

# Beyond Transition

## Barriers to entrepreneurship

Policymakers in country after country are trying to foster entry. Yet many questions remain about which government policies can help create a favorable business climate for entrepreneurship. Is a great number of small firms in a country, such as Italy, a sign of low entry barriers? Why do startups grow more slowly in some countries? How does enforcement of entry regulations affect new firm creation? *Leora Klapper and Luc Laeven of the World Bank, and Raghuram Rajan of the IMF* provide answers to these and other questions after conducting an extensive empirical analysis of more than 3 million firms in Eastern and Western Europe. They find that some regulations worsen welfare and hamper firm expansion, while others are beneficial to entrepreneurship.

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## Theme of the Issue: Entrepreneurship and Barriers to Entry

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## Russian entrepreneurs: tell me who your friends and family are...

When studying the determinants of entrepreneurship, social scientists emphasize three sets of variables: institutions, social networks, and personal characteristics. Although all three seem relevant, there remains no clear consensus on why people become entrepreneurs. This makes it difficult to devise policies that will encourage entrepreneurial development. *Simeon Djankov (the World Bank), Gerard Roland, Edward Miguel and Yingui Qian (all from the University of California at Berkeley), and Ekaterina Zhuravskaya (CEFIR/NES in Moscow)* have embarked on a large study of entrepreneurship that will encompass five countries with significant economic potential in the coming decades: China, Russia, Brazil, India, and Nigeria. In this issue we present the results of the pilot study in Russia, based on 2,000 interviews in seven cities.

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## Creative destruction in industrialized and developing countries

In all countries, firms undergo significant changes over time, through resource reallocation among existing firms and firm entry and exit. *Eric Bartelsman (Free University Amsterdam and Tinbergen Institute), John Haltiwanger (University of Maryland and the Census Bureau) and Stefano Scarpetta (the World Bank)* analyze the magnitude of firm creation and destruction and the effect of "creative destruction" on productivity in 24 industrialized and developing countries. They find that "creative destruction" has played an especially important role in transition economies, where new firms not only displaced obsolete incumbents but also filled in new markets and, for a time, faced a relatively low level of competition.

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## Banking deregulation promotes "creative destruction"

In many countries around the world, banking sectors remain heavily regulated, and the state intervenes directly or indirectly in banks' lending decisions. *Marianne Bertrand (Chicago Graduate School of Business), Antoinette Schoar (MIT) and David Thesmar (Ecole Nationale de la Statistique et de l'Administration Economique, Paris)* investigate the consequences of the 1985 French banking sector deregulation on firm behavior and industry structure. They identify several important effects on firm behavior, product markets and allocative efficiency, implying that a more efficient banking sector plays an important role in fostering a Schumpeterian process of "creative destruction".

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## Russian entrepreneurs: tell me who your friends and family are...

Simeon Djankov, Gerard Roland, Edward Miguel, Yingui Qian, and Ekaterina Zhuravskaya

**I**t is increasingly recognized that entrepreneurship plays a crucial role for successful economic development. Schumpeterian analysis advances the view that entrepreneurial dynamism is the key to innovation and growth. Why does entrepreneurship thrive in certain societies and not in others? When studying the determinants of entrepreneurship, social scientists emphasize three sets of variables: institutions, social networks, and personal characteristics. The results of 2,000 interviews in seven cities across Russia provide evidence in all the three areas, with a particularly strong effect coming from social networks. The study is part of a larger project to be conducted in five large developing and transition countries — China, Russia, Brazil, India, and Nigeria.

Social scientists have proposed numerous explanations to account for cross-country differences in entrepreneurial activity, falling generally into three categories. An *institutional perspective*, favored by economists and political economists, focuses on the role of economic, political, and legal institutions in fostering entrepreneurship. Particularly relevant are credit markets and the protection of property rights: credit constraints make it impossible for the relatively poor to borrow funds to start up a business, and insufficiently strong property rights may not provide entrepreneurs with the necessary incentives.

A second perspective emphasizes *sociological* variables, such as social norms, values, and social networks, including relatives, friends, and social groups.

The third perspective emphasizes the *individual characteristics* of entrepreneurs, such as a personal need for achievement, self-confidence, self-reliance, and attitudes toward risk.

Although all three perspectives seem relevant, there remains no clear consensus on the determinants of entrepreneurship. This makes it difficult to devise policies to encourage entrepreneurial development in any given country. For example, relaxing credit constraints may not be of much help if the main obstacle to entrepreneurship lies in the insecurity of property rights. Similarly, financial and legal reforms may not achieve much if the roots of entrepreneurial potential lie in cultural factors and personal traits.

Our project studies entrepreneurship from all three perspectives, using a new data set from several developing and transition countries. The choice of countries is explained by their potential economic power in the coming decades, as well as size, which allows exploration of regional variations in institutions and culture. As these countries are unevenly developed

and/or have only recently embraced the capitalist system, we are able to study entrepreneurship as it emerges, rather than in the relative stability of highly developed economies.

Russia is a particularly interesting case, as entrepreneurship was not legally allowed in the country until 1992, with the exception of so-called cooperative (de facto private) enterprises created under Gorbachev. Russia's institutional environment has been highly volatile, with large regional variations and weak institutional support for the market economy in many regions. Corruption, racketeering, bureaucratic harassment, and poorly developed financial intermediaries have all negatively impacted the development of the private sector.

The pilot study carried out in Russia in 2003–2004 covered seven cities (including Moscow) in four different regions. We defined an entrepreneur as an owner or a co-owner of a business with five or more employees. The sample included both entrepreneurs and non-entrepreneurs in order to understand how these groups differ in terms of individual characteristics; non-entrepreneurs mirrored the sample of entrepreneurs with respect to age, gender and educational attainment. In addition, 150 non-entrepreneurs were surveyed without regard to demographic characteristics.

Finally, a random sample of 1,200 respondents allowed us to determine the rough proportion of entrepreneurs across cities. We find a considerable variation in the cities surveyed, with the lowest proportion of self-employed and entrepreneurs in Nizhny Novgorod (6%) and Moscow (8%) and the highest in Taganrog (18%).

### Entrepreneurs wealthier, healthier and happier

Controlling for individual age, gender, education, and location, we find that:

- Entrepreneurs are more likely to be married and tend to have slightly more children (1.3 vs. 1.2 in non-entrepreneurs' families);
- Entrepreneurs seem to have been better students in secondary school (or so they like to recall), and indeed they scored higher in a test of cognitive ability (see the figure);
- Entrepreneurs are wealthier, they spend a smaller proportion of income on food, are more likely to own a home, a car and a computer: only 5% do not own either a car or a computer, compared to 48% among non-entrepreneurs;
- Entrepreneurs are healthier and more physically active, although this might be due to higher-than-average income and wealth; they are also happier and more successful:

73% consider themselves successful, compared to about 40% of non-entrepreneurs;

- Entrepreneurs are more mobile, both professionally and geographically;
- Entrepreneurs like what they do and are less likely to substitute work for leisure even when offered compensation equal to 500 times per capita GDP: only 18% would choose to retire then, compared to 47% of non-entrepreneurs.

### Who is more likely to become an entrepreneur?

Two factors increase the probability of becoming an entrepreneur. First, having a father and mother who have completed higher education — by 4.7 and 20.4 percentage points, respectively. Second, the presence of a businessperson among close relatives and friends from adolescence — by 5.6 and 2.9 percentage points, respectively. Location-specific effects were weighted out to control for differences in institutional environments. Yet, individual perceptions of the business climate matter for career choice: lower perceived levels of corruption and a more benign public attitude towards entrepreneurship increase the probability that an individual will become an entrepreneur.

Looking at family background, we find that the parents of an entrepreneur were almost twice as likely to have higher degrees and good jobs than non-entrepreneurs' parents, and they were also wealthier. Interestingly, though, while the fathers of entrepreneurs were more likely to have been a director (19% for entrepreneurs vs. 11.4% for non-entrepreneurs), the opposite is true for mothers (2.5% vs. 8.1% for non-entrepreneurs). A significantly higher proportion of entrepreneurs' fathers — nearly 50% — were members of the Communist Party, as compared to 35% for non-entrepreneurs.

The social environment in general and social networks in particular seem to play an even bigger role. While the likelihood that a grandparent was an entrepreneur is negligible for both groups — not surprising in a formerly communist country — the proportion of close relatives who have run a business at some point since 1986, when the first private enterprises were allowed, is more than double for entrepreneurs. Note that only 5% of the entrepreneurs in our sample inherited a family

business, so family effects played a role through other, less direct channels.

Beyond the family, one's social circle in general, e.g. friends from childhood and adolescence, seem to affect one's decision to become an entrepreneur. In our survey, respondents were asked to remember five such friends and then report how many of these have become entrepreneurs. Out of each entrepreneur's group of five friends, 1.2 had started a business themselves, compared to only 0.6 for non-entrepreneurs. Although making a causal claim about the effect of social interactions on the basis of such data is problematic, it is nonetheless significant that more than a quarter of entrepreneurs in our sample claim that friends who became entrepreneurs influenced their own career decisions.

Cultural differences and values are found to play less of a role than expected. Entrepreneurs attach more value to work, intellectual achievement, power and politics than non-entrepreneurs. In regards to family, friends, leisure, religion, service to others, financial security, health, and freedom, they tend to share the values of non-entrepreneurs.

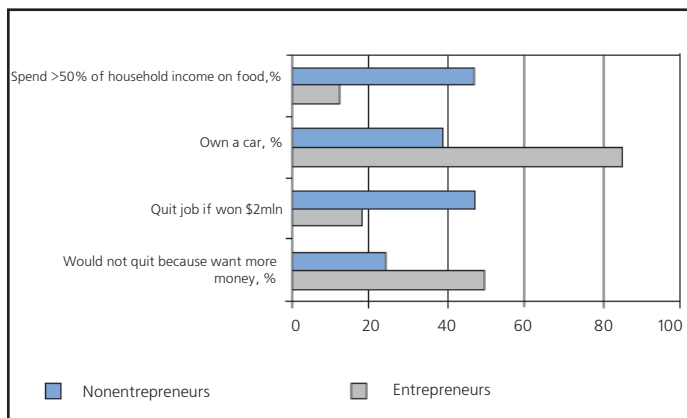
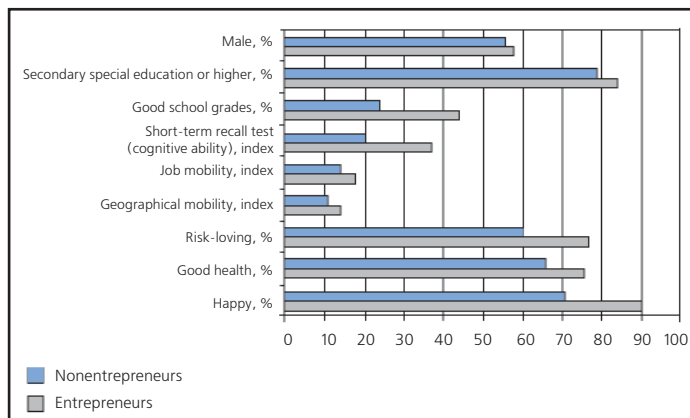
### Two types of entrepreneurs

Our analysis further reveals that there are two major categories of entrepreneurs: one is what we call “entrepreneurs by opportunity”, the other “entrepreneurs by necessity”. The first group became business owners because they seized an opportunity. In the Schumpeterian sense, these are the only true entrepreneurs. The second category became business owners primarily because they lost a job or the industry they worked for declined.

Family networks have a positive effect only on the probability of becoming an “opportunity entrepreneur” and have a negative effect on “entrepreneurs by necessity”. Government officials' perceived favorable attitude toward entrepreneurs increases the chances that an individual will take a business opportunity, while reducing the chances that he/she will start a business out of necessity.

Why do more people not become entrepreneurs? Three main reasons given by non-entrepreneurs are insufficient

Differences between entrepreneurs and non-entrepreneurs (selected characteristics)





funds, a lack of entrepreneurial skills, and risk aversion. The latter two are individual characteristics. Lack of money can be interpreted both as a credit constraint and as a lack of drive to raise funds. Thus, it seems that individual characteristics play an important role in the decision to become an entrepreneur. Confidence in starting one's own business is boosted by having entrepreneurs in one's family and among one's friends.

## Conclusions

The results of the pilot survey suggest that social networks, i.e. having entrepreneurs among family members and friends, is the most important variable affecting the decision to become an entrepreneur. Certain personal characteristics, such as academic success, cognitive ability, personal confidence, greed, and risk-taking are also important determinants of entrepreneurship, echoing the claims of Schumpeter. Weak institutions play some role in discouraging people from starting or expanding an enterprise, but not a crucial one. Cultural differences do not seem to be of great importance in Russia.

The limited number of cities and regions in the pilot study makes it difficult to generalize about the impact of regional institutional and cultural differences on entrepreneurship. This is a topic we will explore in the larger survey, which will cover a wider range of regions in Russia. The findings will then be compared to survey results in other countries.

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## Entrepreneurs in Latvia: a few pieces of the puzzle

How does entrepreneurial activity in Latvia compare to other countries? We attempt to answer the question by compiling and analyzing data for 2004 that are compatible with that of the Global Entrepreneurship Monitor (GEM). The latter creates measures of entrepreneurial activity by conducting adult population surveys in 41 participating countries. The GEM National Survey for Latvia will be conducted for the first time in 2005, and our study can be considered its forerunner.

In estimating the extent of entrepreneurial activity in Latvia, we rely on the Enterprise Register data, provided by Lursoft. From a known pool of 12,377 registered new-firm entrepreneurs (defined as an owner-manager of a firm less than 3.5 years old), we drew a simple random sample of 2,000 individuals.

We find that, compared to most other countries, the level of entrepreneurial activity in Latvia is very low. The New Firm Prevalence Index, defined as the number of new-firm entrepreneurs per 100 of population aged 18 to 64, is a mere 0.8. This is comparable to such countries as Croatia, France, Japan, Russia, and Poland, but remains well behind the world's most entrepreneurial countries, such as China (7.4).

A typical entrepreneur is a 39 year-old ethnic Latvian male who works in the wholesale or retail trade sector. Latvian entrepreneurs are somewhat older than their peers in other GEM-surveyed countries, where most entrepreneurs are in the 25-34 age group. Young people (18—24) are underrepresented in Latvia compared to other countries, with only 5% of young Latvians engaged in entrepreneurial activity, compared to the

GEM average of 11.5%. That entrepreneurship in Latvia is male-dominated (65%) comes as no surprise and does not differ markedly from most other countries.

As many as 84% of Latvian entrepreneurs work in the service sector, primarily in trade, construction, transport and communications. Of the new businesses started, 12% were in manufacturing and only 4% were in agriculture. The service sector accounted for 72.9% of Latvia's GDP in 2003, so we might predict that the contribution of this sector to the national economy will grow in the future. Consistent with our expectations, the capital, Riga, is the hub of economic activity, with 67% of all enterprises registered in the area.

