement must be strengthened significantly. In the short to medium term this would involve a reduction in the tax wedge (pay-



roll taxes) as well as an increase in the flexibility of the labor market. In the longer run, policies are needed that will close the mismatch of skills between labor demand and supply, which means promoting investment in human capital and education.

- Fiscal policy works best if it is pro-poor. The tax component of fiscal policy appears to perform its anticipated stabilization role. Any changes in the system to improve its pro-poor impact should be considered carefully, so that they do not further increase the distortions and the overall tax burden. The elimination of exemptions and an overall reduction in payroll taxes in at least a budget neutral way is a plausible recommendation.

- Although Poland's system of social transfers plays an important role in poverty reduction, it is more than costly and inefficient. Improving the targeting of social transfers is an immediate necessity. Poor targeting not only leaves many of the vulnerable without the help of the state; it also skews incentives to work and places a significant burden on government finances.

- As has been demonstrated, Polish society is still changing. The Polish economy is growing, but it is simultaneously becoming more polarized. Therefore, there is a strong case for good poverty/social monitoring, going beyond aggregations and applying more complex analytical tools, such as various decompositions, growth incidence, benefit incidence, etc. Such monitoring can provide both the public and policy-makers with a better knowledge of whether and how society is changing, assessing winners and losers. An *ex ante* assessment of the impact of social programs on income distribution and poverty could become a valuable policy tool.

*Pierella Paci is lead economist for the Europe and Central Asia Region (ECA); Marcin J. Sasin is an ECA country economist, and Jos Verbeek is lead economist for the Africa Region, all at the World Bank in Washington, DC. The full text of the paper may be accessed at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=643241](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=643241) ■*

## Latin America 1980–2005: institutions, growth and poverty

Alvaro Garcia

**D**espite the promises of democratic governments in Latin America to implement reforms that would bring "equitable growth", the results have been quite disappointing. Since the 1980s, Latin American countries have been growing more slowly than the rest of the world. Moreover, both the share of population living in poverty and the level inequality have increased. What was missing from the reformers' agendas? Having analyzed failures and mistakes, as well as the "success stories" in poverty reduction in Chile and Brazil, the author concludes that economic and socio-political reforms need to go hand in hand. In particular, more attention should be paid to building and strengthening the institutions that deal with distributional matters.

In the last quarter century, Latin America underwent important political and economic changes. The 1980s, known as the "lost decade" because of poor socio-economic performance, undoubtedly had an important political impact by weakening the authoritarian regimes of the time (only three out of 18 countries had democratic regimes before 1980). By the early 1990s, all countries had restored democracies, and the newly elected governments came in with promises of economic reforms that would bring "equitable growth". The so called "first-generation economic reforms" were geared towards fostering national and international competition by reducing trade barriers and fiscal deficits, fighting inflation, liberalizing prices, lifting credit constraints, privatizing, and reducing government intervention.

However, the outcome of these economic reforms was disappointing. While Latin American countries had enjoyed steady growth of about 5% per year over the preceding two decades, in the 1980s the average fell to 1.3% per year, and after an increase to 3.3% in the 1990s fell again to 1.5% in 2000-2003. Since 1980, the Latin American economy has grown half as fast as the rest of the world.

The social outcomes were even worse. According to CEPAL, 42.9% of the Latin American population lived in poverty in 2004, a larger share than in 1980 (40.5%). The proportion of the poor increased throughout this period, as income distribution became more concentrated. The Gini coefficient increased from 0.48 to 0.52 between the 1970s and the 1990s and remains significantly higher than on all other continents except Africa.

### Reform failure decreased support for democracy

Though extensive and painful, "first generation" economic reforms initially had strong popular support. But as the reforms failed to bring higher growth or reduce poverty, support waned for the reforms and the governments that implemented them. Unfortunately, rising poverty and inequality reduced confidence

in democratic institutions, such as the government, the judicial system, congress and political parties. Between 1996 and 2004 the support for democracy decreased from 61% to 52% of the population (as found by "Latinbarometro 2004, Una decada de mediciones"). The population perceived that the worst problems of democracy were poverty and inequality and also believed that governments were run for and by the wealthy and powerful. This meant that many democratic governments were unable to complete their mandates.

### Why did the reforms of the 1980s fail to reduce poverty?

A recent World Bank (2005) study offers some explanations. First, the reforms did not touch upon labor issues, the most crucial area in terms of income distribution. Second, as the *ex-post* analysis of the study shows, the reforms had very little effect on growth. For instance, a sharp reduction of inflation in Brazil (by 60 percentage points) increased growth by a mere 0.2% per annum. Added to this were "unexplained" variables, likely related to the external shocks during the 1990s (the so-called Tequila, Asian, and Tango crises). Besides, the volatility of growth has increased with globalization, and Latin America has been particularly unable to cope.

A second line of explanation is that the reforms were not deep enough, particularly in building up and strengthening institutions. The institutions are those related to voice and accountability, political stability, government effectiveness, regulatory quality, rule of law, control of corruption and economic freedom. Corbo *et al* (2005) show that if all Latin American countries had post-reform institutions similar to those in Chile, their average annual rate of per-capita GNP growth would have been 1.6 percentage points higher. If the quality of institutions had been similar to that of Finland, per-capita growth would have been 2.3 percentage points higher.

These conclusions correlate with Rodrik's (1999) findings that Latin American countries have been slower to recover after external shocks than the rest of the world, due to institutional weakness and, particularly, the inability of institutions to deal with the distributional impacts that external shocks generate. This in turn creates political and economic instability, prolonging the effect of the shocks.

### Learning from successful experiences

The two Latin American countries that have fared best in terms of poverty reduction are Brazil and Chile. Brazil reduced the share of population living in poverty from 41.4% in 1990 to 29.9% in 2001, and Chile — from 33.3% in 1990 to 18.8% in 2003. Two other countries, Costa Rica and Uruguay, have also been quite successful: their poverty levels fell from 24% to

19% and from 12% to 9%, respectively, but they also had lower initial levels. Interestingly, Costa Rica and Uruguay also have the highest support for democracy in Latin America.

Although Brazil's and Chile's success in poverty reduction is quite impressive, their rates of economic growth have been very different. Brazil's per-capita GNP hardly grew at all (0% in the 1990s and 0.1% in 2000-2003), while Chile's per-capita GNP growth was quite substantial (4.1% per year in the 1990s, and 2.1% in 2000-2003). These enabled Chile to reduce its per-capita GNP gap with developed countries by 30%. Attanassio and Szekely (2001) show that about 85% of the poverty reduction in Chile is due to economic growth, while in Brazil 70% of the decrease can be explained by income distribution. Despite very different paths, both countries undertook profound institutional reforms. Chile placed its emphasis on financial and economic institutions, while Brazil emphasized social reforms.

Successful poverty reduction also had a positive effect on politics, and both Brazilians and Chileans have strongly supported democratic governments. Presidents in both countries enjoy the strongest public support in Latin America (over 70%). However, while support for democracy is growing in Chile (from 54% in 1996 to 57% in 2004), it is decreasing in Brazil (from 50% to 41.5% over the same period). It seems that growth combined with poverty reduction pays off more, in terms of political support, than distribution combined with poverty reduction. However, neither of them by itself is sufficient to maintain political support: the perception that the government works for the rich is still large in both countries, but higher in Chile (70%) than Brazil (65%).

The challenge for Latin American countries seems to be to integrate these two complementary objectives: growth and distribution. Cornia (2005) shows that high inequality — with a Gini coefficient above 0.45 — hinders growth. Additionally, achieving this would mean fulfilling the political promises of equitable growth made by all governments in the 1990s. Left unfulfilled, they remain a major source of frustration for the population.

A clear conclusion of this analysis is that economic and socio-political reforms need to go hand in hand. In particular, there is a need to pay more attention to building and/or strengthening the institutions that deal with distributional mat-

ters. Not incidentally, the three countries with the lowest poverty levels — Uruguay, Chile and Costa Rica — are also those with the strongest institutions (according to Kaufmann *et al*, 2003). Brazil ranks fourth in poverty and fifth in institutions.

### Labor market and social security institutions essential

The greatest challenge for the reformers is to create or profoundly transform important labor-market and social-security institutions. These include creating unemployment insurance, increasing the coverage of social security and worker training, introducing changes to labor and social security legislation, and addressing labor standards and compliance issues. These are crucial to dealing with distributional issues, particularly given the volatile growth that Latin America confronted over the last quarter century. Adequate financing is an absolute requirement for the successful reform of labor institutions. Tax reform is another area in which Latin America needs important changes. A crucial issue to deal with is the high level of tax evasion, which, if dealt with appropriately, could simultaneously increase government revenues and allow for tax cuts. Other important areas, such as education, have already received greater attention.

Labor and tax reforms are also among the most politically sensitive issues, and this is probably why they have been postponed in Latin America. In order to facilitate this process, an institutionalized form of social dialogue (such as a socio-economic council) can be very helpful. This has been the experience of almost all countries that have successfully combined growth with distribution in recent decades.

Growth, distribution and strong democratic institutions are the necessary conditions for progress in poverty reduction in Latin America. Reaching these complementary goals requires placing a greater emphasis on institutional development and going beyond the issues once favored by the “first-generation reforms” in Latin America. The crucial institutions are those that enable governments to deal with their very large and long overdue distributional issues.

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Country	Life expectancy at birth, years	Mortality rate, infant (per 1,000 live births)	Country	Life expectancy at birth, years	Mortality rate, infant (per 1,000 live births)
Armenia	74.98	30	Latvia	70.69	10
Belarus	68.17	13	Moldova	67.02	26
Brazil	68.72	33	Poland	74.6	6
Chile	76.44	8	Romania	70.09	18
China	70.8	30	Russian Federation	65.7	16
Croatia	73.99	6	Slovak Republic	73.39	7
Czech Republic	75.17	3.9	Slovenia	76.09	4
Estonia	71.18	8	Turkey	68.64	33
Georgia	73.47	41	Ukraine	68.29	15
Kazakhstan	61.32	63	Uzbekistan	66.68	57

Source: The World Bank, World Development Report 2005

## Microlending to vulnerable groups: evidence from a recent UNDP survey

Andrey Ivanov

**S**uffering from poverty and high rates of unemployment, vulnerable groups such as the Roma depend heavily on social welfare and other government transfer payments. To break out of the spiral of poverty and unemployment, they could engage in small-scale production, farming or trade. For this they would need access to financing, which a number of organizations have come forward to offer. A new UNDP survey shows, however, that the Roma have not gained from these efforts to improve access to microfinancing. At best, micro-loans need to be part of a broader array of support, including training and other services that are usually provided by business incubators.

Typically, the poor have no access to formal lending institutions because of the high costs in terms of time, money, and bureaucracy, the collateral requirements, and the unwillingness of these institutions to administer microcredits to the poor. The poor do have access to informal money lenders, but they charge enormous interest rates and are often linked to organized crime.

For a commercial bank, microlending is not attractive for several reasons. First, small loans are more expensive to administer and bring lower returns: administering a small loan is not much cheaper than administering a larger one, but the return on the latter is considerably greater. Second, vulnerable groups, especially the poor, have difficulties in providing collateral. Third, small entrepreneurs usually do not follow strict accounting rules, making it difficult for bankers to assess their creditworthiness. Fourth, most micro- and small-scale entrepreneurs, including the poor, lack the experience and the ability to write the business plans that are required for bank loans. As a result, both banks and micro-entrepreneurs have rational reasons to avoid each other.

