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# Beyond Transition

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## Special Issue: ABCDE Conference

**2006 ABCDE Conference: Focus on 15 Years of Changes**

Boris Pleskovic **6**

## Poverty and Inequality

**Inequality and Growth in Transition: Does China's Rising Inequality Portend Russia's Future?**

Pradeep Mitra and Ruslan Yemtsov **3**

**Trade Liberalization, Inequality and Poverty Reduction in Latin America**

Guillermo Perry and Marcelo Olarreaga **5**

**Patterns of Regional Inequality in India and China**

Kiran Gajwani, Ravi Kanbur, and Xiaobo Zhang **8**

## Institutions in Transition

**Corporate Governance and Bankruptcy in Emerging Market Economies**

Erik Berglof, Patrick Bolton, Sergei Guriev, and Ekaterina Zhuravskaya **9**

**The Institutional Determinants of Effective Policies in Latin America**

Ernesto Stein and Mariano Tommasi **11**

**Three Dilemmas for Judicial Reformers**

Matthew Stephenson **13**

**Transforming Judicial Systems in Europe and Central Asia**

James Anderson and Cheryl Gray **14**

## Privatization Revisited

**Privatization: Lessons from a Quarter of a Century**

Sergei Guriev and William Megginson **16**

**Objections to Voucher Privatization: Not So Valid?**

Marek Louzek **18**

## Transition Experiences

**Dynamics of Institutions, Development and Elites**

Francois Bourguignon **19**

**Joined at the Hip: Economics and Politics in Russia's Transition**

Yegor Gaidar **22**

**The Eurasian Growth Paradox**

Anders Aslund and Nazgul Jenish **24**

**Lessons from the "Slavic Tiger"**

Yudit Kiss **25**

**World Bank \ IMF Agenda** **26**

**New Books and Working Papers** **28**

**Conference Diary** **30**

## From the Editor:



Dear Reader,

This issue is devoted to this year's Annual World Bank Conference on Development Economics (ABCDE) held in January in St Petersburg to which the "Beyond Transition" newsletter lent its name.

By bringing the conference to Russia, the organizers clearly wanted to show that the transition experience has broad relevance for developing countries. At the same time, the title "Beyond Transition" suggests that transition countries must think beyond their own immediate context. Increasingly, the transition region is diverging into two groups: those countries in the process of catching up with the advanced economies, and those stuck with the institutions and problems of developing countries.

The phrase "Beyond Transition" also captures a development in the academic literature over which development economists and transitologists are interacting more and more. The common goal is to develop conceptual frameworks and analytical tools that allow us to better understand institutional change: how momentum for reform and change is created, how institutions can evolve, how momentum can be lost, how bad institutions are sustained, and so on.

This exciting research agenda was well represented at the conference. The opening keynote address by the World Bank Chief Economist Francois Bourguignon focused on the political economy of institutional change. Drawing on the influential work of James Robinson and Daron Acemoglu, Bourguignon called for a better understanding of institutional dynamics and institutional change.

Several papers presented at the conference and summarized in this issue were devoted to institutions and institutional change in important areas such as the design and implementation of effective legal and judicial reforms (Grey and Anderson, and Stephenson), setting priorities and finding tailor-made solutions when drafting corporate governance and bankruptcy legislation (Berglof et al.), and more generally, selecting and implementing better-quality policies to create "virtuous" institutional dynamics (Stein and Tommasi).

One fundamental challenge shared by developing and transition countries is how to reduce poverty and inequality. Comparative analyses of Poland, Russia, and China (Mitra and Yemtsov), Latin American countries (Perry and Olarreaga), and India and China (Gajwani et al.) not only contrast country experiences, but also distinguish between the role of local factors and global changes affecting most countries. They also highlight the importance of complementary policies in education, labor markets, access to finance, and the investment climate.

Another interpretation of the phrase "Beyond Transition" is that the objectives of transition have been accomplished in some countries. Whether the transition period has officially ended or not, we still look back for answers or explanations to current problems and concerns, be it privatization (Guriev and Megginson, and Lousek), government overspending in a volatile macroeconomic environment (Gaidar), or factors behind high economic growth (Aslund).

*Erik Berglof, Managing Editor*

# Inequality and Growth in Transition: Does China's Rising Inequality Portend Russia's Future?

Pradeep Mitra and Ruslan Yemtsov

**W**ill inequality keep rising in Russia in parallel to improved economic performance? The authors conclude that China's experience of rapidly rising inequality is to a large extent a developmental, rather than a transitional phenomenon, and therefore can hardly predict changes in inequality in Russia.