Nearly all firms are limited liability companies, and 42% of entrepreneurs are sole owners. Only a third of all entrepreneurs have taken long-term loans from banks or other financial institutions, suggesting that firm growth is financed primarily from own funds or informal sources.

Entrepreneurship is widely believed to be a major driving force behind innovation and economic growth. Our findings suggest that Latvian policymakers need to take measures to foster entrepreneurship, otherwise the economy's recent high growth rates will be difficult to sustain.

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## Barriers to entrepreneurship

*Leora Klapper, Luc Laeven, and Raghuram Rajan*

**P**olicymakers in country after country are trying to implement policies that will foster entry. Take, for example, the debate in continental Europe on the lack of home-grown venture capital for promoting new firm creation in high-tech industries. Yet many questions remain about which government policies can help foster a business climate favorable to entrepreneurship. Our empirical analysis of more than 3 million firms in Europe confirms that bureaucratic entry regulations are neither benign nor welfare improving. Entry regulations hamper the creation of new firms, especially in industries that naturally should have high entry. Value added per employee in such industries grows more slowly, and older firms are slower to expand and thus remain smaller. Such are the adverse effects of the lack of competition from new entrants. Regulations beneficial to entrepreneurship are those that improve access to finance and protect property rights.

Some facts about entrepreneurship are striking. For instance, one might expect that Italy, with its myriad small firms, should have tremendous new firm creation (we use “new firm creation”, “entry”, and “entrepreneurship” interchangeably). Actually, new firms (up to 2 years of age) as a portion of the total number of firms is only 3.5%, compared to 13.5% on average for other European countries in the G-7.

Our study suggests an explanation for such low levels of entry: the average direct cost of fulfilling the bureaucratic regulations for setting up a new business in Italy is a huge 20% of per capita GNP, compared to the average of 10% for other European G-7 countries.

### Entry rates higher in Eastern Europe

Our analysis is based on the Amadeus database, a new, comprehensive database on private and publicly traded firms in 34 countries in Eastern and Western Europe. Having excluded countries with incomplete coverage and poor data quality, as well as certain industries (such as the agriculture, mining, utility, finance, and public sectors), we end up with a sample of almost 3.4 million firms in 21 countries.

We find that the average share of new firms is 13.3%. This figure ranges from 19.2% in Lithuania to 3.5% in Italy (see the table). Overall, the share of new firms in Eastern European countries is 15.7%, compared to 11.9% in Western Europe. This difference reflects the recent emergence of a large number of private firms in the transition economies.

The direct costs of setting up a new business, expressed as a percentage of per capita GNP in US dollars, vary from an excessive 86% in Hungary to just 1% in Finland and the UK, with the average at 20%.

Most of the entering firms are small. Interestingly, we find a greater proportion of new, larger firms in the Eastern European countries. This may reflect continued privatization

and reincorporation of larger state-owned firms following transition. On average, 63% of new firms have fewer than 10 employees, 23% have 10—50 employees, 12% have 50—250 employees and 2% have more than 250 employees. The largest new firms are likely to be existing firms that reincorporate following a merger or acquisition.

### How do bureaucratic regulations affect entrepreneurship?

The early debate on corporations emphasized the possibility that crooks might register with little capital and dupe unsuspecting investors or consumers. According to this view, entry regulations serve the public interest by preventing fraud. By contrast, a long literature from Adam Smith to Joseph Stigler describes regulations as devices to protect the private interests of industry incumbents or regulators.

To address the problem of causality, i.e. the possibility that in countries with generally low entrepreneurship people may not be sufficiently motivated to press for the repeal of archaic regulations, we focus on cross-industry, cross-country interaction effects. In particular, we test whether entry is relatively lower in “naturally high entry” industries in countries with excessive bureaucratic regulations.

We therefore need to know what entry would look like if there were few artificial or infrastructural barriers to entry, such as rigid labor regulation or poor access to financing. Under the assumption that these barriers are low in the United States (entry costs in the U.S. are just 0.5% of per capita GNP, compared to the European average of 20%), we would expect the rate of entry in an industry in the United States to be a good proxy for the “natural” propensity for entry in that industry. The “natural” propensity reflects technological barriers like economies of scale or incumbent organizational efficiencies obtained from experience. Of course, there is a degree of heroism in assuming that entry in the United States does not suffer from artificial barriers. Nevertheless, all that is important is that the rank ordering of entry in the U.S. corresponds to the rank ordering of natural barriers across industries and carries over to other countries.

Both in Europe and the U.S., we find high entry rates in the computer and communications industries and low entry rates in infrastructure-related sectors.

### Findings: Barriers to entry slow down business growth

Growth in value added is relatively lower in naturally high-entry industries in a country with substantial bureaucratic barriers to entry. There may be two explanations for this finding: slower growth could be attributed to incumbents having more monopoly power and restricting quantities, or incumbents may be less efficient as they are less subject to the discipline of competition. We find evidence for the latter explanation: older

firms in naturally high-entry industries grow relatively more slowly in countries with high bureaucratic barriers, while the relative growth of young firms is indistinguishable. Since age should not affect the incentive to restrict quantities, older firms working in a more competitive environment in countries with low entry barriers become relatively more efficient and continue to grow.

As a suggestive comparison, we plot average value added for firms in different age groups for two countries, high entry-barrier Italy and low entry-barrier United Kingdom. Across all industries, firms start out larger when young in Italy, but grow more slowly, such that firms in the United Kingdom are about twice as large by age ten. This suggests Italy has small firms not because there is too much entry, but perhaps because there is too little!

It turns out that entry barriers are more effective in preventing firm creation in high-income countries, suggesting that their purpose is not to screen out the untrustworthy, or that low-income countries have other natural barriers that prevent firm creation. More interestingly, entry barriers are effective in retarding entry only in the least corrupt countries, implying that their purpose may well be to protect incumbents and their rents.

#### Access to finance stimulates entry

Liquidity constraints hinder people from starting businesses, so entry rates should be lower in countries with less developed financial systems. We also expect that access to finance is especially important for new firms in industries that require a lot of external financing. Bank credit is likely to be the most important form of financing for small firms, but we also examine access to start-up capital, such as sup-

plier trade credit, and measures of banking and capital market development.

As predicted, entry is higher in industries that depend heavily on external finance in countries that have better financial development. What is particularly interesting is that entry is relatively higher in industries that depend on trade credit financing in countries with greater extension of trade credit, even after controlling for the traditional effects of financial development. Supplier credit turns out to be an important aid to entrepreneurship.

#### Other regulations are important

There are other regulations and aspects of the business environment that might affect entry, such as protection of intellectual property, labor regulations, and the effects of taxes. Our examination reveals that:

- Labor regulation hampers entry in labor-intensive industries. The cost of compliance with regulations may inhibit entry through fixed components, which are costly for small businesses. Small firms may not be able to afford to keep their employees through downturns and thus might “underhire” in the face of strict labor regulations;
- Better property right protection in a country promotes entry in R&D-intensive industries. New entrants that do not have the organizational structure, finance, or intellectual capital to create a significant first mover advantage and dissuade potential imitators might have a greater incentive to do research if they know it will be legally protected; and
- Entry is significantly higher in high-entry industries in countries where tax rates on corporate income are much lower than those on personal income. That is, higher taxes work much as regulatory barriers.

#### Conclusions

Policymakers should note that competition has disciplinary effects that outweigh any possible screening benefits from entry restrictions. Moves to reduce bureaucratic entry regulations will help their countries. Interestingly, entry regulations especially hurt countries that are more developed and less corrupt, i.e. where existing entry regulations are most effectively enforced. This is an interesting example of a situation where more advanced countries have “bad” institutions.

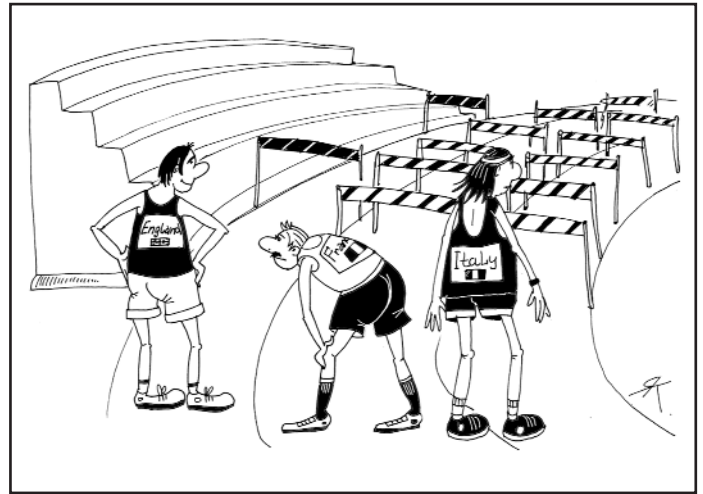
Table: Entry rates, number of required procedures and entry costs, selected countries

Country	% of new firms	Number of entry procedures	Entry cost (% of per capita GNP)	Private Credit (% of per capita GNP)
Bulgaria	8.60	10	14.41	19.30
Czech Republic	11.55	10	8.22	58.48
Finland	11.13	5	1.16	56.34
France	14.68	15	14.30	84.07
Germany	12.34	10	15.69	112.03
Hungary	17.38	8	85.87	23.84
Italy	3.46	16	20.02	60.13
Latvia	18.16	7	42.34	11.22
Poland	12.04	11	25.46	16.89
Romania	17.97	16	15.31	9.87
UK	15.01	5	1.43	120.27
<b>Average, Western Europe</b>	<b>11.92</b>	<b>8.85</b>	<b>15.50</b>	<b>80.84</b>
<b>Average, transition countries</b>	<b>15.67</b>	<b>10.29</b>	<b>28.15</b>	<b>21.80</b>

Note: the analysis is limited to 1998–1999 to avoid potential survivorship bias

However, it is by no means obvious that the best way to encourage entry and competition is to eliminate all regulation. Regulations that expand access to finance and strengthen property rights help the creation of new firms, and their absence can be an effective entry barrier.

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## Business owners' growth expectations in Lithuania

In Lithuania, as in other transition countries, private enterprise mushroomed in the early 1990s. However, the growth trend in the number of enterprises was reversed in the mid 1990s, and in just two years — from the beginning of 1999 to the end of 2000 — the number of registered small and medium-sized (SME) enterprises decreased from 81,600 to 52,000.

Whereas in transition countries most large private firms sprung up through a shift of resources from state to private hands through privatisation, in advanced western countries large private firms emerged through the growth of privately-owned enterprises. As privatisation does not necessarily modify organisational routines and capacities and improve performance, the emergence and growth of SMEs is of special importance, not only for their potential to generate wealth and jobs, but also for its ability to foster innovation, experimentation and adaptation in the new business environment.

Our survey of 399 owners of small and medium-size companies in Lithuania investigates why some business owners expect their firms to expand, while others do not. Following recent trends in the literature, we use business owner perceptions and focus on expectations of future growth, measured as the increase in both turnover and employment.

We find that the following factors have a positive effect on growth expectations:

- The owner has higher education;
- The owner has private business experience, i.e. 'learning by doing' either through previous work or additional entrepreneurial experience;
- The firm has export experience (though the result may be sensitive to the timing of the survey, conducted two years after the Russian crisis);

- Gender: women entrepreneurs have higher growth aspirations than their male counterparts.

The firm's size has a clearly important but non-linear impact on growth aspirations. Small- and medium-size companies (with fewer than 70 employees) expect to grow, while micro-firms and the self-employed express little interest in developing their business. This confirms earlier research that businesses without employees are more likely to represent hidden unemployment than a form of true entrepreneurship. On the other hand, the owners of the largest companies in the survey also do not expect to grow.

A second theme relates to the link between business owners' perceptions of barriers and their growth expectations. Generally, the barriers ranked highest are not always those associated with slower growth. Our study finds that both taxation and corruption are significant barriers to the growth aspirations of SMEs. Corruption is not ranked high amongst barriers, although where experienced it negatively affects entrepreneurs motivation to grow. Interestingly, neither access to finance nor demand-related barriers (such as low purchasing power and delays in payment by clients) seem to matter significantly for growth outlook. These represent standard constraints in market economies. While troublesome for entrepreneurs, they may be overcome by appropriate business strategies, such as the increasing credibility of external providers of finance and better addressing demand.

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# Banking deregulation promotes "creative destruction"

Marianne Bertrand, Antoinette Schoar and David Thesmar

**M**any economies around the world have heavily regulated banking sectors, with the state intervening in banks' lending decisions, either through state ownership of banks, regulatory limits on competition, or subsidies. The deregulation of the French banking industry in the mid-1980s reduced government interference and allowed French banks to compete more freely on the credit market. The deregulation had several efficiency-enhancing consequences for the real sector: banks were less willing to bail out poorly performing firms, some of which had to exit; firms were forced to cut costs and restructure; and product markets became more competitive as more entries occurred. A more efficient banking sector therefore plays an important role in fostering a Schumpeterian process of "creative destruction". The French experience provides important lessons and an encouraging example for transition countries contemplating liberalizing their banking sectors.

Our study investigates the effects of banking sector deregulation on firm behavior and industry structure. The analysis is based on a dataset of 15,000 firm observations per year for the period 1978–1999. While the analysis is restricted to a single country, the scope of pre-reform regulation in France mirrors the experience of many other countries with regulated banking sectors. In this regard, the French reform is quite representative of the multiple changes other countries would have to perform to liberalize their banking sectors.

## French banking prior to the 1985 reform

After World War II, the French financial sector had been under the centralized control of the Treasury, whose general aim was to channel deposits into priority industries. To control the credit market, the Treasury set up a deposit network, consisting of several selected banks, which had a monopoly over the distribution of subsidized loans allocated by the Treasury. Banks outside the network faced monthly ceilings on credit growth. So, while the deposit network under the Treasury's control could expand credit almost without limit, banks that were not part of that network were asphyxiated. By 1979, subsidized loans amounted to nearly half of all new loans granted to the private sector.

With a growing number of loan subsidy programs, the credit market was becoming progressively more opaque, with different interest rates for different programs. At the same time, banks were increasingly accumulating non-performing loans. In the beginning of the 1980s the French banking industry was so heavily regulated that interest rates played almost no role in the allocation of capital. It also became more and more difficult to assess the cost of these loans to the state budget.

In the fall of 1984, the socialist government announced a drastic reversal of policy. The goal was to transform the financial system into a decentralized credit market, where interest

rates would be used to match the supply and demand of capital for each type of project.

Most loan subsidies were eliminated, with the exception of some loans provided to "small" firms (with total sales below US\$150 mln). Moreover, the Treasury-controlled deposit network no longer held a monopoly on the distribution of these loans. Credit growth limits were gradually removed and replaced by a system of reserve requirements against deposits. The 1985 Banking Act partially unified a myriad of banking regulations, helping the market become more transparent and conducive to fair competition. Banks also faced more competition from other providers of external finance, such as the bond and equity markets.