Vulnerable groups do use credit. To shed light on what opportunities exist for the microfinance industry, and what difficulties the Roma have in obtaining credit, the UNDP included a section on access to capital in a recent major survey of vulnerable groups in Southeastern Europe. The survey covered all the countries of the region, dividing respondents into three separate samples: the Roma, refugees/internally displaced persons (IDPs) in countries with these groups, and the majority population living in close proximity to Roma. The survey was conducted in November 2004 in Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Romania, and Serbia and Montenegro (with separate samples for Serbia, Montenegro and Kosovo). In total, 8,273 households were surveyed, of whom the Roma and majority populations living in close proximity to Roma accounted for about 43% each, and the remaining 14.5% were IDPs and refugees. The individual profiles of 34,116 household members were recorded. In all countries, the survey used identical questionnaires and fol-

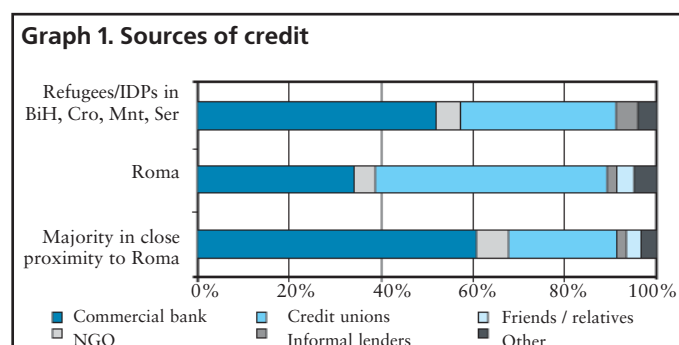
lowed identical sampling and methodological guidelines. The survey classified the Roma as a distinct group, in order to investigate to what extent their limited access to credit was caused by ethnic discrimination, and to what extent this was caused by depressed local economies.

### Less access to bank credit for Roma and refugees

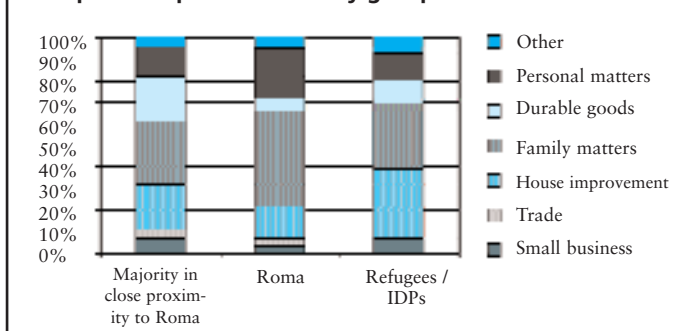
The results show that the three major factors limiting access to capital — lack of collateral, lack of credit history, and lack of skills — are more pronounced for the Roma and refugees/internally displaced persons (IDPs) than for the majorities living in close proximity to Roma. Data show that Roma, IDPs and refugees in the countries of Southeastern Europe have less access to credit from commercial banks than do the majority populations living nearby. Among the 3,537 majority-population households surveyed, 910 (26%) said they had used some type of credit. By comparison, 15% of the 3,534 Roma households and 19% of the 1,202 IDP/refugee households said they had taken out loans.

Graph 1 shows the sources of loans for the three groups. The Roma rely more on informal borrowing from friends and family. They are also the least involved in credit cooperatives or credit unions, which further limits their access to microfinance services.

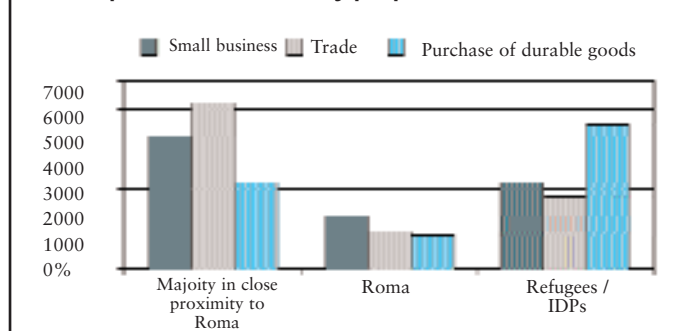
Examples from projects implemented in the region confirm the survey conclusions. Indeed, the Roma tend to fall out of the scope of formalized channels of business support. In Bulgaria, for example, the UNDP has implemented a financial leasing scheme within the JOBS (Job Opportunities through Business Support) program. Under the scheme, which started in 2000, micro- and small loans worth a total of \$3,788,233 have been disbursed to 567 micro- and small-scale businesses, including food companies, furniture manufacturers, farmers and agribusinesses, apparel and sewing enterprises, and various service enterprises. The interest rate charged is the national interest rate plus 10 percentage points (currently, 12.36%). The unemployed are charged at a lower rate, 5 percentage



Graph 2. Purpose of loans by group



Graph 3. Size of loans by purpose



points above the national interest rate, or 7.36%. By November 2004, 111 loans had been paid back, totaling \$740,636. The portfolio at risk (over 30 days past due) is 2.78%, and the default rate is 1%. The problem is that only 2.12% of the borrowers are Roma entrepreneurs (accounting for 2.23 % of total loans), and 20.28% are women (with 16.05% of the loans).

These findings show that, although over-represented among the unemployed, the Roma are usually underrepresented as borrowers, even in projects explicitly designed to provide them access to micro-credit. These results question to what extent small-business-oriented projects can tackle issues such as unemployment among the Roma.

### Roma different from other vulnerable groups

Examples from other countries also provide evidence that the Roma borrow less than other groups. This raises the question, what is special about the Roma? Perhaps the answer has to do with the fact that the Roma belong to 'first world' societies but live in 'third world' pockets of poverty. In a lesser developed society, a small loan can go much further towards boosting people's economic situation and improving productivity. But the Roma live in developed economies, where a loan of a hundred or even a few hundred dollars is not more than a consumer loan. The most one can do with it is small-scale trading, with marginal added value.

Loans to the Roma are primarily micro- and small loans, unlike for the majorities living in close proximity to Roma and for IDPs/refugees. This disparity is both a cause and an outcome of limited business opportunities for Roma. The average size of loans for Roma is 706.5 euros, against 2,729.3 euros for the majority populations and 2,629.2 euros for IDPs/refugees.

With various barriers to entry due both to low competitiveness and discrimination, the Roma face difficulties generating the necessary revenues to pay back loans. Typically, they can apply for credit for crafts businesses, trade or subsistence agriculture, but these are rarely marketable and liquid enough to generate sufficient cash for repayment.

The data support these conclusions. As Graph 2 shows, the Roma borrow small sums primarily for personal reasons, usually for unexpected health-related expenditures, and for family matters, such as weddings. None of this is business oriented and thus cannot generate the revenues necessary for repay-

ment. The data also show that the Roma borrow the least to finance the purchase of durable goods, often small equipment which tends to boost productivity. This also shows that the Roma borrow primarily for non-productive purposes.

The data in Graph 2 show that the share of loans for business purposes as a portion of total loans for each surveyed group is more or less equal. This, however, is misleading. Graph 3, which illustrates the distribution of loans by size for three purposes, clearly shows that the Roma are in a disadvantaged position because the small size of the loans they receive is insufficient for anything beyond financing current consumption.

The results of the survey correspond to empirical evidence from UNDP projects. A Roma-oriented program in the north-eastern part of Slovakia illustrates these difficulties. An integrated community-mobilization project called 'Your Spis' has been running for three years, sponsoring educational activities, training and local community-building efforts for the Roma. Initially, the program was running in eight municipalities, but this number grew to 13 in 2004. A microlending component disburses microloans to individuals willing to start a business and gain economic independence. A total of \$50,000 was allocated for this purpose. The size of the loans averages \$800, with a 10% annual interest rate paid in monthly installments. Despite these favorable conditions, by the end of 2004 only 10 loans had been approved and disbursed. There was not enough interest among the target beneficiaries to borrow. The major reason reported was the difficult market environment and borrowers' lack of confidence that their business would be successful.

### Conclusions

A powerful tool for poverty alleviation elsewhere, microlending still does not work for the Roma. The Roma's limited access to microloans is both a cause and consequence of Roma poverty. We believe that microlending, on its own, cannot and should not be seen as the starting point to lift the Roma out of poverty. However, it can contribute to poverty reduction as part of a broader approach, including training and other services usually performed by business incubators and other support systems for micro- and small-scale businesses.

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## Labor market distortions, rural-urban inequality and the opening of China's economy

Thomas Hertel, Fan Zhai

**H**ow will the further opening of the Chinese economy affect rural-urban inequality? The answer depends in part on the functioning of factor markets — in particular the market for labor. Currently, the ratio of urban to rural incomes in modern China is extremely high by international standards — almost three to one, by World Bank estimates. This is in part due to barriers to permanent migration in China — the most important being the system of official registration (*hukou*) in urban areas and the absence of a fully functioning land market. As a result, rural-urban migration, involving roughly 19% of the total rural labor force, or nearly 90 million workers, is mostly temporary. Our analysis highlights the key role of factor market reforms in determining the future of rural-urban inequality in China. We find that China's WTO accession, if accompanied by factor market reforms, will not necessarily induce income inequality, but may instead significantly improve both efficiency and equality.

China's accession to the WTO has heightened concerns about increasing rural-urban inequality. Most analyses suggest that accession will exacerbate inequalities, as it will lower barriers to grain imports and increase opportunities for manufacturing exports and foreign investment in the urban-based services. However, the extent to which inequality will be affected will depend on how easily rural workers will be able to move into the rapidly expanding urban and coastal economies. Higher rates of labor mobility will ensure that the benefits of WTO accession will be shared more widely.

The most important factor currently restricting permanent migration is the system of official registration, whereby households must have a *hukou* in order to reside legally in an urban area. Without this registration, access to urban amenities such as housing and education is limited and quite expensive. While highly skilled individuals and investors can purchase a "blue stamp hukou", this avenue is not open to the vast majority of rural residents. Another restricting factor is the absence of a fully functioning land market that would permit existing landowners to rent their land to others and migrate to the city, if they found wages there to be more attractive.

Using newly available data from the Chinese National Bureau of Statistics, we develop a general equilibrium (CGE) model of China that incorporates disaggregated households in both the rural and urban areas. It permits us to assess the potential interactions between ongoing product-market reform and prospective factor-market reforms.

The WTO accession scenario in our model includes the gradual reduction of import tariffs, the introduction of quotas for commodities (rice, wheat, cotton, etc.), the phasing out of textile and clothing quotas, a halving of barriers to service

trade, and a productivity boost for the automobile sector, stemming from the rationalization of production in the wake of increased foreign investment, as well as competition from imports.

### Factor-market reforms increase migration

The results of our simulation analysis show that both the elimination of the *hukou* system as well as the introduction of fully functioning land markets would serve to increase migration from the lower-productivity agricultural sector to the higher productivity non-agricultural sector, and thus from rural to urban economies.