## Consequences of reform

According to data from the Bank of France, the ratio of total debt to assets, as high as 70% in the early 1980s, went down by 20% and remained stable around 50% until 1996. This decrease in leverage can only partly be explained by the rise in real interest rates that took place in the late 1980s.

Another consequence was a change in banks' behavior. The reforms signaled that the Treasury was willing to let market forces shape the credit market landscape for the long run. These new conditions forced banks to change their lending practices and undergo internal restructuring. A survey conducted in 1985 among French bankers showed that bank managers increasingly focused on reducing costs, controlling risks and introducing tighter performance monitoring. The greater competitive pressures were most intensely felt by banks in the Treasury network, as these banks lost their privileged access to deposit and loan markets. The Treasury network's share of total deposits decreased by 28% between 1985 and 1990, and its share of loans went down by 25%.

What effect did these regulatory changes have on the real economy and on firm behavior?

## Firms forced to change capital structure

Our analysis shows that, after the reform, firms experienced a drop in debt (see table). For firms in an industry at the 75th percentile of the pre-reform banking dependence distribution (banking dependence is defined as average debt in each industry between 1978 and 1983), bank debt fell seven percentage points further than for firms in a 25th percentile industry. Firms compensated this loss by increasing equity finance and, to a larger extent, through trade credits. Nevertheless, the cost of capital for firms in bank-dependent industries increased. This effect was especially pronounced for worse-performing firms, indicating that banks became more selective in their lending behavior.

### Banks change lending behavior

Were banks more willing to “bail out” poorly performing firms before or after the reform? We find that banks became more conservative in their lending decisions, especially in those sectors that had been most reliant on banks. But increased conservatism by itself is not a sign of better capital allocation, since banks may inefficiently screen out firms that are experiencing temporary difficulties but are profitable in the long run.

Our analysis confirms that banks' lending behavior changed considerably with respect to poorly performing firms, implying that banks were no longer willing to lend to the same extent to poor performers.

Another interesting fact is that before the reform, the relationship between new bank loans and a firm's future performance (measured as a change in return on assets) was negative! This relationship did change after the reform, reflecting a change in the explicit functions of banks, which now put more emphasis on the credit quality of borrowers when determining loan size and interest rates. This also likely reflects a switch from an operating environment plagued by distorted interest rates to a more market-oriented environment.

### Firms pressured to restructure

Firms responded to the reform by cutting costs and restructuring activities, as they faced stronger incentives to strengthen their credit rating:

- Average wages fell substantially, with a particularly pronounced impact on bank-dependent sectors: wages fell 4% further among industries at the 75th percentile of the pre-reform banking dependence distribution compared to industries at the 25th percentile. Somewhat surprisingly, average wages declined more strongly among the better performing firms.

- Firms, especially weak performers, outsourced part of their operations to other firms.

While all firms improved performance, better-performing firms improved further. One can conclude that worse-performing firms were forced to shut down.

### More dynamic and competitive industry structure

As poorly performing incumbents no longer received easy access to cheap bank loans, some had trouble surviving. Consequently, this lowered the barriers to entry for prospective entrants.

Asset creation through new entries increased by about 26% more in industries at the 75th percentile of the pre-reform banking dependence distribution than in industries at the 25th percentile. Importantly, most of the economic impact came from newly created firms. Thus, the distortions in lending before the reform had a negative impact on competition by creating effective barriers to entry in the real economy.

The more dynamic and competitive structure of industry is associated with lower market concentration. Indeed, two different measures of concentration, a Herfindahl index and a measure of the market share of the five largest firms in each industry and year, confirm that concentration decreased, especially in bank-dependent sectors. Thus, the market share of the five largest firms in an industry at the 75th percentile was three to four percentage points lower than in an industry at the 25th percentile.

Higher reallocation rates are often interpreted as a sign of a more competitive and efficient business environment. This view goes back to Schumpeter's idea of processes of “creative destruction”. However, an increase in the turnover rate of firms need not imply higher efficiency, if firms are wrongly forced to exit.

To investigate whether the post-reform increase in asset reallocation is symptomatic of an increase in allocative efficiency, we return to the firm-level data. We find that

- Worse performing firms were more likely to exit;
- Better performing firms had higher market shares within their respective industries after the banking reform;
- Bank-dependent sectors increased employment after deregulation;
- Labor cost per worker fell, and value-added per worker increased in bank-dependent sectors.

### Conclusions

Our study identifies several important effects of banking deregulation on the real economy and on firm behavior. Specifically, after deregulation:

- Firms in more bank-dependent sectors are forced to change their capital structure, cutting debt and turning to trade credit and equity finance;
- Banks improve their monitoring and screening abilities and are less willing to bail out poorly performing firms;
- Firms have to cut costs (e.g. lowering wages and increasing outsourcing) and restructure;
- Market concentration decreases, product markets become more competitive;
- More new entries occur, and new firms create more assets and jobs.

Table. Selected firm characteristics, 1978—1999

	Before 1985, mean	After 1985, mean
Bank debt	0.48	0.42
Trade credit	0.31	0.27
Capital cost	0.07	0.09
Return on assets, ROA	0.07	0.17
Sales (1980 francs)	92.6	112.3
Total assets (1980 francs)	95.5	132.7
Employment	203.6	188.5
Average wage (1980 francs)	67.52	79.20

Distortions in bank lending create artificial barriers to entry in the real economy. New entrants may be discouraged by incumbent firms' easy access to cheap credit. Once banks become less willing to provide such cheap credit to poorly performing firms, prospective new entrants find it more attractive to come in and compete with incumbents. A more efficient banking sector therefore plays an important role in fostering the Schumpeterian process of "creative destruction" that has been theoretically, and increasingly, empirically linked to higher economic growth.

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## No Exit?

Regulation of entry in banking — including minimum capital requirements and so-called 'fit and proper' entry tests — is a more or less standard part of the regulatory framework. The primary justification for regulating entry (and, indeed, for regulating banks' activities generally) is the avoidance of systemic risk. Regulating entry can also help strengthen investor protection and the efficiency of intermediation by promoting confidence in, and trust within, the sector. Efficient exit is essential for the same reason: unsafe and unsound banks pose a threat to the system and need to be rendered sound or removed promptly.

Until recently, the regulatory framework governing Russia's banking sector reflected neither of these requirements. The regime governing entry was, until well into the 1990s, excessively liberal, while there were substantial *de jure* and *de facto* obstacles to efficient exit. The rules have since changed dramatically, but the legacies of the past continue to complicate the job of the Central Bank of Russia (CBR).

Hundreds of banks emerged in the final years of the Soviet era under the very permissive provisions of the Law on Cooperatives. Politicians challenging central power used the lax entry regime then in force to undermine the financial power of the all-Union authorities, while managers and bureaucrats quickly discovered the rents that could be derived from running a bank. At the time, many of the new banks could write credits on the so-called inter-branch turnover (i.e. creating money), effectively acting as miniature central banks in their own right.

This rapid growth continued into the post-Soviet period, as high inflation made it easy for would-be bankers to meet minimum capital requirements. As late as 1994, a new bank needed only \$65,000 in charter capital. Moreover, banks were allowed to include all manner of illiquid (and often rapidly depreciating) assets in their calculations of 'tier-2 capital'. As a result, the CBR in the early 1990s found its limited supervisory capacities overstretched: the sector comprised more than 2,500 banks. Most were severely undercapitalized, and the vast majority did little actual banking, being primarily concerned with other activities, ranging

from financial speculation and tax 'optimization' to money-laundering and outright fraud.

Nor did exit mechanisms work well. In part, this simply reflected the reluctance of the CBR to act decisively to wind up failed banks. However, it also reflected the absence until 1999 of a law on the bankruptcy of credit organizations. Even after its adoption, this law achieved little until it was further amended in 2003–04. The general laws on bankruptcy, adopted in 1992 and 1998, were wholly inadequate, not least because they required, *inter alia*, that the court consider individually each creditor claim contested by the debtor. Banks were able to stall proceedings merely by challenging thousands of the claims against them. Even after the adoption of a law concerned specifically with the bankruptcy of banks, the cumbersome and generally inefficient (from creditors' perspective) procedures for liquidating failed banks left many in legal limbo for years, allowing insiders to siphon off assets before creditors' claims were met (at any given time, there are several hundred such 'bank-corpses' in the sector).

Matters have improved greatly in recent years. Entry requirements for new banks have become much tougher, while the mechanisms for liquidating failed institutions have been streamlined. The number of banks has gradually declined, and average capitalization has risen. However, the CBR has been unable to apply the entry requirements retroactively, while the turbulence provoked by its intervention in Sodbiznesbank in May 2004 highlights the continuing risks associated with liquidating problem banks. In a sector characterized by low transparency and little trust (whether it be trust among banks or trust in the authorities), every intervention risks setting off a chain of unintended consequences. The CBR is still struggling to overcome the sector's history of easy entry and no exit.

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## Creative destruction in industrial and developing countries

*Eric Bartelsman, John Haltiwanger and Stefano Scarpetta*

**F**irms in all countries undergo significant changes over time, as resources are continuously reallocated across existing firms, and markets are affected by the entry of new firms and the exit of obsolete ones. Our analysis of 24 industrial and developing countries shows that, on average, 10–20% of firms enter and exit each year. But market selection is harsh, and about 20% to 40% of new firms fail within their first two years. This process of creative destruction affects an economy's productivity both directly, shifting resources towards more productive uses, and indirectly, through increased competition, encouraging incumbents to enhance productivity. Transition economies show an even more impressive process of creative destruction, with more firms entering and exiting the market, and a stronger contribution to overall productivity growth.

Our firm-level data cover countries with different economic structures, institutions and growth performances: ten industrial countries, five Central and Eastern European countries (Estonia, Hungary, Latvia, Romania, Slovenia), and nine economies in Latin America and East Asia. The data are harmonized across countries to enable meaningful international comparisons.

The analysis of firm size is an important building block of our analysis of creative destruction. Small firms are dominant in the creative destruction process, but successful small entrants also have great potential to expand, create more jobs and contribute to technological adoption. We find that, in all countries, micro units (with fewer than 20 employees) dominate, accounting for at least 80% of the total number of firms. Their share of total employment is much lower, ranging from less than 15% in Romania to 20% in the United States and around 30% in some small European economies.

### High degree of turbulence in all countries

The other interesting finding of our analysis is the magnitude of firm turnover: if we focus on the population of firms with at least 20 employees, we observe that firm turnover (entry plus exit rates) accounts for 3% to 8% of the total number of firms in industrial countries and more than 10% in some transition economies. If we then also consider micro units (i.e., adding all firms with at least one employee), we observe firm turnover rates on the order of 20% to 25%. It is also interesting to note that entry and exit rates tend to be highly correlated in most countries; in other words, entries and exits seem to be part of a process in which a large number of new firms displace a similar number of obsolete firms, without affecting significantly the total number of firms in the market at any given time. But in transition economies, where new firms are populating new sectors and activities while obsolete firms exit other markets, the correlation between entry and exit across sectors is weak.

Both entering and exiting firms tend to be small, at 20–60% of the average size of incumbents, so firm flows affect only 5% to 10% of total employment. This may suggest that entry is relatively easy, but many small newcomers fail before reaching an efficient scale of production.

As noted earlier, in transition economies firm entry greatly exceeds firm exit. New firms not only displace obsolete incumbents, but also fill new markets that were either nonexistent or poorly populated in the past. However, the large flows seen in the beginning declined as the transition moved forward and reached levels similar to other countries.

Turnover rates vary significantly across sectors: they are somewhat higher in the service sector (especially in trade) and lower in manufacturing, with the exception of the high-tech industries, which had relatively high entry rates in the 1990s.

Market selection is fairly harsh. Between 20% and 40% of start-ups fail within their first two years. Failure rates decline with duration, but only 40% to 50% of firms entering in any given year survive beyond their seventh year.

Successful entrants, on the other hand, expand rapidly, but their growth rates vary across industries and countries. U.S. firms tend to start small and, if successful, expand quickly to approach the minimum efficient scale. Firms in Western Europe have less scope for expansion than in the U.S. Transition economies show higher survival rates and greater growth for successful firms, compared to industrial and other emerging economies, as new firms enter new, relatively less populated markets and have enjoyed in the early phases of the transition a relatively lower level of competition.

### Creative destruction important for productivity growth

Our analysis reveals that the continuous process of retooling and innovation within existing firms accounts for the bulk of overall labor productivity growth. But, especially in manufacturing, productivity enhancement is often associated with downsizing rather than expansion.

The overall contribution of firm entry and exit accounts for between 20% and 50% of total productivity growth. In all countries, the exit of the least productive firms boosts aggregate productivity. As for entry, its effect on productivity is different across countries: new firms tend to be relatively less productive than incumbents in their early years, but those that survive tend to experience rapid productivity growth. And in transition economies, entrants are more productive than the incumbents even in their first years. It is also noteworthy that the new entrants' contribution to productivity varies a lot across industries; new firms make a strong contribution to aggregate industrial productivity in high-tech industries, where stronger technological opportunities are often better harnessed by new firms.

Productivity improvements within incumbent firms and new entrants' efforts at productivity also tend to be closely related. Strong firm turnover, with newcomers replacing less productive units, tends to promote competitive pressures and push existing firms to enhance their performance in order to preserve their market shares. Indeed, higher firm turnover is associated with stronger productivity growth among incumbents. The more creative destruction increases productivity, the more it stimulates incumbents' growth.

### Conclusions

Our analysis shows significant differences across countries in terms of firm size, firm turnover, survival rates and productivity growth:

- All *industrial countries* show a marked process of creative destruction, though there are significant country differences. New U.S. firms tend to be smaller in size than incumbents and have lower relative productivity levels than new firms in Europe. But market selection and learning effects imply that successfully surviving entrants quickly expand, while low-productivity entrants exit rapidly, freeing resources for new ventures. This indicates a higher degree of market experimentation in the United States than in Europe. Also, the European countries exhibit a weaker ability to direct resources towards the most productive uses than in the U.S.

- Creative destruction assumes an even stronger role in *the transition countries* studied. The magnitude of firm creation and destruction is larger than in industrial countries: many new smaller firms have been replacing obsolete larger units inherited from the central-planning period. Moreover, new firms have filled in new market niches, enjoying, especially in the early years of transition, relatively low competition and thus higher survival rates. As markets develop and become more populated, competition increases and new firms face a tougher market selection. The process of resource reallocation has become increasingly effective over the course of transition, shifting resources to new, but also more productive, firms. There are also interesting differences across countries. Hungary, Estonia, Latvia and Slovenia have all experienced a strong creative destruction process, with strong growth after the entry and a significant contribution by new entry (and exit) to productivity growth. Romania is still dominated by some large firms; the entry of new firms has increased rapidly in recent years as market reforms have progressed. Nevertheless, even successful new firms seem to have difficulty expanding.

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## Lobbying on Entry

In our model of a basic political conflict between two classes of entrepreneurs — established wealthier entrepreneurs and potential entrants — the former lobby politicians to maintain a low level of investor protection in order to prevent potential entry. A low level of protection prevents entering firms from raising capital. Incumbents can earn higher rents in a less competitive environment and can promise larger political contributions than the entrants. Thus, they win the conflict. The main implication of the model is that entry should be higher in more democratic and less unequal societies.

Lobbying can create various sorts of formal and informal entry barriers. Undermining financial development is a natural channel for blocking entry. Informal barriers, created by the selective enforcement of contracts or property rights, are probably more dangerous than explicit barriers, as they escape public scrutiny and may coexist with adequate formal legislation.

An empirical test of the model's predictions on a sample of 38 developed and developing countries for 1983–1992 shows that, in more accountable countries, entry is significantly higher in industries that require more external capital. This appears to be true independently of the country's level of economic development and legal framework.

An increase in the democracy score from zero to 5.6, i.e. from the level in Indonesia to the Philippines, is associated

with approximately a one-half-point increase in effective investor protection (out of a possible six). The democracy score measures the general openness of political institutions and ranges from 0 to 10. A decrease in wealth inequality by 10 points — from that of Brazil to that of Turkey — is associated with an increase in effective investor protection of one third of a point. Wealth inequality is measured by the average Gini coefficient over 1964–1983 interval, taking values from 0 to 100, with a higher number indicating greater inequality.

While financial development promotes entry in our model, we cannot offer a generic recommendation in favor of financial development as an engine of entry, ignoring the institutional context in which it would take place. Privatization and liberalization of the banking system may fail to deliver growth if they are undermined by connected lending and outright plundering by bank owners. While good legislation and policy play a role, ultimately financial development, entry and growth require the effective and fair enforcement of rules.

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# What makes small firms grow? Evidence from Romania

David Brown, John Earle and Dana Lup

**T**he contributions of new start-up firms to innovation and economic growth are well recognized, as is the crucial role played by this *de novo* sector in the transition of formerly socialist economies. Our study focuses on policy-relevant factors that may determine whether newly founded enterprises in transition economies develop into larger firms, creating jobs for workers and producing goods for consumers, or instead languish as tiny "mom-and-pop" operations with relatively few externalities for economic development. Considering the effect of finance, human capital, technical assistance, and the business environment on the development of Romanian firms, we find that finance is very important in stimulating the growth of small firms, as are tax credits provided by the state.

The study is based on a survey of 297 Romanian enterprises that at some point before March 2000 had received a loan from an international micro-credit agency. This sampling procedure has the advantage of a very high response rate (90%) of owner-managers and accountants to a long questionnaire requesting very detailed and sensitive information. The firm-level survey data is then linked to longitudinal information from several sources on employment and sales.

More than two-thirds of the sample are micro firms (fewer than 10 employees), which have successfully started up, but whose further growth is far from assured. Micro firms represent the overwhelming majority of small firms in Romania, accounting for 92.8% of all SMEs in 1999. An additional 23% of firms in our sample have between 10 and 19 employees, and only 9.1% percent of the firms are "medium", according to the standard definition of 50–249 employees. Nearly half the firms surveyed operate in wholesale or retail trade, but there is also significant representation from several manufacturing sectors, transportation, and a variety of services. Growth rates in average annual employment and sales are our measures of firm growth in this study.

## Lack of finance is a severe constraint, managers report

In detailed interviews, we asked each respondent to rate on a scale from 1 (not constraining at all) to 5 (extremely constraining) the degree to which he/she believed that a given factor constrained his/her firm's growth. We asked about four main sets of factors:

- *Financial constraints:* about 78% of firms considered the lack of capital as a very constraining factor, and the percentage was higher in slow-growing and smaller firms. The high level of taxation, which may reduce the possibility of internal finance as an alternative to costly external sources, was considered an important constraint by nearly all firms (91.1%), with comparatively little variation by growth rate or size.

- *Labor and material inputs:* about one third of entrepreneurs mentioned hiring as a severe constraint, with the

problem reportedly greater for slow-growing, micro and small firms. The availability of buildings and land appears to be less serious.

- *Malfunctioning of the business environment:* only 17.7% of entrepreneurs consider that at least one type of contract enforcement (with either customers or suppliers) is a very binding or serious constraint. Only a trivial number of firms considered protection payments to the police and private parties (mafias), which threaten property rights, as serious problems. Constraints associated with bureaucratic interference are somewhat higher, with about one third of firms reporting serious problems. About 47% of firms consider unfair competition a constraining factor. Whether competition is evaluated as "unfair" could certainly involve some subjectivity, but in the Romanian context it may reflect the presence of subsidies or regulations favoring larger, state-owned firms or jealousy over special preferences granted to foreign investors, which have been quite controversial in the country. Still more substantial is the view that the administrative burden of taxation is an important constraint, as reported by 90% of managers.

- *Macroeconomic climate:* inflation was viewed by most firms as a severe constraint, and about 30% cited it as the single most constraining factor. Low demand for the firm's products was cited as a constraint by 37%, but it was among the most important factors for only very few firms.

## Objective assessment finds that financing stimulates growth

Studies of managerial opinions are useful and suggestive, but there is a clear need for careful quantitative assessment of the relationship between firm growth and objective measures of policy-related factors. These objective measures include finance, human capital, technical assistance, and the business environment. By "objective", we mean quantities that may be independently verified and that are defined according to generally accepted and interpersonally comparable metrics.

The results of our panel analysis provide evidence that loans stimulate the growth of small startup firms in Romania. This finding, which is highly robust to alternative specifications and methods of estimation, runs counter to the claims by some recent studies that external finance is not an important constraint for small-firm growth in Eastern Europe.

As for other factors, such as human capital, technical assistance and business climate variables, there is little or no evidence that they constrain growth. This is consistent with the evaluations of managers that hiring difficulties, corruption, permits, inspections, and problems with contract enforcement and property rights are not important constraints for their businesses.

Because of the chosen sampling method, the results may be generalized only with regard to firms that are similar to those

in our sample. The relevant policy question, however, is not whether loans should be extended to the universe of all firms in Romania, but rather whether the loan program should, for example, be doubled in size, either by doubling the loans that the sample firms receive or by doubling the number of firms that receive loans. If small firms in Romania are indeed capital-constrained, as our evidence strongly suggests, then we doubt that the next 300 or so firms in the queue for finance would differ materially from the 300 who did receive a micro-finance loan.

The study suggests that international aid in the form of microfinance programs has been well spent, as the programs have played an important role in the growth of participating firms. An expansion of these programs, either by giving each

firm a larger loan or extending finance to more firms, should further promote the growth of the Romanian small firm sector. In contrast, we found little or no evidence that focusing aid on the provision of technical assistance, investing in human capital, or improving the business climate would enhance growth.

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## Financing conditions for small and medium enterprises in the new EU member states

Foreign bank penetration in the eight new Central and East European and Baltic EU member countries plus Bulgaria and Romania has occurred at an impressive speed over the past decade. But while the entrance of foreign banks has significantly increased the efficiency of these countries' banking systems, the degree of financial deepening remains low.

With the exception of Slovenia, the banking sectors of the new member states are largely dominated by foreign-owned institutions. The assets held by foreign-owned banks, relative to the assets of all banks, have increased significantly over the past decade, from an unweighted average of 22% in 1996 to 71% in 2002. In Estonia the share of banking assets in foreign holding is as high as 98%. Financial markets have become more competitive, but also more concentrated. The market shares of the five largest banks in seven out of the ten countries studied varied from 65% to 99%, which is significantly higher than the unweighted average of 55% for "old" EU countries. Over the recent years, the number of banks decreased markedly in all countries.

While there is no data available to control directly for possible effects of foreign bank ownership and the high concentration on SME lending in the new member states, the Business Environment and Enterprise Performance Survey (BEEPS) carried out by the EBRD and the World Bank provides insights into the financing conditions of enterprises of different sizes in these countries. Using data on 2,427 firms, the analysis reveals that financing conditions for all types of businesses in the ten countries have improved since 1999. However, access to finance remains a major problem for business development, and financing conditions are considerably more difficult for SMEs than for larger entities.

While the proportion of external finance as a part of total financing is rather small for firms of all sizes, it is significantly lower for small enterprises. Some 68% of small

firms' working capital comes from internal funds, compared to 56% for large firms. Bank credit generally plays a relatively small role in the overall financing of both working capital and new investment. Borrowing from banks, however, plays a far more important role for large firms, who on average finance around 17% of their working capital and new investment through bank credit. This is compared with around 13% for medium firms and 7% for small firms. In short, the analysis shows a strong positive relationship between firm size and bank financing.

While foreign bank penetration has spurred the efficiency of the financial markets of the new EU member states, empirical evidence from other regions suggests that the high concentration of financial services and the dominance of foreign-owned institutions could have serious effects for the financing of small local businesses in these countries. The so-called large-bank barriers hypothesis and the foreign-owned-bank barriers hypothesis suppose that large and foreign institutions experience difficulties in lending to smaller entities with more opaque structures. In the new member countries, it is specifically these banks that dominate the market, suggesting that SMEs might not see an improvement in their financing conditions on the same scale as larger enterprises. While the results of the BEEPS cannot be taken as sufficient empirical proof of the large-bank and foreign-owned-bank barriers hypotheses, they do support these hypotheses.

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## Doing Business — 2005: removing obstacles to growth

Simeon Djankov

**2004 was a good year for doing business in most transition economies, the World Bank Group concludes in its *Doing Business in 2005* survey. Slovakia was the leading reformer, together with Lithuania breaking into the list of the 20 economies with the best business conditions. However, the survey finds that conditions for starting and running a business in poorer countries are consistently more burdensome than in richer countries. Meanwhile, the benefits of better regulation and property rights protection include higher economic growth and improved human development indicators, while the costs for many of the reforms are modest.**

The major impetus for reform in 2003 was competition in the enlarged European Union. Accession countries reformed in anticipation of the competitive pressures their businesses would face in the larger European market. Incumbent members reformed to maintain their advantage in the presence of the many low-wage producers from accession countries that would now compete with them on equal terms.

Slovakia was the leading reformer: it introduced flexible working hours, eased the hiring of first-time workers, opened a private credit registry, cut the time to start a business in half and, thanks to a new collateral law, reduced the time to recover debt by three-quarters. Two other European Union entrants — Lithuania and Poland — significantly lightened the burden on businesses.

Being in the top 20 on the ease of doing business does not mean zero regulation. Indeed, for protecting property rights, more regulation is needed to make the top 20 list (Table 1). All of the top countries regulate, but they do so in less costly and burdensome ways. And, more than governments in other countries, they focus their efforts on protecting property rights. If Australia requires only two procedures to start a business, why have 15 in Ukraine and 16 in Belarus? If it takes 15 procedures to enforce a contract in Denmark, why have 43 in Romania? If it takes three days to register property in Lithuania, why take 956 in Croatia? And if laws require all seven main types of disclosure to protect equity investors in Canada, why do those in Belarus require only one?

Table 1. Top 20 economies on the ease of doing business

1. New Zealand	11. Switzerland
2. United States	12. Denmark
3. Singapore	13. Netherlands
4. Hong Kong, China	14. Finland
5. Australia	15. Ireland
6. Norway	16. Belgium
7. United Kingdom	17. Lithuania
8. Canada	18. Slovakia
9. Sweden	19. Botswana
10. Japan	20. Thailand

**Businesses in poor countries face much larger regulatory burdens**

It takes 123 days to start a business in Azerbaijan, but 9 days in Turkey. It costs \$711, or 46% of per capita income, to start a business in Bosnia and Herzegovina, and \$166 in Lithuania, or just 3.7% of per capita income. Enforcing a contract in the Kyrgyz Republic costs 48% of the debt value, but only 8.1% in Hungary.

These differences persist across the world: the countries that most need entrepreneurs to create jobs and boost growth — poor countries — put the most obstacles in their way. The average difference between poor and rich industrial countries on the *Doing Business* cost indicators is threefold. Rich countries score twice as high poor ones on indicators relating to property rights-enforcing contracts, protecting investors, and the legal rights of borrowers and lenders.

When entry regulations are burdensome, few businesses bother to register. Instead, they choose to operate in the informal economy. Facing high transaction costs to get formal property title, many would-be entrepreneurs own informal assets that cannot be used as collateral to obtain loans. In “The Mystery of Capital”, Hernando de Soto calls this “dead capital”. The solution is obvious: simplify business entry and get titles to property.

### Payoffs from reform: higher growth, greater savings

A hypothetical improvement on all aspects of the *Doing Business* indicators, reaching the top quartile, is associated with an estimated 1.4 to 2.2 percentage points in annual economic growth. This is after controlling for other factors, such as income, government expenditure, investment, education, inflation, conflict and geography. In contrast, reaching the top quartile in terms of macroeconomic and education indicators is associated with only 0.4 to 1.0 additional percentage points in growth.

Economic growth is only one benefit of better business regulation and property protection. Human development indicators are higher as well. Governments can use revenues to improve their health and education systems, rather than support an overblown bureaucracy.

The gains come from two sources. First, businesses spend less time and money on dealing with regulations and chasing after scarce sources of finance. Instead, they spend their energies on producing and marketing their goods. Second, governments spend fewer resources regulating and more providing basic social services. Sweden, a top 10 country on the ease of doing business, spends \$7 billion a year, or 8% of the government budget, and employs an estimated 100,000 government officials to deal with business regulations. The Netherlands spend \$22 billion, or 11% of its budget.

What would happen if these countries were to reduce red tape by a moderate 15%? The savings would amount to between 1.2% and 1.8% of total government expenditures, or approximately half of the public health budget. Some governments are more ambitious. In 2002, the Dutch government set a goal of cutting expenditures on administrative burdens by 25% by 2006. It is estimated that \$2 billion has already been saved by doing impact assessments before new regulations reach the parliament.

The benefits of regulatory reform are likely to be even greater in developing countries, which tend to regulate more. Yet few governments are eager to reform, arguing that they have limited capacity, that it takes a long time, and that it costs a lot. In 2003, countries that scored lowest on the ease of doing business measure reformed at one third the rate of countries in the top quartile.

### What to reform?

Reform involves simplification. Governments would have more capacity and more money if they reformed. To prioritize reforms, governments can start by measuring regulatory costs and identifying the biggest opportunities for improvement. Belgium did so by introducing an annual survey of enterprises on the main regulatory obstacles they face. A total of 2,600 businesses participate in the survey, and the results are reported to the parliament. The process identified problems in company registration — a main reason for the 2003 reform — and in business licensing, where reform is ongoing. The governments of Mozambique and Vietnam regularly seek advice from the business community on reform priorities.

Simple solutions for starting a business that have already worked in some countries include:

- Registration as an administrative process in Canada, Chile, Italy, and Serbia and Montenegro;
- Use of a single identification number in Belgium, Estonia, Morocco, and Turkey;
- No minimum capital requirement in Botswana, Ireland, Tanzania, and Thailand;
- Electronic application in Latvia, Moldova, Sweden, and Vietnam.