- *Land reform* facilitates permanent movement out of agriculture without the economic loss that would ensue if these families lost the rights to their land as a consequence. By permitting the land to be rented or sold, agricultural households would be encouraged to determine whether to work on or off-farm, solely on the basis of relative returns to labor. As a result, we estimate that 10.7 million additional workers would leave agriculture. These individuals would migrate to the off-farm rural labor market, which in turn precipitates an additional 7.9 million temporary rural migrants moving to the urban sector.

- *Labor market reform*: We capture the economic impact of the *hukou* system through a distribution of transaction costs, capturing the burden placed on rural residents due to their temporary migration to urban areas. We assume that these costs would not be present if they could legally reside in the urban areas on a permanent basis. When these extra costs are eliminated, rural-urban migration expands by 26.8 million workers.



- Aggregate GDP and economic welfare rise in both factor-market reform scenarios, by 2.1% and 1.8%, respectively. This is due to the fact that these reforms result in the movement of labor from relatively low-productivity sectors into higher productivity activities.

- Rural-urban inequality, measured as urban-rural income ratio, declines from the current 2.59 to 2.27 in 2007. The national Gini coefficient also falls, as increased migration boosts rural wages and dampens urban incomes, particularly for unskilled workers.

#### WTO accession combined with factor-market reforms boosts efficiency

China's WTO accession in combination with factor-market reforms:

- Boosts the wages of skilled workers, relative to those of unskilled workers. This increase is fueled by the tendency for manufacturing and services sectors to expand at the expense of agriculture;

- Brings about additional out-migration from agriculture of 1.3 million workers;

- Further increases GDP by 0.5% and welfare by 0.6%;

- Benefits urban households more, and rural households somewhat less, than WTO accession in the absence of such reforms;

- Dramatically decreases the measure of inequality, in spite of the modest boost in the urban / rural income ratio.

#### Conclusions

Of the various factor- and product-market reforms considered here, we find that reform of the *hukou* system has the most significant impact on aggregate economic activity as well as income distribution. Whereas land-market reform primarily benefits agricultural households, eliminating the *hukou* restrictions mainly benefits rural households currently sending temporary migrants to the city. By reducing the implicit tax on temporary migrants, *hukou* reform boosts their welfare and contributes to increased rural-urban migration.

In the potential interactions between labor market reforms and WTO accession, a significant portion of the aggregate gain comes about by moving labor out of agriculture and into relatively higher productivity activities in the manufacturing and service sectors. By reducing this productivity differential across sectors, labor market reforms dilute the gains under WTO accession. When viewed as a combined policy package, however, the value of these reforms is far greater than that of WTO accession alone. Furthermore, rather than increasing inequality in China, the combined impact of WTO accession and labor-market reforms significantly reduces rural-urban income inequality. This is an important outcome in an economy currently experiencing historic levels of rural-urban inequality.

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## Urban poverty in Russia and social assistance to the urban poor

Anastasia Alexandrova and Elena Grishina

**I**n 2003, 62.7% of Russia's population lived in urban areas. That high level of urbanization has an ambiguous effect on citizens' welfare during periods of economic transformation, and, unlike in other Eastern European countries, urban poverty in Russia is no less problematic than rural poverty. Thus, according to data from the 10th round of the Russian Longitudinal Monitoring Survey (RLMS), the lion's share of the poor live in cities other than the two capitals (Moscow and St. Petersburg): 56% of the first income quintile (i.e., 56% of the lowest 20% by welfare) and 60% of the second quintile, or almost twice as many as in rural areas. (The 'capitals' are home to only 5% of the first quintile and 9% of the second.) What factors influence the welfare of city dwellers, and what are the social risks of urban life? Which social programs, aimed specifically at supporting urban residents, would be most effective?

We draw our picture of urban households on the basis of data on households' social and demographic attributes, consumption, and geographic distribution from the urban population subset of the National Household Welfare Study (NOBUS), conducted by the Russian Federal State Statistics Service in 2003.

*Education.* A relatively high proportion — one fourth — of the adult urban population has completed higher education, although the largest group (38.5%) have completed secondary professional education.

*Employment.* Of the adult population, 53.6% are working, while 27.6% are retired. Of those who are working, the vast majority — 84.3% — are hired employees, while only approximately 3% are owners or entrepreneurs. Surprisingly, the employment distribution is heavily weighted toward the state

and municipal sectors (47.9% and 14.9%, respectively), rather than to private enterprise (26.7%). This represents a significant departure from Goskomstat's nationwide data, according to which the state and municipal sector employs 36.8% of the population, while 51.8% work in private enterprises. Unemployment, by ILO criteria, accounts for 4% of the workforce, while unemployment was lower in *oblast* capitals than in other cities (3% versus 4.7%).

*Income.* Urban households' income is dominated by salaries (the main source of income for 67.1%) and pensions (the main source of income for 27.8%). Various allowances, subsidies, reimbursements and privileges are also listed as important — though not top — sources of income.

On average, in order "to live well and not deny oneself anything", households require a monthly per-capital income of 19,768 rubles (approximately \$700), while living "adequately" requires 5,356 rubles (approximately \$190). City dwellers' conception of an adequate level of consumption diverges strongly from the Russian 'subsistence minimum' of 2,137 rubles per month (approximately \$76) and from current state pensions of 1,637 rubles per month (approximately \$58).

Urban residents make fairly active use of their rights to various privileges. In *oblast* capitals, the most widely used privileges are free use of public transportation (used by 26.1%, compared to 17.4% in other cities), and discounted utilities payments (used by 22%, compared to 20.1% in other cities). Allowances were granted to 12% of city dwellers, a larger proportion of which live in non-capital cities (13.6%, compared to 9.8% in *oblast* capitals).

*Expenditures.* By our calculations, urban residents spend almost half of their resources on food (45.4%); this indicator, meanwhile, is somewhat lower in *oblast* capitals than in other cities. Individual agricultural plots continue to be significant sources of subsistence, likely due in part to their relatively low cost to maintain; they are a supplemental source

of food for 25% of capital-dwellers and 39.5% of residents in other cities.

### Retired better off than families with children

By our calculations, the poverty index is quite high regardless of which indicator one chooses. This is due first and foremost to our decision to use the so-called 'subsistence minimum' as a bench-mark, rather than the so-called 'recommended poverty-line indicator' (1,056 rubles in 2002), according to which the World Bank estimated Russian poverty at 25%. The relative poverty indicator includes the real distribution of consumption expenses, regardless of their relationship to the subsistence minimum, and we believe that this index is closest to reality, particularly in light of the high degree of urban inequality. Notably, the proportion of the poor and the extremely poor is almost without exception higher in the 'other cities' category.

The households of urban retirees appear relatively well off. However, it is important to note the significant divergence between two subgroups: working and non-working retirees. The proportion of poor working pensioners by current consumption is only 18% (less than 5% by relative poverty), while for non-working retirees the figure is 41.4% (11% by relative poverty). This suggests that advanced age, physical handicaps and other obstacles to work are quite significant factors in urban poverty.

Most frequently observed among the poor are households with several children (85% of all poor households, and even 38.5% by relative poverty), single parents with children, other households with children, and households that include handicapped or unemployed persons. On the whole, these data indirectly confirm the hypothesis about demographic factors as symptoms of poverty.

Evaluating the profile of poverty by comparing the 'contributions' made by various groups of households to the overall indicator, we find that residents of *oblast* capitals make up 41.3% of the total number of poor, while residents of other cities account for the remaining 58.7%. This fits with the World Bank's finding that, "the smaller the city, the greater the proportion of poor people".

Meanwhile, our analysis shows that social assistance does not always go to poverty alleviation. For example, benefits for housing, utilities and telephone services given to non-poor households exceed those given to poor households by 1.3-1.8 times. If we turn to the quantity of benefits, non-poor households receive 1.6 times more than the poor. The non-poor also received 1.6 times more social services than the poor. All of these results speak to the necessity of shifting social assistance to a more targeted regime. The quantity and variety of services provided to city dwellers suggests the necessity of cutting down their number in order

Table 1. Poverty Indices

	All cities	Of which	
		Oblast capitals	Other cities
		poor, % (extremely poor as % of poor)	poor, % (extremely poor as % of poor)
By resources available	47.2 (13.6)	44.6 (24.3)	49.3 (31.7)
By current consumption indicator	63.9 (32.8)	63.3 (29.8)	64.6 (35.0)
By relative indicator of current consumption (relative poverty indicator)	14.3 (18.5)	10.8 (17.3)	17.0 (19.1)

The 'by resources available' indicator includes data on expenditure on food, clothing, shoes, services and other goods. It also includes expenditure on the purchase and/or lease of real estate, debt payments, debt, etc.

The current consumption indicator includes the purchase of food, non-food goods other than durables, and services, as well as privileges/subsidies and costs associated with the use of durable goods.

Table 2. Reduction in poverty levels as a result of various approaches

	Total urban sample			Influence sub-sample		
	All cities	Oblast capitals	Other cities	All cities	Oblast capitals	Other cities
Increase in educational attainment by one degree*	2.07	1.18	3.64			
Increase in educational attainment from secondary/professional to higher education	1.37	0.72	2.50	2.44	1.41	4.20
Increase in educational attainment from secondary/general to secondary/professional	0.44	0.34	0.63	1.47	1.21	2.00
Increase in professional qualifications from mid- to high-level	1.29	0.77	2.43	2.70	1.61	5.04
Increase in professional qualifications from non-skilled worker to skilled worker	0.58	0.30	0.99	4.37	2.59	6.65
Decrease in the number of unemployed persons in the household by one	0.22	0.11	0.38	2.80	1.52	4.12

\* The influence sub-sample is the entire urban population, but individuals who already have higher education remain unchanged.

to find a better fit both for the capabilities of public budgets, as well as for the most pressing needs of the poor population.

### The risk of poverty increases with the number of dependents

How is a household's welfare linked to its educational, professional, demographic and spatial characteristics? We built a regression analysis using data on the employment status, position and sphere of the head of the household. Spatial characteristics included the growth of regional turnover in the region of inhabitation, the level of long-term unemployment in the region, and the regional subsistence minimum.

The results showed that, in 2003:

- The risk of poverty grew in line with the number of children, retirees and handicapped persons in the household for those households headed by a woman or an unemployed person, as well as for those households with low educational attainment;
- The greater the sum of all benefits provided to the household for public transportation, utilities and telephone service, the greater the household's welfare and the lower the risk of falling into poverty; and
- Residence in an *oblast* capital had a positive effect on welfare. The growth of retail turnover and paid household services in a region reduces the risk of poverty. And increasing levels of long-term unemployment, as well as growth in the volume of industrial production in a region, increased the likelihood that a household would fall into poverty.

### What can be done to alleviate poverty?

We evaluate several approaches to decreasing the level of poverty, both for the urban population sample as a whole, as

well as for so-called 'influence sub-samples'. Influence sub-samples are those households that include an individual who has undergone one or another transformation. For example, if we are modeling the result of lowering the level of unemployment, then the influence sub-sample would be those households with unemployed members.

The results of simulated calculations lead to the following conclusions:

- An increase in the level of education, qualifications and/or employment has a stronger positive

effect on the influence sub-sample in cities other than *oblast* capitals, with the divergence ranging from 1.9 to 3.5 times;

- Increasing educational attainment from secondary/professional to higher education is more effective in reducing poverty than increasing educational attainment from secondary/general to secondary/professional. The higher return on investment from higher education reconfirms the notion that education is one of the most important aspects of human capital; and

- The effect of increasing the qualifications of non-skilled workers is insignificant for decreasing urban poverty, although individual non-skilled workers may significantly increase their welfare by increasing their qualifications.