### Modest reform costs

The costs are modest for many reforms. Setting up a private credit bureau cost less than \$1.5 million in Bosnia and Herzegovina. Setting up an administrative agency for business registration cost less than \$2 million in Serbia and Montenegro. Integrating the business start-up process into a single access point cost \$10 million in Turkey. Simple calculations from growth analysis suggest that the benefit-to-cost ratios of such reforms are on the order of 25:1. Easing start-up was recently listed by a panel packed with Nobel laureates as one of the most cost-effective ways to spur development — ahead of investing in infrastructure, developing the financial sector, and scaling up health services.

*“Doing Business in 2005” was prepared by a team led by Simeon Djankov and Caralee McLiesh. More information about the report is available on the Doing Business website: <http://www.doingbusiness.org>. ■*

**Table 2. Starting a business, selected countries in Eastern and Central Europe and the CIS**

The survey studied commercial or industrial firms with up to 50 employees and start-up capital of 10 times the economy's per-capita Gross National Income.

Country	Number of procedures	Time (days)	Cost (% of income per capita)	Min. capital (% of income per capita)	GNI per Capita (US\$)
Azerbaijan	14	123	14.7	0	810
Belarus	16	79	25.3	44.3	1 590
Bosnia and Herzegovina	12	54	46.2	65.0	1 540
Croatia	12	49	14.4	24.4	5 350
Czech Republic	10	40	10.8	44.5	6 740
Estonia	6	72	7.5	49.7	4 960
Hungary	6	52	22.9	86.4	6 330
Kazakhstan	9	25	10.5	32.7	1 780
Lithuania	8	26	3.7	62.8	4 490
Poland	10	31	20.6	237.9	5 270
Russian Federation	9	36	6.7	5.6	2 610
Slovak Republic	9	52	5.7	46.1	4 920
Slovenia	10	61	12.3	19.0	11 830
Turkey	8	9	26.4	0	2 790
Ukraine	15	34	17.6	113.9	970

## Russia's small-business climate continues to improve

Oleg Zamulin

**S**ince 2001, a team of CEFIR researchers has been regularly monitoring the administrative barriers to small business development in Russia, having completed to date four rounds of extensive surveys of small business owners, the most recent conducted in the spring of 2004. The surveys revealed a notable improvement in the business climate for small firms between 2001 and 2003.

An improvement in the business climate for small firms between 2001 and 2003 is visible both in the subjective perceptions of business owners and in the figures they report. Our results are based on detailed interviews of some 2,000 small firms, i.e. firms with a median size of 10 employees, in 20 Russian regions. Improvements can probably be attributed in part to the country's rapid economic growth in recent years. However, we find that the de-bureaucratization reform launched by the government in 2001, which aimed to simplify registration, licensing, and other such procedures, has had a positive effect as well.

The fourth round demonstrates that small businesses perceive such vital issues as the tax level, tax administration, the economic environment, and government regulations as less severe than two years earlier. Interestingly, the only problem that provoked more complaints than before is increased competition. In fact, in 10 out of 20 regions surveyed competition ranked as firms' No. 1 problem. Given an overall increase in the number of small firms and their share of GDP in 2001—2003, stronger competition is likely due to the emergence of new firms and the expansion of existing ones.

### Cheaper start-ups

The survey also shows that the costs of starting a business have diminished, due to streamlined regulatory procedures. Thus, a year after the registration law was adopted (in 2002), the number of state agencies a median entrepreneur had to visit to register a new business fell from five to three. Almost half of all firms registering in 2003 completed the procedure within a week, as prescribed by the new law, while previously only a fifth of all firms managed to register that fast.

Firms now spend less time obtaining licenses, partly because the list of licensed activities has been shortened, and the period of license validity has, on average, increased. In the second half of 2003, only 15% of respondents had applied for licenses and permits, down from 30% in the corresponding period two years earlier.

The number of inspections by state agencies has been falling as well, as has the amount of time managers spent dealing with inspectors. Almost half of the firms said their top managers spent no time on inspections in the second half of 2003, while only about 25% could say so two years earlier.

Tax administration also improved significantly, thanks to the 2003 law simplifying the tax accounting system for small

businesses. Many firms chose to switch to the simplified system that year and reported paying fewer types of different taxes (by two or three) than other firms. This, in turn, reflected on entrepreneurs' subjective perceptions of the tax administration: firms using the simplified system viewed taxation as a significantly less severe problem than did other firms.

### A lot more work ahead

All of the above suggests that the business climate has considerably improved, and government policies have played a role. At the same time, a great deal more needs to be done before the government can claim victory over corruption and excessive regulation. The positive impact of the new laws described above is apparent, however their implementation leaves something to be desired. Some 40% of licenses issued still have a period of validity shorter than the five years required by law; and many “permits” demanded by local authorities in particular have dubious legitimacy. Registering a new firm takes more than a week for half of Russian businesses, exceeding the five working days mandated by the registration law, and a far cry from the one-stop procedure in many other countries. Certain government agencies are reported to harass businesses with frequent repeated inspections: for example, 70% of respondents who were inspected by the police during a six-month period, had several such inspections. As for fines by the police, 62% of them are not based on any official scale and are simply bribes. So, the improvements documented in our survey are only one step forward towards lifting the bureaucratic burden on business.

Clearly, the ultimate victory over the predatory nature of regulation requires more than just new laws. Indeed, the study continues to record that such things as civil society, political competition, fiscal incentives of local governments, and state capture do matter. De-bureaucratization is found to be faster in those regions and municipalities, in which:

- small businesses are better represented, in terms of their share in the local economy;
- governors had been elected by a small margin;
- local governments depend more on the local tax base and less on transfers from higher-level governments; and
- the structure of industry is more diverse, such that big companies are prevented from capturing governments and blocking the entry of smaller competitors.

*Oleg Zamulin is assistant professor at the New Economic School (NES) in Moscow and a senior economist at CEFIR at NES. The monitoring project has been conducted by CEFIR since 2001, in collaboration with the World Bank and with the financial support of the U.S. Agency for International Development and the Foreign Investment Advisory Service, a joint facility of the International Finance Corporation and the World Bank. ■*

## Russian customs: a barrier to foreign trade, investments and entry?

Ksenia Yudaeva and Konstantin Kozlov

**V**arious surveys of local and foreign businessmen in Russia suggest that corruption in customs and the unpredictability of the customs clearance process are important barriers to increased flows of international trade and FDI. To address these problems and bring Russian legislation in line with the WTO standards, a new Customs Code was introduced on January 1, 2004. Has the new law addressed the all too common ills? Six months after the law was adopted, a new study by CEFIR finds little or no improvement in Russian customs.

To get a better understanding of the problems faced by Russian import/export firms and to see whether the new Customs Code has led to any improvements, CEFIR surveyed 510 firms in seven central and north-western regions. Of these, 194 were importers, 115 were exporters, and 201 were engaged in both import and export, with an average size of 350 employees. Partially or fully foreign-owned firms made up 13% of the sample. Firms were asked to make qualitative assessments of any changes they encountered in their dealings with customs authorities shortly after the adoption of the law.

The survey found two major changes in the customs clearance procedures brought about by the new Code. On the positive side, the amount of time spent on customs clearance decreased for at least 35% of importers. However, for 33% of importers and 42% of exporters the costs of customs intermediaries' services increased; only 5% of the firms surveyed saw these costs decrease. Customs intermediaries are routinely employed by firms to speed up customs clearance. Small firms explain that they rely on intermediaries because they lack the needed qualifications themselves. Large firms say that using intermediaries is "more convenient", as the latter have the necessary licenses and certificates, which would otherwise be difficult or costly to obtain. Thus, the system of licenses and certificates does not serve as a filter, i.e. to block the import of low-quality goods, serving instead mainly as a source of corruption.

Small firms also report that customs officials sometimes insist that they hire intermediaries. Various government offices

not infrequently give insistent advice to use the services of certain firms, and customs is not an exception. Instead of demanding bribes, government officials create private firms on the side, which collect "official" fees for services rendered, thereby "institutionalizing" corruption.

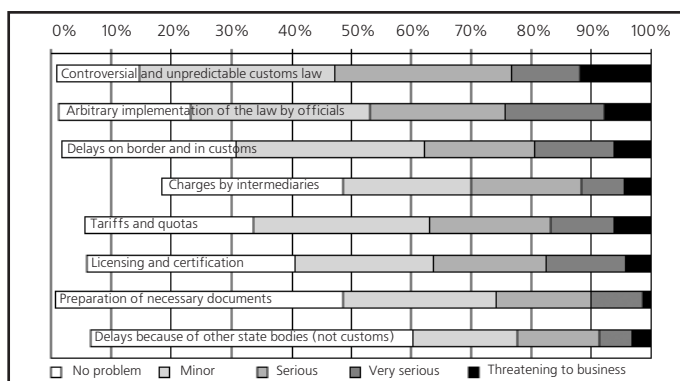
Another potential source of corruption is the official requirement that customs inspect almost 100% of all shipments, a very time-consuming process and a source of massive delays in customs clearance. In developed countries, customs officials rely on special techniques to assess the probability of cheating and inspect only those shipments, which have a high risk. Russian regulations create grounds for corruption, in that a bribe may be paid to avoid an inspection. More than 80% of respondents reported that they faced custom inspections "always" or "often".

When asked to rank the various obstacles created by customs, more than half of the firms ranked controversial and unpredictably changing legislation as a serious or very serious problem (see the figure). This result is surprising, given the recent improvements in the customs legislation. The problem of arbitrary interpretation and implementation of the law by customs officials was ranked a close second.

The results of the survey also reveal remarkable differences in the quality of customs operations in various regions. The Leningrad oblast seems to be the fastest in terms of clearance time and the most predictable as concerns documentary requirements, however more than 50% of firms — by far the highest share of all the regions — stressed increased payments to intermediaries. In all regions, one third of firms reported an increase in intermediaries' fees, and only a fraction of firms, mostly in the Moscow oblast, said that fees had decreased. The fact that intermediary services have become more costly could be purely a result of inflation. However, anecdotal evidence suggests that an increase in demands for bribes by customs officials played an important role.

Six months is a very short period of time for a new piece of legislation to have an effect on customs operations. Indeed, most of the firms surveyed said that they had seen little difference in the customs procedures in the first half of 2004 compared to the second half of 2003. The government's effort to simplify customs procedures has had some success, mainly in reducing clearance times. But there is plenty of room for improvement, particularly if a probability assessment technique were to be introduced. Progress varies substantially across regions. The growing importance of intermediaries indicates that significant entry barriers for new trade firms still exist.

*Ksenia Yudaeva is director of policy programs at CEFIR at NES in Moscow and scholar-in-residence at the Carnegie Moscow Center. Konstantin Kozlov is an economist at CEFIR.*



Several representatives and members of SME organizations in Lithuania, Slovakia, Romania and Russia provided their opinions on entrepreneurs and entrepreneurship at our request:

Arvydas Darulis, Director of the Lithuanian Small and Medium Enterprise Development Agency;

Camelia Bulat, program director, Centre for International Private Enterprise, Romania;

Dina Krylova, member of the board of directors, OPORA, Russia;

Ispas Adriana, vice-president of the Chamber of Commerce and Industry, and director of SME's Center of

Consultancy and Management;

Ludovit Balco, Director of National Agency for Development of Small and Medium Enterprises (NADSME), Slovakia;

Oana Irina Coanta, owner of Inside Communication, member of the Association of Business Women and Top Managers in Brasov, Romania;

Stamate Lamaita, Economic and Marketing Director of S.C. Sistem S.R.L., member of the Association of Business Women and Top Managers in Brasov, Romania.

The views expressed below are those of the authors and not necessarily of the organizations they represent.

### 1. Who is a typical entrepreneur (or member of your association) in your country? Why do people become entrepreneurs?

*Dina Krylova, Russia:* These are people who cannot sell themselves as employees for a high price, but who have good business qualities and are ready to take on risks. Their start-up capital is either their own savings or what they can borrow from relatives and friends. Their sector is usually trading and services.

*Stamate Lamaita, Romania:* In Romania, I don't think there is a typical entrepreneur. Generally, people become entrepreneurs because they have a spirit of "adventure", something like "I should try this...". Of course, theoretically, there are a lot of steps in management that one has to make before becoming an entrepreneur, but the impulse comes from the inside.

*Arvydas Darulis, Lithuania:* Entrepreneurs are usually people who are energetic, self-confident. They set long-term goals and consider money to be a measure of accomplishment. They persist in problem solving, take moderate risks, learn from failures, seek and use feedback, take initiative, accept personal responsibility and use all available resources. They compete with themselves and believe that success or failure lies within their personal control or influence. Their main reason for starting a business is a great desire to work independently, as they are tired of working for others; they also wish to improve something for themselves and for others.

*Ludovit Balco, Slovakia:* Our survey of 2000 people conducted in 2003 showed that the two most frequent reasons for starting a business for current entrepreneurs were the desire to increase one's income (35%) and lack of other job opportunities (33%). Striving for independence, becoming "one's own boss" motivated 18%, and the opportunity to follow one's interests motivated 16% of current entrepreneurs.

### 2. Can you trace any regional differences in SME development? To what do you attribute these?

*Camelia Bulat, Romania:* Bucharest, the capital of Romania, attracted most of the investments, because of the power, infra-

structure, closeness to authorities, etc. Transylvania is the second region in Romania where entrepreneurship is well developed. This area is perceived as populated by serious, hard-working people, determined to do things well. The Eastern part of Romania, Moldova, is struggling. With the exception of larger cities, the Moldova's area is behind the rest of the country.

*Oana Irina Coanta, Romania:* The different regional development is a consequence of the influence of the surrounding countries. Transylvania and Northern Moldavia are areas where entrepreneurship has, since the first years after the revolution, received more material and logistics support than the rest of the country. Better infrastructure, people's mentality, and their ability to communicate are factors that have led to a more rapid development of certain areas.

*Arvydas Darulis, Lithuania:* The level of SME development follows the economic development of a region. For instance, Vilnius, Kaunas and Klaipeda are economically the most developed counties in Lithuania, they have the main industrial, intellectual and cultural assets and the lowest unemployment levels (Vilnius is also the capital city and Klaipeda is the seaport). And these are the ones that have the largest number of SMEs compared to other counties. Nevertheless, it is expected that regional differences will gradually diminish. The successful absorption of EU structural funds and national regional development programs will help to minimize regional disparities.

### 3. Some studies show that there is a certain fixed share of the population who become entrepreneurs (7-10%). Do you think that entrepreneurship can be fostered, and, if yes, why?

*Stamate Lamaita, Romania:* I associate entrepreneurship with people who write poetry — not everybody can be a poet, so not everybody can be an entrepreneur. Usually, this attitude of responsibility, of taking life in your own hands, is not specific to every individual, but only to some. Entrepreneurship may be fostered, but not successfully. I think the effort is huge and the results are only average.

*Ispas Adriana, Romania:* Entrepreneurship can be fostered because there are a lot of unexploited abilities among employ-

ees and the unemployed. This process should begin in early school years and college years.

*Arvydas Darulis, Lithuania:* I highly approve of the opinion that it is very important to foster entrepreneurship. The experience of developed countries all over the world points out that small and medium-sized businesses promote greater competitiveness and economic growth and are the main condition for the successful formation of the middle-class. This sector of the economy has the ability to react quickly to supply-demand changes in the market, to deliver the products and services that are in the greatest demand in a specific period of time, and to create new jobs. That's why a favorable environment for business development has to be created.

*Dina Krylova, Russia:* The readiness to go into business is linked to the level of entrepreneurial risks and the opportunities for alternative employment or social support. Russia has a traditionally low level of social support and limited number of well-paid jobs, is used to high risks and unpredictable results, has a population that learned to be creative under socialism but is not prepared to perfect themselves professionally as a hired employee. As a result, there is a relatively high percentage of people prepared to go into business. The problem is with the viability of those businesses and with entrepreneurs' willingness to take on the necessary knowledge.

*Camelia Bulat, Romania:* Maybe it might be fostered, but not too much, not above the "normal" level. Friendly legislation, easiness in starting a company, access to capital, little bureaucracy are just some of the conditions that help to foster entrepreneurship. Still, if this "normal" level is pushed too far, just to increase entrepreneurship, then the market may become distorted. Legislation and fiscal stimuli must be fair and consistent. Otherwise, they would lead to worsened efficiency, incompetence, and decreased competitiveness.

*Ludovit Balco, Slovakia:* Entrepreneurship can be fostered by eliminating barriers in business environment. This is the most effective way, because it creates the same favorable conditions for all and does not damage competition.

#### 4. Is the public attitude towards entrepreneurs important for small business development? How would you describe the attitude in your country?

*Ispas Adriana, Romania:* I consider the public attitude to be very important. Unfortunately, in Romania, this attitude is rather hostile. Such hostility may be explained by two things: media that mostly focus on the negative side, such as cases of entrepreneurs breaking the law, and by the typical Romanian mentality of envying others' achievements, without being aware of the risks that every business is exposed to, and without trying to follow a good example.

*Ludovit Balco, Slovakia:* The public attitude towards entrepreneurship is slowly changing in a positive direction. Negative attitude stems from the untransparent privatization process and insufficient legal framework that has given room to instances of tax fraud, unfair competition, and corruption.

*Dina Krylova, Russia:* A large portion of society has some sort of relationship with small business and is sympathetic to

its problems. Intolerance is sometimes aroused by the ethnic dominance of certain spheres (such as fruit and vegetable trading, for example), connections with criminal elements, and the at times low level of general entrepreneurial culture. The younger people are, the more positive their attitude tends to be toward small business, as well as their desire to run their own business.

#### 5. What are the biggest problems and constraints small business owners face in your country?

*Oana Irina Coanta, Romania:* Probably the most uncomfortable are the political and ethnical ones.

*Arvydas Darulis, Lithuania:* According to different surveys, the most frequent complaints concern constantly changing laws, high tax rates, lack of capital, complicated access to credit, lack of working capital, high competition, and bureaucracy.

*Dina Krylova, Russia:* The basic problem is the huge and constantly growing amount of administrative costs, the extraction of extra-legal fees for permissions and approvals, and the high pressure of corruption. The state's participation in business, its interference in competition and its violation of the rights of entrepreneurs are serious barriers.

*Camelia Bulat, Romania:* Currently, the pressure on leu, Romanian national currency. After 15 years of constant depreciation of the leu, since last autumn we have been witnessing the opposite situation. Entrepreneurs are having a hard time to adapt, especially the ones who export in Europe. Access to capital, a labor code that is very much in favor of the employees, and competition from China and other Asian countries are other constraints to developing entrepreneurship.

#### 6. Do you believe that the government should support small business owners? Why? If yes, can you name specific measures it should take?

*Camelia Bulat, Romania:* No. Romania's new government has already introduced a major change: the 16% flat tax rate.

*Ludovit Balco, Slovakia:* The best support for enterprises is the improvement of the business environment. It means the elimination of administrative and financial barriers, a fair competitive environment, easy access to financing, transparent and stable legal system and effective law enforcement. The government can intervene only in cases of market failure, such as the unavailability of some types of financing, inadequate innovative activities, etc.

*Dina Krylova, Russia:* The state must even the playing field, supporting small start-ups that don't have sufficient resources, helping them get onto the market. The most important thing is to create economic stimuli for business activities, without interfering in the activities of enterprises, limiting regulators' purview and keeping oversight to the necessary minimum.

*Ispas Adriana, Romania:* The government should replace the incoherent legislation, adopt measures to protect exporters from fluctuations of the currency and maintain the income tax for SMEs at 3%. ■

## Who bears the cost of Russia's military draft?

Michael Lokshin and Ruslan Yemtsov

**E**ach year approximately 400,000 young men between the ages of 18 and 27 are drafted to serve two years in the Russian military. Although all young men in Russia have a duty under law to perform military service, many manage to avoid it, and fewer than 10% of the eligible population is actually enlisted. Who bears the burden of military draft? Our analysis of the distributional and welfare implications of the military draft, based on the data from a large survey in Russia, finds that poor, low-educated, rural households are much more likely to have their sons enlisted. The poor also face disproportionately large economic losses, which exceed the statutory rates of personal income taxes.

The Russian military currently have 1.2 million personnel, made up of conscripts and professional cadres (contractual employment still remains at only 15,000 soldiers). Conscription is regulated by the Law on military service, which in principle obliges all fit males between the ages of 18 and 27 to perform military service. However, it offers exemptions to certain groups and allows alternative civil service. The regulation leaves substantial room for discretion on the part of public officials to decide who is going to serve in the army.

Service in the army remains a feared duty, to be avoided by the majority of Russian families. Serious abuses in the army are well known, and many young soldiers fear being dispatched to Chechnya, where ongoing conflict continues to claim lives. Widespread aversion to military service encourages recruitment officers to rely on coercion in order to fill draft quotas. The selective enforcement in enlisting young draftees leads to discriminatory outcomes, to which the poor and unprotected fall victim. The well-off, on the other hand, can often avoid the draft through influence, bribery and other means.

### Significant economic implications for individuals and households

The presence of a military draft affects economy-wide resource allocation. Compulsory military service inflicts direct short-term costs on households with male children: forgone market earnings of the conscripts and the loss of production of household-specific goods, which can be interpreted as an implicit tax on households. But in contrast with taxes, the military draft is avoided by a majority of the eligible population, producing an inequitable distribution of such losses.

The long-term negative implications of the service include the impact of military service on human capital formation.

Some countries introduce incentives that would motivate young men to enlist, including offering monetary compensations (stipends), training in marketable skills, and tuition cred-

its. In compulsory service systems such as Russia's, soldiers receive negligible or zero monetary compensation, and the military training obtained during service is hardly transferable to civilian occupations.

In studying the distributional and welfare implications of the military draft, we rely on the 2003 Round of the National Survey of Household Welfare and Program Participation (NOBUS) collected by the Federal State Statistics Service in collaboration with the World Bank. The survey covers 45,000 households in 46 regions. In contrast to other surveys of living standards, it includes information on household members who have been absent from the household for more than six months. We are thus able to identify 466 households with individuals in military service.

The descriptive statistics shows that the lowest proportion of conscripts is registered among the smaller households (see figure). Fewer than 2% of sons in the single-parent (usually mother-only) families are drafted. The probability of serving in the army reaches almost 8% for large households. The probability of being drafted is larger for smaller-sized locations. For example, young males living in capital cities — Moscow and St. Petersburg — are almost 6 times less likely to be drafted than those from rural areas.

### Which households attempt to avoid military service?

A simple theoretical model that we develop in our paper examines parents' decisions about investments in the human capital of their children. We test the model's predictions on the sample of 6,126 households with male youth aged 18—27 and in good health, i.e. those eligible to serve in the army. The main findings are in line with our theoretical model and can be summarized as follows:

- The higher the household's income, the lower the probability that a member of the household will serve. The probability of enlistment ranges from almost 20% for the lowest consumption percentiles to less than 3% for the richest households. Educational attainment of household members, which is related to the potential to generate income, has an even larger impact: the larger the share of highly educated adults in the household, the less likely the household is to have its sons in the army.
- Households with a single son are much less likely to have him enlisted. The probability declines with size for households with four or fewer members and increases for larger households.
- There are strong regional differences in draft enforcement, even controlling for labor market conditions in the

region. This implies that different regions are characterized by very different costs of draft avoidance.

- The size of settlements strongly correlates with the incidence of military draft. Males residing in cities with more than 100,000 population have a much lower probability of being drafted, compared to those living in smaller towns and villages. Probability declines for the larger cities.

- The presence of professional military personnel among family members has no significant influence on the probability of service. This may suggest that having their children enlisted as rank-and-file soldiers is not an attractive option even for the families of military officers.

Thus, the effects of military service are not distributionally neutral. Poor, poorly educated, rural households are more likely to have their sons enlisted than are urban, wealthy and better-educated households.

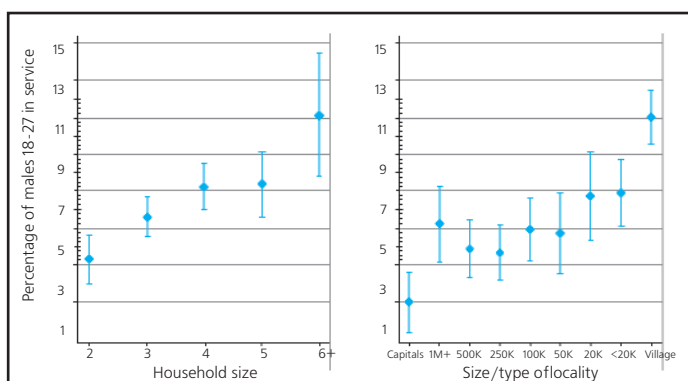
### Short-term welfare costs up to 50%

To quantify the differential burden of military service on household well being, we estimate wages that currently serving household members would earn had they avoided the draft. The wages of new entrants to the labor market are usually low, but even these low wages can represent a substantial addition to the income of households in poverty. The loss of these wages could push a household into a poverty trap. At the same time, for wealthier households, this potential income source is trivial.

Since we lack critical information on education level and tenure of conscripts, we adopt a complex strategy using a group of households with 16–17-year-old males, under the assumption that their characteristics are similar to the characteristics of households with sons in an older age cohort.

The relative importance of losses associated with conscription could be captured by the ratio of expected forgone wages to total household consumption. The estimated ratios range from 50% for the poorest to almost zero for the wealthiest households. The poor are disproportionately affected by such losses. On average, households below the poverty line experience approximately a 15% drop in per capita consumption due to the forgone wages, as opposed to an average of 6% for households above the poverty line. Conceptualizing the oppor-

**Figure 1: Proportion of males aged 18–27 in compulsory military service by household size and type of locality. Mean and 95% confidence interval.**



tunity cost of military service as a tax, we see that for poor households the order of magnitude is similar to the rate of personal income tax in Russia. However, unlike the flat 13% income tax, the “military service tax” is very regressive. Although military draft is not regarded as redistribution policy, the way it is implemented in Russia has profound distributional consequences.

### Conclusions

The burden of military service is not negligible, amounting on average to 15% of household consumption for poor households. Richer households have more resources to evade service obligations and are at least three times less likely to have their sons enlisted than the poor. Therefore, losses associated with military service disproportionately fall on the poor.

The highly regressive features of discretionarily enforced conscription into the military imply that inadequately governed regulations have a large impact on the poor, even though at first glance they seem to have no connection to redistribution policies. The existing system of military personnel procurement in Russia opens the way for the rich easily to shift the burden of a costly obligation before the state (the obligation to serve) onto the poor.

One important area that we omitted in our paper is the gender dimension of welfare losses due to military draft. By distorting the human capital formation decisions of households with sons, conscription has effects on the demand for the human capital of female children and may lead to even wider welfare losses.

Our findings have significant implications for the ongoing military reform in Russia. One could argue that a better enforced, uniform military draft should be implemented in Russia to shift the costs of the military draft from the poor to other groups of society, and thus to restore justice. We are very strongly against this position. If better educated young men would have to serve in the army, the short- and long-term costs of conscription both for individuals and for society as a whole would be even higher than at present. We interpret our findings as important evidence that the non-universal draft that exists in Russia is inferior to an all-volunteer approach to military personnel procurement, not only on efficiency grounds (as has been widely argued), but also, most importantly, on equity grounds.

Although we rely on Russian data, systems of involuntarily military procurement exist in many developing and transition economies. We believe that households in these countries face similar choices, and the resulting misallocations could have important distributional and welfare implications.

*Michael Lokshin is a senior economist in the Development Research Group of the World Bank. Ruslan Yemtsov is a senior economist in the Eastern Europe and Central Asia Poverty Reduction and Economic Management unit of the World Bank. The findings, interpretations, and conclusions of the paper are those of the authors and should not be attributed to the World Bank, its Executive Directors, or the countries they represent.* ■

## How transition paths differ: enterprise performance in Russia and China

Sumon Bhaumik, Saul Estrin

**C**hina's GDP per capita has been increasing by an impressive 8% per annum for more than twenty years, while Russian GDP had fallen to 64% of its 1990 level by 2000, with output declining in seven years of the ten. To throw light on the broader issues of divergence in transition paths, we analyze the determinants of company performance in China's and Russia's very different economies. We find that in China enterprise performance was associated with rapid increases in factor inputs but was not significantly affected by ownership or institutional factors. In contrast, region-specific factors were the most important determinants in Russia, while improvements in factor quantity (except for labor), quality and privatization to outsiders did not improve sales growth.

The study is based on two comparable random surveys conducted in 2000 of 274 Chinese firms from three provinces, and 437 Russian firms operating across 13 oblasts. Quantitative measures, such as sales, labor and capital are comparable across the samples, although some qualitative variables differ.

In most firms in our Chinese sample collectively the state had the controlling stake, while in Russia the majority of firms were controlled by insiders. Even though the real sales of the average Chinese firm in our sample grew between 1995 and 1999, while the real sales of the average Russian firm in our sample declined, sales per laborer in Russian firms remained higher than that in Chinese firms, even after the 1998 recession. Further, there was real sales growth in a large minority of Russian firms. The size of the labor force for both Russian and Chinese firms declined over time, indicating some degree of restructuring in both countries. While the real capital stock (valued at historic cost) of an average Chinese firm grew substantially over the 1995–99 period, an average Russian firm experienced severe real decapitalization during 1997–99, rather more markedly than the decline in demand. This decapitalization is probably the consequence of Russian firms selling assets and writing off unproductive capital in the aftermath of the 1998 crisis. Interestingly, however, despite the significant capitalization of the Chinese firms, the average of the proportion of new (i.e. less than five years old) capital stock in Chinese firms remained less than 20%, suggesting that investment was concentrated in large firms.