Consequently, the goal of increasing welfare and alleviating poverty in Russia calls for programs designed to improve the quality of the workforce and develop the productive potential of the urban population.

### Conclusions

The problem of urban poverty in Russia, although an extremely widespread phenomenon given Russia's high level of urbanization, is quite heterogeneous, both in degree and in the characteristics of risk groups. No matter how the numbers were calculated, the proportion of the poor and extremely poor was higher in cities other than *oblast* capitals.

Data on the extremely poor suggest that targeted urban programs to support the poor would be feasible, on the condition that needs-assessment is benchmarked not against the subsistence minimum, but against a lower indicator, reflecting the income distribution within the poor population.

A high level of educational attainment in 'other' cities has a much greater effect on welfare than in *oblast* capitals. This may be due to the higher concentration of highly educated people in central cities and the greater degree of competition on the market for qualified workers. At first glance, it would seem that opportunities for education in smaller cities are fewer, but, evidently, the few residents of small cities who do have higher education are more likely to find work with a stable income.

Thus, programs aimed at improving the quality of the workforce and developing the productive potential of urban populations can and should be part of the strategy for increasing welfare and alleviating poverty in Russia.

Regardless of long lists of benefits and services, social assistance is often given only to a quite small portion of the urban population, around 1-2%. Moreover, in many cases

the portion of non-poor families receiving any given form of social assistance is not lower — and is often higher — than the portion of poor families. What's more, the group that receives the lowest volume of social assistance has a higher proportion of retirees and handicapped people than the group with the highest volume of benefits. This underscores the necessity of shifting to a targeted system of social assistance and personal payments to replace subsidies and privileges.

*Anastasia Alexandrova is director of Social Policy and Elena Grishina is expert in Social Policy at the Institute for Urban Economics in Moscow. The authors of this report would like to express their gratitude to German Yu. Vetrov, Igor B. Belyakov, and Mikhael M. Lokshin for their valuable advice and timely comments. ■*

## Adjustment costs of trade liberalization for the Russian labor market

Irina Denisova

**W**hat are the effects of trade liberalization, including Russia's WTO accession, on the demand for labor and on wages across sectors? How does trade affect the wage gap between skilled and unskilled workers? Using the balance sheets of 53,000 large and medium-sized enterprises in Russia from 1995–2001, we investigate the influence of tariff policy in the 1990s on the level and volatility of employment and wages. Based on this analysis of previous trade shocks, we find that, overall, the adjustment costs of anticipated trade liberalization are likely to be much smaller than expected.

In the 1990s Russia underwent a dramatic foreign trade liberalization, switching from non-market interventions in the form of state monopoly on the majority of foreign trade operations to market-based interventions, such as import tariffs. The distribution in time of tariff policy changes over the period 1994–2000 allows us to identify their influence on the Russian economy and, in particular, on the labor market. The analysis of the responsiveness of Russian enterprises to tariff increases makes it possible to evaluate labor market adjustments to expected trade liberalization and WTO accession, provided firms' reaction is symmetric to tariff rise and reduction. Labor market institutions have been relatively stable throughout the period.

### Labor demand most volatile in export-oriented industries

Labor demand is the key determinant of employment on the labor market. The increased openness of an economy is likely to result in a higher demand for labor in exporting sec-

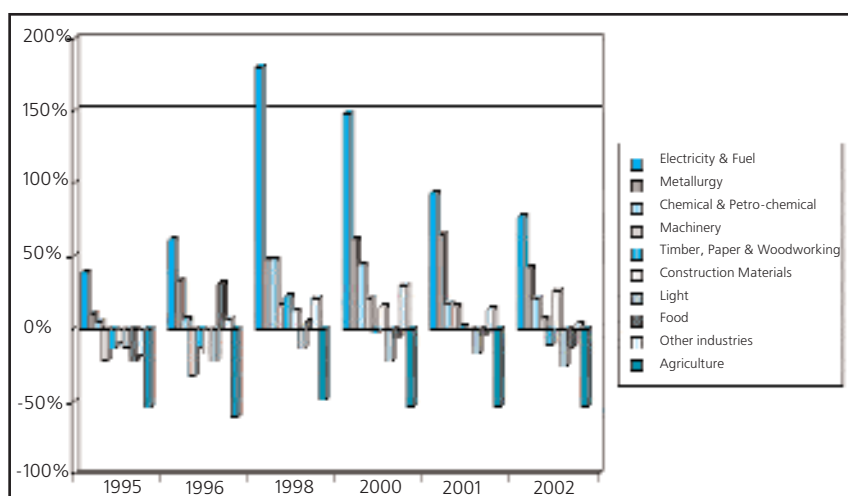
tors and a lower demand in import-competing sectors. Domestic industry protection measures, and tariff increases in particular, bring the opposite results.

The industries in our sample are grouped according to the level of their exposure to foreign trade:

1. Export oriented (with export share more than 30%, import share less than 30% and a low intra-industry trade, or ITT, index);
2. Import competing (with import share more than 30%, export share less than 30%, and a low ITT index);
3. With high intra-industry trade (IIT index more than 50%); and
4. Non-trade.

It turns out that for the entire sample a 10% increase in real wages would diminish labor demand by 4%. With respect to output, a 10% increase in output would cause a 2.2% increase in demand for labor. These estimated labor demand elasticities are lower than those in Poland, Hungary and Czech Republic during transition, as well as in developed countries. It is widely acknowledged that, in contrast to most Eastern European countries, shocks to the Russian labor market were absorbed mainly through reduction in real wages, including the accumulation of wage arrears. However, in the second half of the 1990s Russian enterprises became more sensitive to economic shocks and somewhat faster than earlier in adjusting.

Different industries have been adjusting to shocks at different speeds: industries with high intra-industry trade were the slowest to adjust, while export-oriented industries were the



most flexible, i.e. had higher employment volatility (employment inertia coefficients of 0.41 and 0.28, respectively). One could attribute this difference to the influence of protectionist measures, and import tariffs in particular. Industries that are less exposed to trade shocks are likely to demand a higher number of workers and be more conservative in terms of employment adjustment.

In addition to indirect influence through output changes, trade shocks could affect demand for labor directly. We find that higher import tariffs are associated with higher (lagged) demand for labor, and higher import penetration with lower demand for labor. Hence, trade barriers have a positive impact on the number of workers demanded by the industry, and trade liberalization has a negative impact. The magnitude of this effect is not high, however, and it is noteworthy that the effect is only significant for import-competing sectors.

### Regional industrial structure important for labor demand

Overall, we find higher labor demand elasticities in the northwestern parts of Russia. Divergences arise due to differences in industrial structure, including the degree of industry concentration, on the one hand, and differences in the elasticity of final demand for products, on the other.

Let us consider two regions: northern and northwestern Russia. Northern Russia has higher elasticities than the northwest: 0.34 vs. 0.22 for output labor demand elasticity, and -0.55 vs. -0.18 for wage responsiveness. We believe that the difference is driven by a significantly larger share of industries exposed to trade shocks and more volatile employment in the north: the share of metallurgy, petrochemical and timber industries in the region amounted to 58% in 1999, with the fuel industry accounting for another 16%, while the analogous shares in the northwest were 19.4% and 6.2%, respectively (based on Goskomstat data). The north has higher industrial concentration and labor markets with a significant degree of monopsony, and so higher wage labor demand elasticities, i.e. more volatile labor markets.

Turning to the effect of trade openness on labor demand, higher trade barriers have a positive impact on employment in

several regions, implying the effectiveness of regional protectionist measures for domestic industry.

### Workers in fuel and energy industries better paid

Trade shocks affect not only the employment structure of an economy, but earning profiles as well, and, thus, income inequality and poverty. What is the correlation between trade exposure and wage distribution?

An analysis of around 4,000 households, taken from the Russian Longitudinal Monitoring Survey (RLMS), shows that workers in fuel and energy industries earned from 40% to 180% (in different years) more and

agricultural workers earned 50-60% less than workers in retail and wholesale trade with the same observable characteristics. We are thus able to identify winners from trade liberalization (with the highest wage premiums): workers in export-oriented sectors.

Fuel and energy industries are known to have relatively low tariff levels and a larger share of skilled workers, as well as larger profits and increasing demand for labor. These industries are situated in remote regions, where the supply of labor is limited due to low worker mobility. Therefore, employers in the fuel and energy and metals industries seem to compete for employees by paying high wage premiums.

Wage premiums in food production, other light industries and agriculture, which have a large proportion of low-skilled labor, are low. First, these industries are not as profitable as the fuel and energy and metals industries. Second, the large share of low-skilled workers decreases workers' ability to capture rents, and hence decreases the pressure for industrial wage premiums.

Our analysis shows that tariffs do not have any significant effect on wages or wage premiums. Thus, the protection of domestic industry can be effective in terms of increasing demand for labor, but it does not result in higher wages. Rather, the difference in wage premiums is driven by market structure across industries (variation in concentration ratios and exposure to domestic and international competition). If workers were able to move to trade-exposed industries, they would not lose much from further trade liberalization.

### Do education and experience pay off?

Theory does not provide an unambiguous answer as to the effects of trade on the wage gap between skilled and unskilled labor, and the question is left for a country-level empirical analysis. This issue is of particular interest for Russia, given its relatively low income and large endowment of skilled labor. Our estimations set the wage gap between skilled and unskilled workers at 20% in 1995-2001.

Among observable explanations, education has the largest explanatory power: it accounted for 20-30% of the wage gap

in 1995 and 50% in 2002. Additionally, employment in manufacturing industries, except the metals industry, tends to increase the wage gap, albeit modestly.

### Conclusions

The low responsiveness of demand for labor demand to trade shocks observed during the 1990s suggests that the adjustment costs to expected trade liberalization in the form of changes in industrial labor demand and wages are likely to be much smaller than expected. Moreover, the shift from industrial employment to employment in services should have a dampening effect on these costs. Trade liberalization may lead

to only a slight increase in the wage differentials between skilled and unskilled labor. Tariffs are found to have no significant effect on wages and wage premiums, and the claim that "workers in more protected industries earn relatively more" is therefore ungrounded.

*The article draws on the paper "Adjustment Costs of Trade Liberalization: Estimations for the Russian Labor Market", by Akhmed Akhmedov and Evgenia Bessonova (economists) and Irina Denisova (lead economist) at CEFIR at NES in Moscow, Ivan Cherkashin, Penn State University, and Elena Grishina, an expert with the Institute of Urban Economics in Moscow. ■*

## Poverty Effects of Russia's WTO Accession

Among the most important policy changes that Russia may undertake in the near future are those that it will agree to as part of its accession to the World Trade Organization. Policymakers are concerned not only with accession's aggregate effects and its impact on productive sectors of the economy, but also with its impact on the poor and its income and other distributional effects.

We evaluate these effects through the use of a computable general equilibrium model of the Russian economy, with 55,000 "real household" agents (taken from the Russian Household Budget Survey) integrated into the model.

In the medium term, we find that virtually all Russian households gain from WTO accession. The gains, averaged over all households, are 7.3% of Russian consumption (or 3.4% of GDP). The gains typically range from a minimum of about a 2% increase in household income to about 25%. The lack of virtually any losers in our model at the micro level is explained by the fact that we incorporate foreign direct investment in services with endogenous productivity effects from the liberalization of services and trade. We show that a constant-returns-to-scale model with no foreign direct investment would find that 7% of Russian households would lose from WTO accession.

The gains are rather evenly distributed across income groups, but we find that the poor gain slightly more than the wealthy, because the wage rate of unskilled labor increases more than the rate of return on capital. Rural households gain less than urban households, because the wage rate of skilled labor increases more than the other factors of production, and rural households are less well endowed with skilled labor than urban households.

By decomposing these overall gains into their sources, we find that the gains from the liberalization of foreign direct investment in services alone are 5.3% of the value of Russian consumption, or more than 70% of the total value of the gains. The welfare gains from Russia's tariff reduction are estimated at 1.3% of consumption, and improved market access results in gains of 0.7% percent of consumption. Thus, while improving its offer to foreign service-providers within the context of the GATS has been one of the most difficult aspects of Russia's negotiation for WTO accession, our estimates suggest that the most important component of WTO accession for Russia in terms of the welfare gains is liberalization of its barriers against FDI in the service sectors.

Despite these significant gains, during the transition period it is possible that many households will lose. Displaced workers will have to find new employment. They will suffer losses from transitional unemployment and will likely incur expenses related to retraining or relocation. Some of the poorest members of the population are ill equipped to handle these transition costs. Thus, despite the likelihood of a substantial improvement in the standard of living for almost all Russians after accession to the WTO, government safety nets are very important to help with the transition, especially for the poorest members of society, who can ill afford a harsh transition.

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## Assessing legal systems: a catalyst for reform

Michel Nussbaumer

**S**ince the mid-1990s the European Bank for Reconstruction and Development (EBRD) has been conducting assessments of the state of legal transition in the countries of Central and Eastern Europe and the Commonwealth of Independent States (CIS). As the single largest investor in the region, the EBRD has focused its assessment programme on legal sectors directly relevant to foreign investments: concessions, corporate governance, insolvency, secured transactions, securities markets and telecommunications. As a result of this process, the Bank has developed a unique collection of analytical tools relating to the commercial and financial laws of these countries. All assessment results are available on the Bank's web site. The EBRD's legal assessment work is part of the Bank's Legal Transition Programme, a significant component of which comprises direct technical assistance to national governments.

### Quality of the "laws on the books"

Assessing legal transition in the countries of Central and Eastern Europe and the CIS is a two-step process. First the EBRD evaluates the degree to which local legislation (the "laws on the books") complies with relevant international standards of best practice. This first criterion is referred to as the "extensiveness" of the legal framework. To date, such extensiveness assessments have been carried out and published for concessions, corporate governance, insolvency, secured transactions and securities markets. A similar assessment of telecommunications regulatory frameworks is planned for 2005-2006.

The extensiveness analysis is conducted on the basis of a checklist of questions, which reflect the contents of the relevant international standards. Countries are given scores and put in different categories ranging from "very low compliance" to "very high compliance". Chart 1 provides an example of such a ranking in the corporate governance assessment published in 2004, using as a benchmark the Organisation for Economic Cooperation and Development (OECD) Principles of Corporate Governance.

### Law implementation

Interested observers are likely to argue that, although an assessment of the "laws on the books" provides a good overview of progress in legal reforms, it is not sufficient to give a full picture of the impact of those reforms. Rather, what actually matters in order to support a vibrant market economy is the way these laws are implemented by courts and other state institutions. This is absolutely true. The EBRD is dedicated to obtaining a full picture of legal transition in its region by also assessing the level of implementation of laws. This is the second step of the assessment process: an analysis of law "effec-

tiveness", i.e. the actual practice developed in the countries. This part of the process is methodologically very challenging, as it is designed to capture facts, rather than rules, and to reflect the multitude of individual practices that may have developed within a given jurisdiction.

Following recent trends in the international legal community, the EBRD has based its assessment of law effectiveness on case studies, which serve as a proxy for the functioning of the relevant area of law. The first evaluation focused on secured transactions laws and was conducted in 2003, in collaboration with local lawyers in the region. It addressed the enforcement of charges. Based on a simple scenario (a bank trying to enforce its security against a defaulting debtor), the study revealed how the systems worked in practice in each country: how much money could a creditor recover through the realisation of charged assets, how quickly, and how easily? Countries were ranked on the basis of these three variables. Hungary, Latvia and Slovakia topped the list, while Bosnia and Herzegovina and Armenia had the least efficient enforcement. A similar case study was conducted on insolvency law in 2004 and on corporate governance in 2005. Studies of concessions and securities markets are scheduled for 2006 and 2007, respectively.

### Aggregate country law ratings

Going one step further, the EBRD has combined the two parts of its legal assessments available to date, i.e. the quality of "laws on the books" and the effectiveness of their implementation, to arrive at an aggregate score for each countries in which it operates (see Chart 2). The chart gives an idea of the general state of legal transition in 2005 in the commercial and financial law sector of the EBRD region.

**Chart 1. Compliance of legislation with OECD Principles of Corporate Governance**

Very high compliance	High compliance	Medium compliance	Low compliance	Very low compliance
(none)	Armenia Hungary Kazakhstan Latvia Lithuania FYR Macedonia Moldova Poland Russia	Albania Bulgaria Croatia Czech Republic Estonia Kyrgyz Republic Serbia & Montenegro Slovak Republic Slovenia Uzbekistan	Bosnia & Herzegovina Georgia Romania Turkmenistan	Azerbaijan Belarus Tajikistan Ukraine

Source: EBRD Corporate Governance Assessment 2004

Generally, Central European countries appear to be more advanced than the so-called early transition countries, confirming the broad correlation between progress in rule of law and economic transition. In that sense, European Union integration has played a positive role in pushing reform agendas. There are some less intuitive results, however: Poland comes in last among Central European countries, likely the consequence of an over-burdened court system, which makes it difficult for investors to process their claims expeditiously.

Early transition countries such as Moldova and the Kyrgyz Republic, on the other hand, fare relatively well, probably reflecting the substantial amount of technical assistance received to upgrade their written laws. But despite these anecdotal points, the most striking feature of the chart is the huge transition challenge that remains for the entire region. Graphically, that challenge can be seen in the lighter top part of the bars, i.e. the gap that these countries need to bridge in order to approximate the international standards advocated by the EBRD. There remains a lot of work to be done.

### Impact of EBRD legal assessment work

Assessing country law in the region is a colossal enterprise that requires substantial resources, both in terms of human and financial resources. Why does the EBRD engage in this huge effort? The rationale is three-fold:

- Firstly, the EBRD can make use of its knowledge of local law to inform its own investment decisions;
- Secondly, by publishing country ratings and related information, the Bank can encourage other investors to venture into this part of the world by providing them with the information necessary to make informed decisions;
- Thirdly, and most importantly, legal transition assessments can be a formidable tool for policy dialogue with local governments. In other words, the publication of studies on legal systems is likely to encourage national governments to address the issues highlighted in the assessments and take appropriate steps.

An example will illustrate this motivational effect. When the case study on the enforcement of charges was published in the

Bank's 2003 Transition Report, the fact that Poland scored poorly did not go unnoticed. The case study highlighted the challenges that existed in that country in trying to enforce a pledge through the local court system, the only available method for enforcement: secured lenders were likely to face a long, complex and expensive process. The procedure was described as more challenging than in any (then) EU candidate country, and even than in a number of early transition countries.

This view was compounded by the World Bank Doing Business in 2004 and Doing Business in 2005 reports, which concluded that it would take an average of 1,000 days to enforce a simple contract, and that the legal rights of borrowers and lenders scored a 2 on an index of 1 to 10. The countries at the top of the index are the UK, Hong Kong Special Administrative Region (SAR), and also Albania and Slovakia. Poland, with an index of 2, ranks alongside Brazil, China, Haiti, and Morocco.

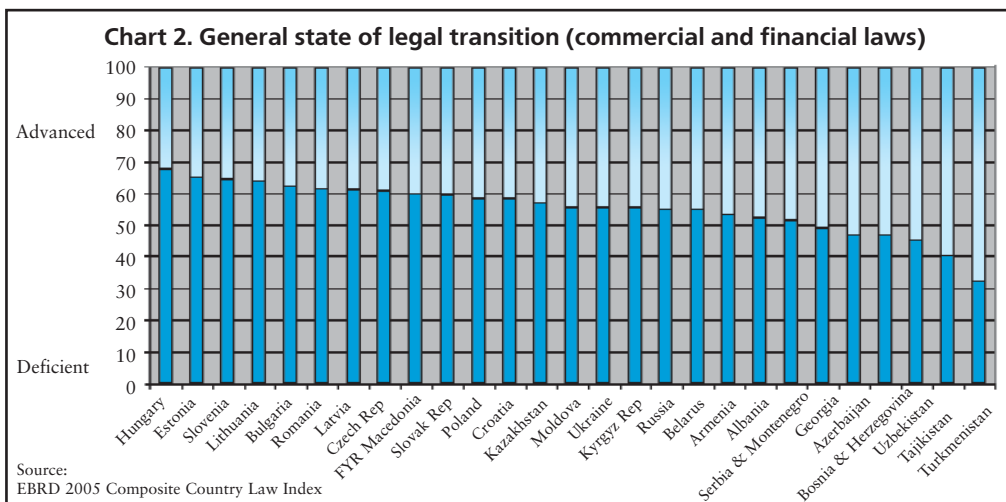
Following these publications, the National Bank of Poland approached the EBRD with a request for assistance in assessing the impact of the legal framework on the credit sector in Poland and drafting recommendations for improvement. EBRD technical assistance is currently being provided, in conjunction with a World Bank project, "Reducing Legal Barriers to Contract Enforcement".

### Maintaining legal reform momentum

The EBRD assessments reveal a need for pursuing legal reforms in the countries of Central and Eastern Europe and the CIS. Although legal frameworks have been substantially upgraded since the early 1990s, much work remains to be done in order for these countries to approximate international standards of best practice. In addition, and more significantly, implementing legal provisions remains fraught with uncertainty in a majority of countries. Investors cannot, in many instances, rely sufficiently on the ability of local courts to uphold their contractual rights. Significant efforts are still required to build legal institutions and increase judicial capacity in the commercial sector. By publishing detailed assessments highlighting the areas that need overhauling, the EBRD seeks

to encourage policy makers in the region to take appropriate steps. If requested, the Bank is also able to offer technical assistance to conduct the necessary reforms.

*Michel Nussbaumer is head of the Legal Transition Team at the EBRD. He contributed this article to BT. The contents of this article reflect the opinions of the author and do not necessarily reflect the views of the EBRD. For more information on the EBRD Legal Transition Programme, see [www.ebrd.com/law](http://www.ebrd.com/law). ■*



## Family background and schooling outcomes in the Baltic countries

Mihails Hazans, Olga Rastrigina and Ija Trapeznikova

**O**ne of the most interesting but least studied effects of transition on inequality is its impact on intergenerational mobility. In the three Baltic countries, rapid changes have taken place in the process of human-capital accumulation since the fall of communism. After 12 years of transition, a wide tertiary participation gap has emerged between the titular ethnicity in each country and sizable (predominantly Russian-speaking) ethnic minorities.