The empirical strategy involves the estimation of separate augmented sales functions using the Chinese and the Russian data. The results show that, in the late 1990s, economic factors had a much greater impact on enterprise performance in China than in Russia, even though we have contrasted samples of firms from more isolated inland regions in China with companies from across Russia, including such leading centers as Moscow and St. Petersburg.

To summarize the main results, in China enterprises appear to be responsive to market and supply phenomena — managerial effort, technology and investment. However, we find little or no significant impact from institutional factors at a sectoral or regional level, or from the extent of privatization. In contrast, Russian firms are unresponsive to almost all the normal economic drivers — long run factor supplies, outsider versus insider privatization, competition, management effort, or technological factors — though we do identify a positive relationship between changes in sales and employment. The determinants of enterprise performance in Russia in fact prove to be mainly region-specific, and these we interpret to be largely institutional. We go on to explore more formally whether these findings may be explained by differences in managerial quality between Russia and China and inter-regional variation in the quality of institutions. The regressions suggest that both factors are relevant in understanding the difference in enterprise performance in the two systems.

In conclusion, what inference can we draw from the fact that economic factors like changes in labor and capital and, to a limited extent, the level of technology, explain inter-firm variation in sales growth in China, while in Russia most of the variation is explained by region-specific factors? The first and the most obvious implication is that, unlike in China, the Russian market remains both geographically and institutionally fragmented, an observation that is consistent with our knowledge about the political economy of economic governance in Russia and China. Moreover, the effectiveness of reforms that liberalize markets while leaving ownership unchanged or only partially adjusted seems to be strongly supported by our Chinese findings.

We therefore confirm that state-owned and corporatized firms in China are responding to market signals and improving performance along the same lines as privately owned firms in market economies. This suggests that, in certain contexts, such as the one of modern China, market incentives are sufficient to ensure some degree of efficiency in enterprise activity without immediate full privatization. This is not to say that performance cannot be further improved by private ownership; indeed, the evidence that privatization improves enterprise performance is strong. But it is consistent with the view that neither "big bang" reform policies nor early privatization are the *sine qua non* of successful transition.

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## India's reform attracts interest in Beijing

Suman Bery

**Indian analysts usually laud China's economic achievements: high rates of savings and investments, success in attracting large flows of foreign direct investments and buoyant manufacturing. It turns out China has something to learn from India. Chinese experts are especially impressed by India's success in higher margin activities, such as information technology and pharmaceuticals.**

In December 2004 I was part of a small group of Indian economists invited to a workshop in Beijing, comparing the economies of India and China. The conference was organized by the newly established Centre for China in the World Economy (CCWE) at Tsinghua University. The level of respect and attention paid to the Indian experience by the Chinese analysts and academics — and the degree of self-criticism on issues that are often lauded by Indians — came as something of a surprise. Indian commentators admire China's high rates of saving and investment, the buoyancy of its manufacturing, and its success in attracting foreign direct investment. Chinese participants at the conference provided a somewhat more nuanced view.

While acknowledging the dynamism of their manufacturing sector, the Chinese played down their prowess in manufacturing. One Chinese observer referred to Chinese manufacturing workers functioning as “coolies”, bringing relatively little added value. Indian expertise and success in higher margin activities, such as information technology and pharmaceuticals, was seen as a more impressive indicator of indigenous capacity.

As reported in a December 2004 *Financial Times* survey of China, China's over-reliance on foreign trade and foreign direct investment are now being questioned. A senior fellow at China's Academy of Social Sciences is quoted as saying that it is absurd that exports plus imports should be as high as 60% of GDP in such a large economy as China's. He also notes that the flood of foreign direct investment flowing to China is substantially stimulated by the inefficient and distortionary incentives offered by a myriad of local jurisdictions competing for modern employment. These ought to be reduced or eliminated, but the central government finds it difficult to exercise effective control.

Current Chinese concerns about the politics of economic reform also came as somewhat of a surprise. Despite considerable political concern in India about widening income inequality, there is little conclusive evidence of changes in the personal income distribution in India over the last two decades. By contrast, the recent Chinese experience has involved a clear widening in the distribution of personal income. The different experiences of the two economies are reflected in their different patterns of urbanization. There has been relatively little change in India's rural-urban split, despite accelerating per capita income growth, reflecting relatively equal wage growth in the two sectors. China's rapid urbanization, on the other hand, is a sign of the widening income gap between the two sectors.

Much of the discussion at the workshop revolved around the links between the state-owned enterprise sector (SOEs), social protection, and the financial sector. It was pointed out that the burden of social protection was moved from the state to the SOEs in 1979, as part of the decentralizing reforms. Decentralization was instrumental in stimulating the local enterprises that have provided so much dynamism to the Chinese economy, but reform of the SOEs themselves was not embarked upon till much later, in 1993. As in India, it remains very much a work in progress.

A recent issue of the *McKinsey Quarterly* (“China Today”, the 2004 Special Edition) points out that in 2003, SOEs generated just 17% of China's GDP, although they employed 50% of the work force and controlled 57% of industrial assets. Over the years, the state banking system has propped up these failing businesses, to maintain employment and fulfill their social protection obligations, but at the cost of distress to the banking system. Similarly, the costs of non-income generating infrastructure projects also end up in the banking system.

Efforts are underway to put in place a social security system less dependent on public enterprises. At the same time, a massive recapitalization and restructuring of the public banks is being initiated. In a move reminiscent of current proposals to use Indian reserves for infrastructure development, a sum of \$45 billion (4% of GDP) from China's foreign exchange reserves was transferred to an investment vehicle for holding capital in two large state-owned banks. Following recapitalization and restructuring, these banks will prepare for a flotation on international equity markets and actively seek strategic investors. This is in sharp contrast to India's ideological reservations on the same issue. The situation on the equity markets is distinctly less favorable in China than in India, with the institutional structure considerably less robust and sophisticated, and the role of the equity markets in capital allocation correspondingly less well developed.

What conclusions for India should one draw from all this? As Tarun Khanna of Harvard Business School observes in the *McKinsey Quarterly*, the Chinese government has continued to be more interventionist in resource allocation than the Indian government. On the other hand, it has had a greater commitment to competition, as reflected in its trade and tariff policies and its policies toward foreign direct investment. Neither country has yet been successful in setting up efficient and transparent regulation in the infrastructure sectors. India's relative success in financial sector regulation gives some encouragement that, in due course, such a culture will be established in other sectors as well.

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### New Online Database Brings Investment Climate to Desktop

The database of the Bank's new Investment Climate Surveys (ICS) (<http://iresearch.worldbank.org/ics/jsp/index.jsp>) covers more than 27,000 companies in 51 countries, with data from another 15 countries due on line in March. Covering all major aspects of the investment climate, the database complements the World Bank/IFC *Doing Business* database, which focuses more narrowly on regulatory constraints to business. ICS ask what happens to firms in practice, while *Doing Business* data show what should happen to specific types of entrepreneurs if they follow all of the laws and regulations as prescribed. The surveys allow for analysis of issues across company characteristics such as size, ownership, or different geographical locations within a country.

### Wolfensohn Discussed Competitiveness in Moscow

During his two-day visit to Moscow in early February, World Bank President James Wolfensohn focused on Russia's investment climate and competitiveness. Wolfensohn met with President Putin and other key representatives of the Russian federal and regional authorities. Putin said that Russia no longer needs large-scale borrowing from the World Bank, but remains interested in receiving support for some projects, such as developing infrastructure and improving corporate governance. The World Bank loaned Russia some \$10 billion in 1992–2002. Wolfensohn stressed the need for Russia to identify and implement policies aimed at strengthening global competitiveness. He also suggested that Russia should develop its high-tech industries and follow the example of India, Singapore and Ireland, countries that have successfully tapped into an educated and eager populace to nurture technology booms over the past decade.

### World Bank Report on Closing the Digital Divide

Public-private partnerships would ensure that more people in the developing world get access to modern tools of communication, a new report from the World Bank suggests. The draft report, entitled "Financing Information and Communication Infrastructure Needs in the Developing World: Public and Private Roles", says that one half of the world's households have a fixed telephone line, while 77% of the world's population is under the signal footprint of a mobile phone provider. However, access to more advanced services, such as Internet servers, broadband and international bandwidth, lags considerably in the developing world.

The private sector has invested more than \$210 billion in telecommunications capacity in developing countries over the last ten years, and attracting further private investment remains one key part of the strategy to narrow the digital divide. Well regulated private competition in telecommunications brings higher investment and more rapid rollout of services. But even

with greater private involvement, the government must take the lead role. The World Bank Group will continue to support this area, the report notes.

### Thinking the Unthinkable: Fusion of the Bank and the IMF?

Fritz Fischer, a former German Executive Director at the World Bank, wrote in the latest edition of the *International Economy Magazine* that "changes in the two Bretton Woods institutions in recent years have led to various calls for reforms meant to reconfirm the basic mandates of the IMF and the World Bank and to eliminate duplication of effort". He noted that, "A number of arguments can be made in favor of a reorganization that is less than a full-fledged merger and instead combines the two administrations and Boards under one roof". Further, in a letter to the *Financial Times* (Jan. 31), he wrote that "The IMF and World Bank have been serving the same clients for the past 20 years; i.e. developing and transition countries only. It can thus be debated whether the founding fathers would have created two separate institutions 50 years ago had they foreseen this development and other dramatic changes (for example the surge of private capital markets and investments). This then begs the question whether combining the two institutions and having one board of 24 executive directors (instead of two) would not reduce costs, minimize duplication and, above all, guarantee consistent advice to the clients," he added.

### Eight Nations Agree on Plan to Lift Status of Gypsies

Leaders from Central Europe met in Sofia early February and decided to launch the Decade of Roma Inclusion — the most sweeping effort to improve the status of Roma, Europe's most vulnerable minority. World Bank President James Wolfensohn and Open Society Institute Chairman George Soros, who represented the two principal sponsoring organizations of the initiative, also participated.

Roma are now one of the largest, poorest, and fastest growing minorities in Europe. The total Roma population in all of Europe is estimated at between 7 and 9 million, and approximately 6 million Roma live in the countries of Central and Eastern Europe. Poverty rates for Roma range between four and ten times that of non-Roma in Bulgaria, Hungary, Romania, and Serbia and Montenegro. Some 70–80% of Roma have less than a primary school education. The Decade of Roma Inclusion represents the first cooperative international effort to change the lives of Roma. Progress should be achieved in four priority areas: education, employment, health, and housing.

### New EU Members: Slower Growth, Budget Concerns

Slower growth, easing inflation pressure and budget concerns will characterize future economic development in most new European Union member states, according to a report

released by the World Bank in mid-February. The chief author of the report, Thomas Blatt Laursen, said slowing growth reflects the “waning effects of EU accession, less accommodat- ing fiscal and monetary policies, and a slight slowdown in growth among the EU's pre-enlargement 15 members”.

The World Bank estimates gross domestic product growth for the eight will be 4.5% on average in 2005, compared with a high of 5.5% in mid-2004. The slowdown will be felt in the Baltics more than elsewhere. Election-focused budgets may also slow reform momentum across the region already in 2005. Although the World Bank doesn't expect budget deficits above an average of 4% in 2005, that is still above the 3% threshold prescribed for euro adoption. Most new members plan suffi- ciently tight 2005 budgets, though Hungary risks overshooting its deficit goal again. The World Bank said that with the excep- tion of Slovakia, whose minority government continued to implement its reform plan, weak popular support and upcoming elections have slowed reform efforts in the accession countries.

### Charging Non-Borrowers for Advice?

The World Bank may soon need to charge advisory fees to countries seeking its advice, as growing numbers of middle- income developing countries no longer require loan programs, Peter Woicke, executive vice president of the Bank's International Finance Corporation (IFC), said. Woicke, who since retired, said the World Bank needed to find new revenue sources as Asian and Eastern European countries become increasingly wealthy and no longer need low-interest develop- ment loans. “There is still a demand from these countries for advisory service, technical assistance, knowledge transfer. The bank has to spend more time on figuring out how to get these advisory services right. I can't say that sort of service can be delivered for free to increasingly richer countries”, he said.

Woicke said he believed the IFC needed to phase out its activities in economically successful, mid-income countries. In the next few years, Woicke said he hopes the IFC will be able to end its involvement in the Baltic countries as well as in the EU accession countries. “If you work in an investment bank or a commercial bank, you are always there to make it bigger, to grow it, to be more successful. Our success actually is to make it smaller and to disappear at some point”, he said.

### \$1 Billion Financing Facility for South East Europe Energy Community

The World Bank's Board in late January approved a \$1 bil- lion adaptable program loan (APL) facility to support the Energy Community of South East Europe program (ECSEE), a program aimed at integrating energy systems in South East European countries into the internal energy market of the European Union. The ECSEE APL program will help the coun- tries in the region develop the energy community by imple- menting priority investments supporting electricity market and power system operations, technical assistance for system devel- opment, and project preparation and implementation. Romanian hydropower generator Hidroelectrica S.A. will

receive the first loan awarded under the program, for \$84.3 million, with the guarantee of the Romanian government

### Comparing Purchasing Power across Currencies

In late February Bank Chief Economist Francois Bourguignon, together with leading statisticians of the Bank, and representatives of global partner organizations, launched the first round of the International Comparison Program (ICP), a global effort to collect comparable price data in 108 countries. The new global data collection effort will generate Purchasing Power Parity (PPP) data to convert GDP and its sub-aggregates-reported in different currencies-into a standard common currency that equalizes the real purchasing power of each of the currencies. “The world's largest-ever and most complex statistical price collection program is underway”, said Dennis Trewin, an Australian statistician and Chair of the ICP Executive Board. “Survey workers in over a hundred develop- ing countries have either started or will soon be collecting price data for over a thousand selected products, including various kinds of food, clothing, and housing, among others”.

### \$45 Million Loan to Belarus?

The World Bank may lend Belarus some \$45 million to help tackle the aftermath of the Chernobyl nuclear disaster, despite the ex-Soviet state's reluctance to work with it on other loans, Reuters reports, based on the Bank's information. Last year, Belarus rejected a \$50 million World Bank loan to help fight AIDS and tuberculosis, saying “it needed no loans from the West”. Paul Bermingham, the World Bank's head for Ukraine, Belarus and Moldova, said the funds would be channeled for projects in energy and forestry to help development in regions affected by the 1986 explosion at the Chernobyl nuclear power plant over the border in then-Soviet Ukraine.