In all three Baltic countries, the total number of tertiary students increased sharply from 1995 to 2003. This can be attributed to several factors: rising returns to education, which provided strong new incentives to participate; the removal of quantitative supply constraints; the emergence of new fields of study; the lower ability barrier for those willing to pay; and the introduction of student loans.

This historic change has also had another dimension. The Baltic countries have sizable ethnic minorities, predominantly Russian-speaking (also Polish in Lithuania): 16% in Lithuania, 32% in Estonia, and 42% in Latvia (2002). Up to 1989, instruction in higher-education institutions was provided both in the language of ethnic majority (the titular language) and Russian, in proportions roughly consistent with the population. After regaining independence, instruction in state-financed higher education has switched to the titular languages. By 2002, the proportion of tertiary students (both state- and self-financed) receiving instruction in Russian was about 10% in Estonia and Latvia, and less than 1% in Lithuania.

In studying the nature, strength and dynamics of correlation between demographic characteristics, parental income and education, and children's education, we address the following:

- Conditional on family background, are the schooling decisions and outcomes of ethnic minorities substantially different from those of the majority population?
- How have the effects of family background on schooling outcomes evolved during transition?

Our data come from the 1999 Living Condition Survey NORBALT II and from the 2001-2002 Labor Force Surveys.

During the transition, a wide tertiary participation and attainment gap emerged between the titular ethnicity in each country and the ethnic minorities. In the 21-30 age cohort, the ethnic gap is 8 and 10 percentage points in Estonia and Latvia respectively, compared to 2 percentage points for the 41-50 year olds. In Lithuania the gap has increased only slightly, and it has even become smaller in relative terms. For all three countries the gap in participation, and for Latvia and Lithuania also the gap in the propensity to complete higher education, remains significant after controlling for parental education and (as far as tertiary enrollment is concerned) parental income. Both the language issue and lower returns to schooling might be among potential reasons.

Remarkably, however, the least troublesome dynamics in

the distribution of human capital across ethnic groups is found in Lithuania, the only one of the three countries without substantial provision of Russian-language higher education, even in the private sector.

What are the likely reasons for the Lithuanian phenomenon? The first thing that comes to mind is that minorities are better integrated in Lithuania than in the other two countries: according to the 2000-2001 Population Census, 99% of the population held Lithuanian citizenship, compared to 80% in Estonia and 74.4% in Latvia. Young non-Lithuanians also have better language skills than their peers in Estonia and Latvia. The fact that about half of Lithuanian minorities are ethnic Poles may play a role. Indeed, the Polish minority, which was the least educated in Soviet times, has done more "catching up" than others and is now ahead of other minorities in tertiary enrollment. However, there is no significant difference in terms of secondary enrollment of 15-18 year olds and the propensity to complete higher education for 21-31 year olds. Thus, the Polish factor cannot be the major explanation.

In Estonia and to a lesser extent in Latvia, the ethnic gap in secondary enrollment threatens to reinforce inequality in the distribution of human capital across ethnic groups. The difference between ethnic groups in the propensity to enroll in secondary education in Estonia is currently more than 7 percentage points among 15-18 year olds. Moreover, a difference in preference between general and vocational secondary education does not contribute to the ethnic gap. The unexplained ethnic gap in human capital is the most pronounced and most rapidly increasing in Latvia.

The educational attainment of parents is found to have a strong positive effect on the propensity to enroll in and complete secondary and tertiary education, both in Soviet times and during transition. Some evidence is found for a weakening of the 'mother's higher education effect' during the transition. At the same time, the positive effect of one's father having completed higher education, and the negative effect of living in a fatherless household, strengthened in the 1980s and the 1990s. This may reflect the increasing importance of family income for schooling decisions.

The short- and long-term income effects on postsecondary enrollment were found to be significant in late 1990s, although the size of the effect was modest: doubling per-capita income increased the probability of participation in further education by 6-10 percentage points.

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## A troubled country?

Preston Smith

In March, Poland's prominent business daily, *Puls Biznesu*, released findings that companies see Poland and its public sector as corrupt, while adding that these same companies also bribe each other, perhaps even on a widespread basis.

The news came as no surprise for Poles, who increasingly seem to consider Poland a troubled country. Corruption has become the deciding factor in Polish politics, and this is likely to continue through the September elections, especially considering a recent World Bank report noting a marked increase in the perception that corruption had become a significant obstacle to business in both Poland and Belarus. According to the daily's figures, 53% of those polled see corruption as problematic, and 61% of respondents stated that bribery during public tenders was widespread. Taken together with an October Transparency International report pegging Poland at only No. 67 in a corruption ranking of 146 countries, there is little doubt that the perception of Polish corruption is at an all-time high.

There is also little doubt that the press has played a role in increasing that perception. Since the winter of 2003 a parade of high-level political scandals has dominated Polish news — scandals that not only helped end the career of former Prime Minister Leszek Miller, but which have also crippled, if not destroyed, the once dominant Democratic Left Alliance (SLD) as a viable political party. Yet unlike many countries, which see waves of scandals fade with the ouster of political parties deemed to be corrupt, the Polish wave — and the continued boom in investigative reporting — has shown no signs of letting up. At first this wave seemed to crest with "Rywingate," a bribes-for-legislation scandal centering on film producer Lew Rywin, the Agora media group, and Miller. Rywingate appeared to culminate with the resignation of Miller on May 2, 2004, one day after Poland's EU accession. However, the legacy of the SLD goes far beyond Rywin. Over the past two years the public has been bombarded with not only Rywingate, but also a host of scandals related to state-controlled insurer Powszechny Zakład Ubezpieczeń (PZU) and the state-controlled oil company PKN Orlen, as well as a plethora of "minor" affairs and sub-scandals.

For most countries this would be plenty, but even Poland's longest-running affairs, such as PZU and especially PKN Orlen, continue to mutate and grow more troubling. This has been exacerbated by what have appeared at times to be very politically motivated parliamentary commissions. Critics have claimed that the current PZU commission's primary goal is simply to kick Dutch privatization partner Eureko out of a bogged-down privatization effort that has lasted since 1999. Likewise, few doubt that at least some in the PKN Orlen commission have set their sights on President Kwasniewski himself. Finally, the haphazard approach of both commissions has left

even many journalists jaded, if not confused. The PKN Orlen scandal first began with the politically motivated arrest of company CEO Andrzej Modrzejewski, yet it now encompasses tales of military and police corruption, Russian interference in Poland's energy sector, and allegations directed at both President Aleksander Kwasniewski and his wife, Jolanta Kwasniewska.

As bad as it seems, the perception of Poland as a corrupt state may be misleading. Such riveting headlines are partly a result of an unexpected revolution in investigative reporting that began in the late 1990s, which has tainted — fairly or unfairly — Poland's reputation, and even how Poles see themselves. Such "negative" coverage has been undeniably heavy. A scan of the archives of the daily newspaper *Rzeczpospolita* reveals no fewer than 365 such articles published since January 2004. The independent televised media, Polsat and TVN, have at least matched the output of the print media, with a number of programs dedicated specifically to uncovering scandals on a weekly basis. Ironically, the focus on investigative work has also fed even more newsprint, including charges of irresponsible journalism and lawsuits against journalists, ranging from those filed by indicted or arrested suspects to President Kwasniewski himself.

Meanwhile, the most common Polish reaction appears to be that of general disgust with the current political scene. It is possible that Poland is in the process of a massive clean-up, and that levels of corruption will drop sharply over the next few years, but the current implications may be felt as soon as presidential elections, scheduled for September. In May, Lech Kaczynski's right-leaning Law and Justice Party suddenly moved ahead of the business-first Civic Platform group, led by Jan Rokita, who was himself once thought of as a shoe-in for the role of prime minister in the next government. Instead, Kaczynski, backed by his twin brother and party leader Jaroslaw, has wrestled into the No. 1 spot in the polls, with approximately 26% support, and is now the presidential favorite. His message has long been both simple and consistent, stating that he plans to stomp out corruption in politics and business wherever he can gain a public mandate. And if the polls are to be believed, it appears that Polish politics may have come to exactly that. Ironically, the political future of a country wearied by years of dishonesty will likely be decided by more debates on this very topic. And in the meantime, the Kaczynski brothers seem to have found their ticket.

*Preston Smith is editor of "Poland Monthly", an English-language monthly published in Poland. He contributed this comment in response to corporate governance coverage in October-December 2004 issue of "Beyond Transition". ■*

### Global and Country Development Marketplaces

World Bank headquarters hosted its annual Global Development Marketplace May 24 and 25, where 78 finalists presented their innovative grassroots development projects. The finalists included 10 representatives from seven European and Central Asian countries. The 31 winners included projects from Azerbaijan, Russia, and Bosnia and Herzegovina. The Bosnian project proposed insulating homes with otherwise unusable coarse sheep's wool.

In addition to the global marketplace, several ECA countries have held development marketplaces on a national level. Turkey hosted an extremely successful event on May 3, receiving 765 entries from around the country. Of these, 35 proposals falling under the theme "Social Inclusion and Progress on the Way to Europe" were selected as finalists. Altogether, 23 projects will receive funding to implement their ideas over the next 12 months. The winners included the development of a Turkish form of sign language and bringing pen pals and monthly prison visits to juvenile detention homes. Georgia also hosted its own Marketplace in March, and others, including Croatia and Lithuania, have hosted them in the past couple of years.

### Vice-President's Travels

Shigeo Katsu, VP for Europe and Central Asia, visited Romania May 7-9 to meet with government officials and business and think-tank representatives. He also visited the Social Development Fund subproject in the village of Movila Oii, as well as the newly opened Public Information Center. On May 21 and 22, Shigeo attended the annual EBRD meetings in Belgrade, Serbia, and participated in a panel discussion on investment in Southeast Europe and the World Bank's role in contributing to growth.

### Third Forum on Poverty Reduction Strategies, with Focus on Labor Markets, May 27-28

The third Forum on Poverty Reduction Strategies, or PRSPs, for the western Balkans was held in Thessaloniki, Greece, May 27-28. The Forum brought together government and civil society representatives from countries with active Poverty Reduction Strategies — Albania, Bosnia and Herzegovina, and Serbia and Montenegro — and representatives from UNMIK Kosovo and FYR Macedonia. This year, the PRSP Forum was preceded by a one-day Conference on Labor Markets, Growth and Poverty Reduction Strategies. Participants noted that measures to promote competitiveness were critical to promoting job creation and accelerated growth. These measures centered on policies for improving the business environment, investing in market skills and human development, and strengthening well-targeted social safety nets.

There was general recognition of the substantial convergence of goals and measures embodied in the Millennium Development Goals, the Stabilization Association Program, and the PRSP, which are prepared by governments through a participatory process involving civil society and development partners, including the World Bank and the International Monetary Fund. Forum attendees agreed that these various goals have to be brought together in one single nationally-driven development framework for growth and poverty reduction. The event was sponsored by the Government of Greece, the U.K. Department for International Development, the United Nations Development Program, and the European Union, and organized by the World Bank and the IMF.

### BTC Pipeline Opening May 25

The IFC-supported Baku-Tbilisi-Ceyhan oil pipeline, stretching from the Caspian Sea to Turkey, officially opened on May 25. The 1,760-kilometer pipeline is expected to transport up to 1 million barrels per day and will provide an alternative to existing pipelines going through Russia. The IFC's contribution to the US\$3.6 billion project was two loans of up to \$125 million, one extended on its own account and the other through commercial syndication. The BTC pipeline was constructed and began operations under the strictest environmental and social standards, avoiding the need to resettle any home or household along its route. In addition to the IFC, the pipeline is being sponsored by several national and international oil companies.

### Civil Society Forum in Bratislava, Slovak Republic, June 9-11

The ECA NGO Working Group, in conjunction with the European Commission, the Government of the Slovak Republic, and the World Bank, hosted a conference titled "Sustainability of the CSO Sector in Post-Accession Central and Eastern Europe, the CIS, the Balkans and Turkey". CSOs from all across the region participated. The third forum on this topic, this forum addressed three primary objectives: building understanding and exchanging experiences among CSO leaders, governments, foundations, and intergovernmental agencies; promoting partnerships among these development actors to enhance cooperation between new EU member states and the rest of the region; and strengthening networking and promoting debate on specific themes within CSO communities. Although the experiences of these countries differ sharply, they all face similar problems of sustaining fledgling CSOs. The participants cover a broad range of expertise, from human rights to children's issues, from the environment to agriculture. The program was structured around five main issues: the enabling environment, the role of CSOs in public advocacy and policy dialogue, the role of CSOs in the delivery of social services, financial sustainability, and cross-regional networking.

## Europe Faces Pensions Crunch

A new World Bank report, *Pension Reform in Europe: Progress and Process*, details the urgent need for pension reform in both new EU member states and EU-accession countries in order to keep pace with rapidly-aging populations. Rising budget costs, changing patterns in contemporary society, and the financial requirements for EU integration are driving the unavoidable case for comprehensive, pan-European reform. Thus far, countries have opted for two different reform approaches. The Czech Republic and Slovenia are using a parametric model, which seeks more revenues and reduces expenditures while expanding voluntary private pension provisions. On the other hand, Bulgaria, Croatia, and others have followed the paradigmatic approach, which requires fundamental changes in pension provision, typically by introducing a mandatory funded pension pillar and expanded opportunities for voluntary retirement savings and individual accounts. EU-accession countries have been more inclined to follow the latter approach, perhaps because they "have undergone a profound crisis leading to a major ideological shift, while EU countries for the most part have not," explains Michal Rutkowski, a Social Protection Sector manager for the Europe and Central Asia Region at the World Bank. The report concludes that progress on reform thus far has been happening much too slowly, while the EU-accession countries may perhaps help energize the current members.

## Judicial Reform Study Launched June 20

*Judicial Systems in Transition Economies: Assessing the Past, Looking to the Future*, the World Bank's newest study of legal systems in 26 ECA countries, was released on June 15. The study, based on surveys of managers of 10,000 firms throughout the region, emphasizes the lack of progress in judicial reform. Despite advances in other sectors, judicial reform has deteriorated in many countries. A greater reliance on courts has not necessarily led to better judges and enforcement, even in EU member states such as the Slovak Republic, Slovenia, and Poland. At the other end of the spectrum, countries such as Belarus and Uzbekistan must focus first on economic reforms before their judiciaries can be strengthened. Overall, the report recommends stronger accountability mechanisms, efforts to build operational independence, revisions to case processing procedures to improve judicial control and efficiency, and improving access to courts and their security and operation. The release coincided with a June 21-22 workshop in Warsaw on "Contract Enforcement and Judicial Systems in Central and Eastern Europe," which convened public officials from 14 countries and donors to share experience, exchange information, and lay the groundwork for future collaboration.

## EU8 Quarterly Report on Slow Growth

The April EU8 Report brought diminished growth prospects for the EU new members, as factors that brought strong growth in 2004 are no longer present. In 2005, slower growth in

Western Europe, real currency appreciation, the end of one-time effects related to EU accession, and heightened political uncertainty in the run-up to elections are all expected to lead to slower growth in the region. A troubling development is that stronger output growth has not been associated with higher employment and the alleviation of high unemployment rates, especially in Poland and Slovakia. The authors point out that the high level of labor taxes may be contributing to structural unemployment, which constitutes 50% of the unemployed in six of the countries. Thomas Laursen, lead economist for Central Europe and the Baltic countries, states that "A decrease in the tax wedge, particularly for low-skilled workers — in a budget neutral way — should be contemplated in order to boost employment and reduce high unemployment in some countries".

## Czech Republic Graduates from World Bank Borrowing

On April 18, during the World Bank's spring meetings, the Czech Republic announced its intention to graduate from borrower status from the IBRD. Instead of receiving financial and technical assistance, the Czech Republic will now become a partner and provider of development assistance. After withdrawing from the Bank in 1954, Czechoslovakia rejoined in 1990, and three years later its successor states, the Czech and Slovak Republics maintained their memberships. From the 1990s onward, the Czech Republic transitioned from structural reforms and modernization of the energy and telecommunications sectors to knowledge partnerships focused on institutional reforms. It has been a donor to the International Development Association since 1993 and has recently pledged to increase its contribution to IDA replenishment by 30%. The Czech Republic is also continuing to partner with the Bank in the Decade of Roma Inclusion, among other initiatives.

## Central Asia AIDS Control Project Launched

The IDA-financed Central Asia AIDS Control Project was launched May 12 in Almaty, Kazakhstan, during a workshop attended by representatives from the ministries of health, justice, foreign affairs, and social development, NGOs, international policymakers, and the private sector. The project, to be administered by the Central Asia Cooperation Organization, is funded by a US\$25-million IDA grant and a 1-million pound grant from the UK Department for International Development. The four countries involved — Kazakhstan, the Kyrgyz Republic, Tajikistan, and Uzbekistan — have seen a dramatic increase in infection rates over the past four years, albeit from a low absolute level. The epidemic's main cause is intra-venous drug use, and it is concentrated among young people. The parallel epidemic of tuberculosis, endemic in prisons, compounds the effects of HIV/AIDS. A Regional AIDS Fund has been set up under the project, to fund initiatives to contain the spread of HIV/AIDS and other sexually transmitted infections in Central Asia. The Fund will provide incentives for greater regional cooperation between governments, public and private sector organizations, and public services, such as prisons and AIDS centers. ■

## New Books and Working Papers

### World Bank Publications

*Information and orders: the World Bank, P.O. Box 960, Herndon, VA 20172, U.S.; tel.: +1-703-661-1580, fax.: 703-661-1501, email: books@worldbank.org, www.worldbank.org/publications, or visit the World Bank InfoShop at 701 18th Street, N.W., Washington, D.C., tel.: +1-202-458-5454.*

Nicholas Barr (ed.)  
**Labor Markets and Social Policy in Central and Eastern Europe: The Accession and Beyond**  
*May 2005, 266 pp.*

The report summarizes social policy reform during the transition and EU accession processes and analyses the social policy challenges that continue to face both old and new member states. The book amplifies two sets of arguments. First, social policy under communism was in important respects well-suited to the old order and — precisely for that reason — was systematically badly-suited to a market economy. Secondly, successful accession is not the end of the story: economic and social trends over the past 50 years are creating strains on social policy that will have to be faced by both old and new members.

Robert Holzmann and Richard Hinz  
**Old-Age Income Support in the 21st Century: An International Perspective on Pension Systems and Reform**  
*May 2005, 242 pp.*

The past decade has brought increasing recognition of the importance of pension systems to the security of aging populations and to the economic stability of the countries where they live. The World Bank has been involved in pension reforms in nearly 60 countries, and the demand for its support continues to grow. This book incorporates recent experiences and research, which have significantly increased knowledge and insight regarding how best to proceed. Included is a section on regional reform experiences in Latin America, Europe, and Central Asia.

Francis Conway, Brien Desilets, Peter Epstein, Juliana Pigey, Graeme Frelick, and Fred Rosensweig  
**Intergovernmental Fiscal Relations in Central and Eastern Europe: A Sourcebook and Reference Guide**  
*June 2005, 88 pp.*

Produced by the Urban Institute for the United States Agency for International Development and the World Bank Institute, the sourcebook provides electronic links to a large number of documents, which discuss the basic concepts and principles, and describe the evolution of intergovernmental finance in the region (includes the printed sourcebook and the CD-ROM).

**China's Ownership Transformation: Process, Outcomes, Prospects**  
*June 2005*

Over the past decade, China's economy has moved from reliance on state-owned and collective enterprises to a mixed system, in which private enterprise also plays a strong role. In many cases, this has involved full privatization. The book discusses the main players in this process and their motivation and incentives, providing an assessment of the outcomes, with a focus on employee issues, corporate governance and firm performance.

James Anderson, David Bernstein, Cheryl Gray  
**Judicial Systems in Transition Economies: Assessing the Past, Looking to the Future**  
*June 2005, 135 pp.*

Joana Godinho, Adrian Renton, Viatcheslav Vinogradov, Thomas Novotny, and Mary-Jane Rivers  
**Reversing the Tide: Priorities for HIV/AIDS Prevention in Central Asia**  
*June 2005, 206 pp.*

Joana Godinho, Jaap Veen, James Cercone, Jose Pacheco, Masoud Dara  
**Stopping Tuberculosis in Central Asia: Priorities for Action**  
*June 2005, 216 pp.*

**Ukraine's Trade Policy: A Strategy for Integration into Global Trade**  
*June 2005, 280 pp.*

Bernard M. Hoekman, Subidey Togan (eds.)  
**Turkey: Economic Reform and Accession to the European Union**  
*June 2005, 400 pp.*

Hermine De Soto, Sabine Beddies, Ilir Gedeshi  
**Roma and Egyptians in Albania: From Social Exclusion to Social Inclusion**  
*April 2005, 312 pp.*

### World Bank Working Papers

<http://econ.worldbank.org/>

Bernard Dafflon and Krisztina Toth  
**Fiscal federalism in Switzerland: relevant issues for transition economies in Central and Eastern Europe**  
*WPS 3655, June 2005*

Its highly fragmented structure of local governments and serious horizontal fiscal imbalances make Switzerland a surpris-

ingly powerful model for Eastern European countries that are currently facing the challenge of fiscal decentralization. Among other conclusions, the authors suggest that subnational authorities can effectively fend off recentralization attempts of the central government if they engage in spontaneous cooperation to enhance the efficiency of public service provision. The authors also show that the principle of subsidiarity can best be safeguarded by anchoring the expenditure and revenue powers of subnational governments in the constitution or in a similarly strong law.

## William Davidson Institute Working Papers

<http://www.wdi.bus.umich.edu/>

Jan Bruha, Delia Ionascu and Byeongju Jeong  
**Organized Labor and Restructuring: Coal Mines in the Czech Republic and Romania**  
 WP No. 773, May 2005

The authors examine the role of organized labor in the restructuring experience of two coal mining regions in the 1990s: Ostrava in the Czech Republic and the Jiu Valley region in Romania. Under similar external circumstances, the Ostrava region undertook gradual restructuring from early on, whereas in the Jiu Valley there was no restructuring until 1997, followed by massive layoffs over two years. A quantitative study that accounts for mine productivity, labor market conditions, and the constraints in compensating laid-off miners shows that the delay in restructuring in the Jiu Valley was inefficient: gradual restructuring with compensation would have benefited both the miners and the government.