### Further Steps in Anticorruption Fight

The World Bank on February 24 released its first annual report on investigations into allegations of fraud and corrup- tion, both internally and in Bank-financed projects. In the five years since 1999, the Bank's institutional integrity department has investigated and closed more than 2,000 cases, both inter- nal and external. Allegations received ranged from instances of fraud and corruption in Bank-financed projects or in relation to the Bank's own administrative budget, to other forms of workplace misconduct such as sexual harassment, violations of policies and procedures, and non-compliance with personal financial obligations. Since 1999 to date, the Bank has sanc- tioned more than 300 firms and individuals for fraud and cor- ruption in Bank-financed projects. The number of serious alle- gations involving Bank staff represents less than 1% of the total staff. Nine staff members were found to have engaged in fraudulent or corrupt practices and were terminated and barred from rehire. Three staff members found to have engaged in other forms of misconduct received other discipli- nary action consistent with Bank rules and procedures.

## 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.*

### **Agriculture Investment Sourcebook** *January 2005, 530 pp.*

Investing to promote agricultural growth and poverty reduction is a central pillar of the World Bank's current rural strategy. The book shares information on investment options and identifies innovative approaches that will aid the design of future lending programs for agriculture. Drawing on a wide range of experiences from donor agencies, governments, institutions, and other groups, the book provides generic good practices and many examples to demonstrate that investment in agriculture can provide rewarding and sustainable returns for development efforts.

### Uma Lele **Addressing the Challenges of Globalization: An Independent Evaluation of the World Bank's Approach to Global Programs** *January 2005*

Addressing the challenges posed by globalization often requires collective action at the global level. The World Bank is an important participant in such programs and activities because of its global reach, its ability to mobilize resources, and its multisectoral expertise. The book derives crosscutting lessons for the Bank on program selectivity, design, implementation, governance, financing and evaluation. It also identifies areas where further Bank action on its global-level strategy and programming is needed to improve the global program effectiveness.

### Francois Bourguignon, Boris Pleskovic, and Andre Sapir, eds. **Annual World Bank Conference on Development Economics—Europe. Are We on Track to Achieve the Millennium Development Goals?** *Washington, DC: World Bank and Oxford University Press, 2005, 266 pp.*

## World Bank Working Papers

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

### William Blomquist, Ariel Dinar, and Andrzej Tonderski **Institutional and Policy Analysis of River Basin Management: The Warta River Basin, Poland** *WPS 3528, February 2005, 37 pp.*

The authors describe and analyze the emergence of river-basin management in the Warta River Basin. Water management

issues include pollution of the Warta and its main tributaries, and growing problems of water allocation and scarcity. The dispersion of water policy authority across several levels of government, basin authorities' lack of power and funding, little stakeholder participation, and delays in water law reform have complicated the development and implementation of integrated management at the basin level.

### David Dollar and Victoria Levin **Sowing and Reaping: Institutional Quality and Project Outcomes in Developing Countries** *WPS 3524, February 2005, 25 pp.*

This paper presents microeconomic evidence on factors conducive to the success of aid-funded projects in developing countries. The authors find that the existence of high-quality institutions in a recipient country raises the probability that aid will be used effectively. There is also some evidence that geography matters.

### Lourdes Trujillo, Antonio Estache, and Sergio Perelman **Infrastructure Performance and Reform in Developing and Transition Economies: Evidence from a Survey of Productivity Measures** *WPS 3514, February 2005, 28 pp.*

Having reviewed some 80 studies on electricity and gas, water and sanitation, and rail and ports in developing countries, the authors conclude that there is a difference in the relevance of ownership for efficiency between utilities and transport in developing countries. In transport, private operators have performed better than public operators. For utilities, ownership often does not matter as much. Across sectors, private operators functioning in a competitive environment or regulated under price caps or hybrid regulatory regimes tend to catch up to best practice faster than public operators.

### Mihails Hazans **Unemployment and the Earnings Structure in Latvia** *WPS 3504, January 2005, 90 pp.*

Latvia has recorded sustained GDP and productivity growth since 1997. Yet unemployment rates have remained high. The author analyzes labor flows between employment, unemployment, and nonparticipation and finds that the type of education and the region of residence are the most important determinants of success by the unemployed in finding jobs. The unemployed from ethnic minorities have lower chances of finding a job within a year, while the difference between genders is not significant.

### Judith M. Dean, Mary E. Lovely, and Hua Wang **Are Foreign Investors Attracted to Weak Environmental Regulations? Evaluating the Evidence from China** *WPS 3505, February 2005, 49 pp.*

One of the most contentious debates today is whether pollution-intensive industries from rich countries relocate to poor countries with weaker environmental standards. The authors estimate the strength of “pollution-haven” behavior by examining the location choices of equity joint venture (EJV) projects in China. They find that EJVs from all source countries go into provinces with relatively high concentrations of foreign investment, skilled workers, potential local suppliers, special incentives, and less state ownership. Low environmental levies are an attraction only for joint ventures in highly-polluting industries with partners from Hong Kong, Macao, and Taiwan (China).

George Clarke

**Do Government Policies that Promote Competition Encourage or Discourage New Product and Process Development in Low and Middle-Income Countries?**

*WPS 3471, January 2005, 42 pp.*

The author assesses how competition and trade policy affect innovation. He finds that reducing tariffs and enacting and enforcing competition laws modestly increase both the pressure on firms to innovate and the level of price competition in the domestic economy. The net impact of lower tariffs on new product and process development is negative but small. In contrast, stricter competition laws and better enforcement increase the likelihood of new product and process development.

Jos Verbeek, Pierella Paci, and Marcin J. Sasin  
**Economic Growth, Income Distribution, and Poverty in Poland during Transition**

*WPS 3467, December 2004, 18 pp.*

Poland has struggled in the past few years to reduce poverty while still experiencing positive economic growth. Analyzing linkages between macroeconomic policies and economic growth variables, the authors show that in Poland, poverty-reducing growth depends heavily on the ability of the economy to generate jobs. During the early years of transition, net job growth was positive, while after the Russian crisis of 1998, productivity gains were accomplished mostly by shedding labor, leading to increased poverty in Poland.

## CEPR Working Papers

<http://www.cepr.org>.

**Euro Area Business Cycle: Stylized Facts and Measurement Issues**  
*February 2005.*

The book covers a broad range of issues, including: dating the business cycle, measuring the output gap, the role of international variables in predicting the cycle of European countries, and the relation between the euro and US cycles. Some of the analysis is methodological and evaluates different econometric techniques for assessing turning points in economic activity, measuring the cycle, and the timely assessment of the state of the economy. Some of the analysis is empirical, based on country-specific variables or aggregate euro-area data.

**EU Needs Fiscal Watchdog to Replace Stability and Growth Pact**

2005

The European Union's Stability and Growth Pact has now been suspended. The authors of the new CEPR Report “Stability and Growth in Europe: Towards a Better Pact” argue that the Pact should be replaced with an independent panel of experts, who would have the sole task of safeguarding the sustainability of public finances in the euro area.

## Edward Elgar Publishing

To order: 136 West Street, Suite 202, Northampton, MA 01060-3711, U.S.A; URL: <http://www.e-elgar.co.uk>.

Miroslav N. Jovanovic

**The Economics Of European Integration: Limits and Prospects**  
2005, 944 pp.

Richard E. Just, Darrell L. Hueth, Prof. Titular, Andrew Schmitz, Ben Hill Griffin

**The Welfare Economics Of Public Policy: A Practical Approach to Project and Policy Evaluation**  
2004, 712pp.

Manfred Kets de Vries, Stanislav Shekshnya, Konstantin Korotov, and Elisabeth Florent-Treacy

**The New Russian Business Leaders**  
2004, 368 pp.

Xu Yi-chong

**Electricity Reform in China, India and Russia**  
2004, 384 pp.

## WIDER Publications

<http://www.wider.unu.edu>.

Anthony Shorrocks and Rolph van der Hoeven (eds.)

**Growth, Inequality, and Poverty: Prospects for Pro-Poor Economic Development**

*February 2005, UNU-WIDER Studies in Development Economics, Oxford University Press.*

Ravi Kanbur and Anthony J. Venables, (eds.)

**Spatial Inequality and Development**

*January 2005, UNU-WIDER Studies in Development Economics, Oxford University Press.*

Stefan Dercon (ed.)

**Insurance Against Poverty**

*November 2004, UNU-WIDER Studies in Development Economics, Oxford University Press.*

A.B. Atkinson, (ed.)

**New Sources of Development Finance**

*November 2004, UNU-WIDER and UN-DESA, UNU-WIDER Studies in Development Economics, Oxford University Press.*

**CASE International Conference “Europe after the Enlargement”**  
April 8–9, 2005, Warsaw, Poland

The conference will analyze and discuss opportunities and risks emerging from the 2004 EU enlargement. Topics include: the constitutional future of the EU; economic governance in the enlarged EU and EMU; perspectives on the Lisbon strategy; perspectives on future EU enlargements; and development challenges in countries bordering the EU. Jean-Claude Trichet, President of the European Central Bank, will deliver the keynote address.

*Information:* [http://www.case.com.pl/strona--ID-seminaria\\_miedzynarodowe,seminarium\\_id-3523703,nlang-710.html](http://www.case.com.pl/strona--ID-seminaria_miedzynarodowe,seminarium_id-3523703,nlang-710.html)

**BOFIT/CEFIR Workshop on Russian macroeconomic and financial issues**

April 8–9, 2005, Moscow, Russia

The workshop will discuss exchange rate policies, monetary policy, money demand, inflation, de-dollarization, bank supervision, stock markets, and the sustainability of growth.

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**First Development Economics (DEC) Lectures**

April 21, 2005, Washington D.C., USA

**Opening Remarks:** Francois Bourguignon, World Bank

**Lecture 1:** Lawlessness and Economics: Evaluating Recipes for Development: Avinash Dixit, Princeton University. **Discussant:** Philip Keefer, World Bank. **Lecture 2:** Globalization and Industrial Development: John Sutton, London School of Economics. **Discussant:** Michael Klein, World Bank. **Lecture 3:** Growing Public: Is the Welfare State Mortal or Exportable? Peter Lindert, University of California—Davis. **Discussant:** Francois Bourguignon, World Bank.

The conference is open to World Bank and IMF staff.

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**2005 EBRD Annual Meeting and Business Forum “Building bridges, promoting prosperity”**

May 22–23, 2005, Belgrade, Serbia and Montenegro

The Meeting will discuss the latest investment information in the 27 countries from Central Europe to Central Asia:

- Key challenges in the new EU countries;
- Current developments and reforms in Russia and the CIS;
- Assessment of south-eastern Europe's growth potential;
- Key issues affecting the EBRD region — opening borders and expanding markets, tackling corruption, enhancing municipal development, securing future energy supplies.

*Information:* <http://www.ebrd.org/new/calendar/index.htm>

**7th Annual Bank Conference on Development Economics (ABCDE)—Europe**

May 23–24, 2005, Amsterdam, the Netherlands

**Opening Address:** Agnes Van Ardenne, Minister for Development Cooperation, the Netherlands

**Keynote Addresses:** Francois Bourguignon, Chief Economist and Senior Vice-President, the World Bank; Ernesto Zedillo, former President, Mexico, and Director, Yale Center for the Study of Globalization, USA

**Macroeconomic Vulnerability:** Patrick Guillaumont, University of Clermont-Ferrand, France; **Vulnerability: A Micro Perspective:** Stefan Dercon, Oxford University, UK; **Understanding the Links between Development and Security:** Gregory F. Treverton, Rand Corporation, USA; **Health Risks:** Joep Lange, University of Amsterdam, the Netherlands

**Closing Session:** James D. Wolfensohn, President, the World Bank; Ngozi Okonjo-Iweala, Minister of Finance, Nigeria; Agnes van Ardenne, Minister of Development Cooperation, the Netherlands; Supachai Panitchpakdi, Director General, WTO.

*Information and registration:* [www.worldbank.org/abcde-europe](http://www.worldbank.org/abcde-europe); Gaetano Vivo, *email: gvivo@worldbank.org, tel.: +33-1-40 69 3000, or Leita Jones, email: jones2@worldbank.org, telephone: +1(202)473-5030. For sessions contact: Jean-Christophe Bas, email: jbas@worldbank.org; or Boris Pleskovic, email: bpleskovic@worldbank.org.*

**European Financial Services Conference**

May 30—June 1, 2005, Varna, Bulgaria

The conference, organized by the “Economika 2000” Club, the Bulgarian Industrial Capital Association and “Razvitie XXI” Foundation, will focus on the modernization of financial services in compliance with the European Commission's Financial Services Action Plan. Topics include: the challenges of EU financial market integration in member and candidate countries; banking sector development in light of EU enlargement; the insurance sector and stock markets; and convergence of regulation models in the EU.

*Information:* [http://www.bicabg.org/en/docs/EFSC\\_appl.FormEN+Announce.doc](http://www.bicabg.org/en/docs/EFSC_appl.FormEN+Announce.doc), *e-mail: bica@bica-bg.org.*

**The World Bank and Central European University (CEU) in Budapest Conference “Scaling Up the Success of Capacity Building in Economic Education and Research”**

June 14–15, 2005, Budapest, Hungary

**Opening Address:** Yehuda Elkana, CEU

**Keynote Addresses:** Francois Bourguignon, World Bank; Janos Kornai, Harvard University and Collegium, Budapest; Arjun Appadurai, New School; George Soros, Open Society Institute. **Topics to discuss:** Lessons of Experience and Future Directions; Regional Perspectives; Developing a PhD Program;

Curriculum Development and Policy Research. **Speakers include:** William Newton-Smith, OSI and Oxford University; Gur Ofer, NES and Hebrew University; Justin Lin, CCER and Peking University; William Lyakurwa, AERC and Robert Campbell, EERC and Indiana University, and Jan Svejnar, CERGE and Michigan University. **Closing Remarks:** George Soros, Yehuda Elkana, James D. Wolfensohn.

*General information:* Boris Pleskovic, email: [bpleskovic@worldbank.org](mailto:bpleskovic@worldbank.org), or Aehyung Kim, email: [akim3@worldbank.org](mailto:akim3@worldbank.org). *Logistics information:* Theresa Bampoe, tel: +1(202) 473 1017, email: [tbampoe@worldbank.org](mailto:tbampoe@worldbank.org)

### **Institutions, Development and Transition**

June 17, 2005, Istanbul, Turkey

Organized by the CEPR's "Institutions and Economic Performance" Program jointly with the Bureau for Research and Economic Analysis of Development, this 10th conference will

present new research on institutions and development in comparative perspective. Policy discussions will focus on institutional change in Turkey and the challenges of future entry into the EU.

*Information:* <http://www.cepr.org/meets/Diary/listyear.asp?year=2005>

### **UNU-WIDER Jubilee Conference "WIDER Thinking Ahead: the Future of Development Economics"**

June 17—18, 2005, Helsinki, Finland

Marking the 20th anniversary of UNU-WIDER, the conference will highlight new and emerging issues in development. Topics include growth, trade and finance for development; poverty and inequality; strategies for poverty reduction; conflict; and economic policy-making for development. The conference is open to younger researchers and established scholars, and nationals from developing countries are encouraged to participate.

*Information:* <http://www.wider.unu.edu/welcome.htm>

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