Alexei Gorjaev and Konstantin Sonin  
**Is Political Risk Company-Specific? The Market Side of the Yukos Affair**  
 WP No. 772, May 2005

The Yukos affair provides an excellent opportunity for an inquiry into the nature of company-specific political risks in emerging markets. News associated primarily with law enforcement agencies' actions against the company's managers, not formally related to the company itself, caused significant negative abnormal returns for Yukos. The stock of less transparent private Russian companies has been more sensitive to Yukos-related events, especially employee-related charges by law enforcement agencies.

Balazs Egert  
**Equilibrium Exchange Rates in Southeastern Europe, Russia, Ukraine and Turkey: Healthy or (Dutch) Diseased?**  
 WP No. 770, May 2005

This paper investigates the equilibrium exchange rates of three Southeastern European countries (Bulgaria, Croatia and Romania), two CIS economies (Russia and Ukraine), and Turkey. A systematic approach in terms of different time hori-

zons at which the equilibrium exchange rate is assessed is conducted, combined with a careful analysis of country-specific factors. A unified framework including productivity and net foreign assets, undertaken with a set of control variables such as openness, public debt and public expenditures, is used to compute total real misalignment bands.

Jan Fidrmuc  
**Labor Mobility during Transition: Evidence from the Czech Republic**  
 WP No. 767, April 2005

The paper analyzes the development of inter-regional mobility in the Czech Republic during the transition. The intensity of migration is low and has even fallen during the period, while regional disparities in unemployment rates and earnings have increased. More importantly, labor mobility is weakly effective in facilitating labor market adjustment to employment shocks. While, at present, migration appears more of a social or demographic rather than economic phenomenon, its economic role may strengthen in the future.

## Centre for the Study of Economic and Social Change in Europe

<http://www.ssees.ac.uk/economic.htm>

Alena V. Ledeneva  
**Leadership and Corruption in Russia, 2000-2004**  
 WP No. 54

The paper defines the key features of corruption and the perception of corruption in Russia under Putin. It provides a comparison of trends of the corruption perception index in the CIS region and CEE countries and focuses on the specifics of President Putin's policies in application. The analysis questions assumptions about informal practices and formal institutions and offers interpretations of the dependence of Putin's regime on 'unwritten rules'.

Slavo Radosevic and Andrew Rozeik  
**Foreign Direct Investment and Restructuring in the Automotive Industry in Central and East Europe**  
 WP No. 53

The paper explores the effects of FDI on automotive industry restructuring in CEE. The results suggest that the value-creation potential of CEE as a global automotive location has not yet been fully exploited. A combination of country-specific factors and the strategies of multinational automotive companies has generated different country patterns. Improvements in productivity and technology transfer are significant in countries with large FDI in the automotive industry. Employment effects are positive, particularly in the automotive supply industry. Privatisation policy in the early 1990s, followed by a policy of attracting greenfield FDI on the eve of EU accession, is crucial in explaining country differences in the presence of FDI.

## Other publications

Peter Sanfey and Utku Teksoz

### Does transition make you happy?

*EBRD Working Paper #91, June 2005*

<http://www.ebrd.org/pubs/econo/WP0091.htm>

Using evidence from the World Values Survey, the paper analyses life satisfaction in transition countries. The analysis shows that the happiest groups are females, people with higher levels of education, higher income-earners, and people who are self-employed. On average, however, people living in transition countries are less satisfied with their lives than individuals in non-transition economies.

Elisabetta Falcetti, Tatiana Lysenko and Peter Sanfey

### Reforms and growth in transition: re-examining the evidence

*EBRD Working Paper #90, June 2005*

<http://www.ebrd.org/pubs/econo/WP0090.htm>

A positive link between progress in market-oriented reforms and cumulative growth has been recorded across transition countries. This paper shows that progress in transition in one period can significantly affect growth in the subsequent period, and this growth can act as an immediate spur to further reform.

Rudiger Ahrend and William Tompson

### Fifteen years of economic reform in Russia: What has been achieved? What remains to be done?

*OECD Economics Department Working Paper 430, May 2005*

<http://www.oecd.org/publications>

The paper provides an overview of the course of economic reform and the performance of the Russian economy since the early 1990s and an analysis of the structural reform challenges ahead. Three major conclusions emerge. First, while the Russian authorities have embarked on some impressive 'second-generation' reforms, many 'first-generation' reforms have yet to be completed. Secondly, the central challenges for Russia are primarily concerned with reforming state institutions. Thirdly, the pursuit of reforms across a broad front could enable Russia to profit from complementarities among various strands of reform.

Abdul Abiad and Taimur Baig

### Underlying Factors Driving Fiscal Effort in Emerging Market Economies

*IMF Working Paper No. 05/106, June 2005,*

<http://www.imf.org/external/pubind.htm>

Using a panel dataset of 34 emerging market countries for the period 1990-2002, the paper examines the roles of various economic, political, and institutional variables in determining fiscal effort, as proxied by the primary surplus. It finds that while fiscal effort increases, as expected, with the level of lagged debt, this effect tapers off beyond a certain threshold. Fiscal

effort rises with positive shocks to oil prices (for oil exporters), when the economy grows above its potential, and in the presence of an IMF-supported program. In contrast, high democratic accountability and strong and impartial bureaucracies help lower market risk and hence lower the relative need for fiscal adjustment. Finally, fiscal effort tends to decline when too many constraints are faced by the executive.

Jack Diamond

### Reforming the Russian Budget System: A Move to More Devolved Budget Management?

*IMF Working Paper No. 05/104, May 2005*

<http://www.imf.org/external/pubind.htm>

The Russian federal government has recently initiated a fundamental reform of its budget system, encompassing important policy, procedural, and institutional changes. This paper reviews this reform agenda with reference to the experience of industrial countries and reveals a number of concerns. First, the speed of the reforms appears overly ambitious. Second, the preparedness of budget institutions is questionable. Third, change management capacity needs strengthening, with a more carefully defined strategy. Last, the scope and "big-bang" approach of the current reform plans may need reformulation into a more sequenced strategy with clearer reform priorities.

Dalia Hakura

### Are Emerging Market Countries Learning to Float?

*IMF Working Paper No. 05/98, May 2005*

<http://www.imf.org/external/pubind.htm>

The paper finds that exchange rate flexibility in emerging-market countries has increased over the past decade. This "learning to float" appears to have involved a strengthening of monetary and financial policy frameworks aimed at directly addressing the key vulnerabilities that give rise to the "fear of floating." The results suggest that the trend toward greater exchange rate flexibility, alongside a strengthening of banking supervision, has afforded emerging-market countries more monetary policy independence.

Patrizia Tumbarello

### Regional Trade Integration and WTO Accession: Which is the Right Sequencing? An Application to the CIS

*IMF Working Paper No. 05/94, May 2005*

<http://www.imf.org/external/pubind.htm>

This paper analyzes the appropriate sequencing of accession to the WTO and the implementation of the Eurasian Economic Community (EAEC) customs union, and whether the latter facilitates or delays WTO accession for some member countries of the CIS. If EAEC members pursue a coordinated approach toward WTO accession, this may cause delays that benefit some countries at the expense of others. The results of a simulation of welfare effects show that, from a consumer surplus standpoint, it would be preferable to join the WTO ahead of the EAEC customs union.

**6th International Conference on Financial Development and Governance**

August 22-23, 2005, Moscow

The conference is organized by Enrico Perotti (University of Amsterdam, Netherlands), Erik Berglof (Stockholm Institute of Transition Economics, Sweden), Stijn Claessens (University of Amsterdam), and Sergei Guriev (New Economic School, Moscow) and is sponsored by Amsterdam Center for Research in International Finance, the NES and SITE. Topics to be discussed: liberalization, growth and crises; elections, special interests and the fiscal costs of financial crisis; political economy; politicians and financing; and corporate governance and managerial risk taking.

*More information: Enrico Perotti, Chair professor of international finance, University of Amsterdam, email: E.C.Perotti@uva.nl; and Sergei Guriev, associate professor of corporate finance, rector, NES (local organizer), email: sguriev@nes.ru.*

**The 20th Annual Congress of the European Economic Association**

August 24-27, 2005, Amsterdam, Netherlands

The Program Chair is Prof. Lucrezia Reichlin (ECARES, Universite Libre de Bruxelles, and European Central Bank). Philippe Aghion and Marco Pagano will deliver keynote addresses.

*Information: [http://www.eea2005.org/eea\\_amsterdam.html](http://www.eea2005.org/eea_amsterdam.html)*

**CEPR Annual Public Policy Symposium**

September 9, 2005, Bocconi, Italy

This conference will be the sixth meeting of the Public Policy programme. Its goal is to provide a forum for high quality work in public economics and to bring together economists in the field from across Europe, as well as key researchers from outside the region. Papers are invited in any area of public economics (including political economy and public policy issues in general).

*Info: <http://www.cepr.org/Meets/diary/listyear.asp?year=2005>*

**Business and Marketing Strategies for Central & Eastern Europe**

December 1-3, 2005, Austria

The 13th annual joint conference of the Department of Marketing of the College of Commerce, DePaul University Chicago, and the Department of International Business, Vienna University of Economics and Business Administration, Austria.

Empirical research, case studies and discussion sessions are sought, addressing such topics as comparative analysis of conditions of market entry in CEE countries, market entry through exports versus market entry via capital investment, acquisitions as opposed to joint ventures in CEE, marketing strategies to reach CEE consumers, marketing-mix decisions for markets in CEE, financial strategies for opening CEE markets, and case studies of CEE experiences by western firms.

Abstracts of papers, in English, should be received by September 15, 2005. For more information or to send abstracts contact either of the conference sponsors:

*Prof. Dr. Reiner Springer, Wirtschaftsuniversitet Wien, Althanstr. 51, 1090 Wien, Austria, Phone: + 43-1-313 36/4377, FAX: + 43-1-313 36/751. E-mail: Reiner.Springer@wu-wien.ac.at or Prof. Dr. Petr Chadraba, Department of Marketing, College of Commerce, DePaul University, 1 East Jackson Boulevard, Chicago, Illinois 60604, USA, Phone: +1 312 362-6889, FAX: +1 312 362-5647. E-mail: pchadrab@depaul.edu*

**Inclusion and Exclusion. Diverse and innovative approaches to Central and Eastern Europe**

The 7th Annual International Postgraduate Conference on Central and Eastern Europe, School of Slavonic and East European Studies, University College London, London, February 18-20, 2006

The conference aims to discuss the economic, political, cultural and social factors, both past and present, which have given rise to the problematic informing practices of inclusion and exclusion. Papers on the following themes are invited:

- Political: Migration, crime and punishment, corruption, the politics of transition, religion and the state, NATO expansion, EU integration and enlargement.
- Economic: Natural resources, economic growth, property rights, corporate governance.
- Social: Gender, health and education reforms, children, citizenship and ethnicity issues;
- Cultural: Fine and performance art, confessionalism, bridging the gap between elitist and demotic approaches, national revival and national collapse.

The conference is directed towards research students, although the participation of interested persons in the diplomatic and media communities, as well as from governments and organisations, is encouraged.

*Paper abstracts and/or panel proposals of 300 words should be sent along with a resume to [pgconference@ssees.ucl.ac.uk](mailto:pgconference@ssees.ucl.ac.uk) and/or to SSEES Postgraduate Conference, School of Slavonic and European Studies, Senate House, Malet Street, London, WC1E 7HU, United Kingdom.*

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