During the 1990s, deep transitional recession in Central and Eastern Europe and the CIS was associated with sharply increasing inequality. Russia was no exception, and by the mid 1990s, in the nadir of transitional recession, the Gini index, the most commonly used measure of income inequality, had risen above 0.40 according to any available source or estimate. Meanwhile, inequality rose significantly in fast-growing China: according to the World Bank, the Gini index went up by 2.0 percentage points a year between 1990 and 2001, to reach a level a notch above 0.40 as well. Since 1999 Russia has been growing fast, at times approaching the extraordinary growth performance of China, and pulling up the rest of the CIS, which is now the second fastest growing region in the world. Will inequality keep on rising in Russia in parallel to economic growth, as it did in China, and will improved economic performance come at the price of a further widening of income disparities?

## Inequality in Transition

Former planned economies had suppressed inequality, and the transition to a market economy brought the potential of distribution decompression in individual incomes and consumption. But 15 years later, the ECA region (ECA is the 27 ex-socialist countries of Eastern Europe and the former Soviet Union) shows the full spectrum of inequality outcomes, from fairly unequal to fairly equal (see Graph).

The graph also shows that despite widening disparities, the median inequality in the ECA region is lower than in the rest of the developing

world and is broadly comparable to the median inequality in OECD countries.

The data show a rapid increase in inequality in the middle-income and low-income CIS countries, followed by some moderation. The new member states of the European Union (the EU-8), on the other hand, seem to experience a more gradual but steady increase.

In China, a very uneven increase in inequality from 1981 to 2001 was interspersed with periods of reversals. Faster growth in China did not drive inequality higher. Thus, increasing inequality in China does not foretell raises in income disparities in Russia just because of growth acceleration. Which forces are at work then?

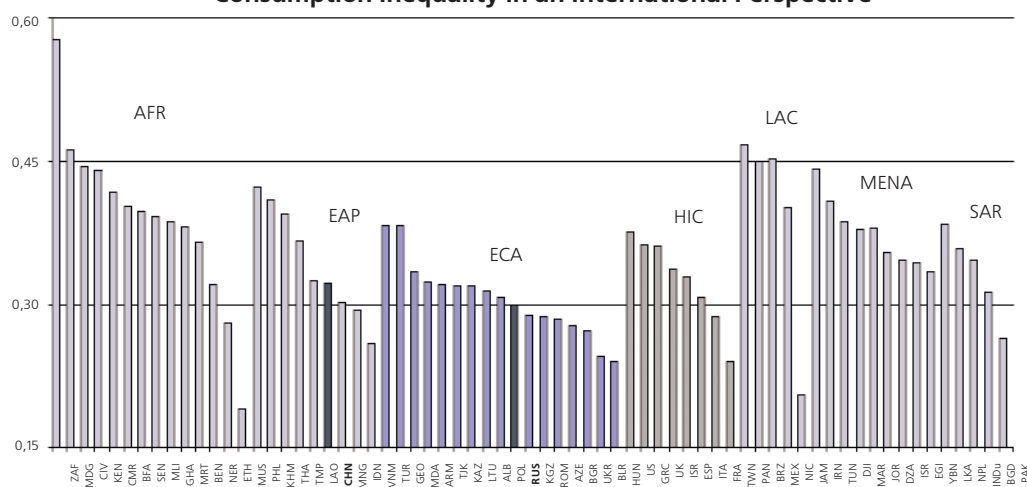
## Main Drivers of Inequality in Transition

The first five factors listed below are specific to transition; the latter three aspects are long-term drivers common to all countries in the world. The factors specific to transition interacted actively with each other and with the long-term drivers.

### 1. Wage decompression and the growth of private sector

Transition has changed the wage setting, reflecting a tighter link between productivity and wages. For most transition countries the inequality in wage distribution has been going up

Consumption Inequality in an International Perspective



Note: HIC stands for High Income Countries; Russia and China (only urban data used) are highlighted.

Source: World Bank, WDR 2006 and Inequality in LAC, and Luxembourg Income Study Working Papers 338 and 341.

throughout the whole period. In China widening wage dispersion reflects a rising education premium and an increased divergence of wages across sectors, regions and occupations, but the pace was slower than in ECA, reflecting a different approach to managing transition. Factors accounting for a large wage dispersion observed in Russia are mostly linked to the institutional and regulatory framework of labor markets and thus are policy-induced.

## 2. *Restructuring and unemployment*

The emergence of a new class of unemployed people increased inequality in transition. The scale of the increase in the number of the unemployed varied across sub-regional groupings, but this factor has been at work everywhere since the onset of transition. In China, the emergence of open unemployment came much later in the process with the liberalization of the labor market in the late 1990s (some 15 years after the start of reforms) when in excess of 50 million workers were dismissed from state-owned enterprises.

## 3. *Changes in government expenditure*

A system of social transfers was a sizeable factor, counterbalancing increasing inequality only in a few EU-8 countries (especially in Hungary), where social assistance programs expanded in real terms. Low-income CIS countries drastically reduced their safety net coverage, focusing on the neediest. Other CIS countries aimed at retaining key benefits but compressed levels to a simple per capita distribution among the claimants. China shows an even smaller scale of formal safety net development with transfer policies having a smaller impact on income distribution.

## 4. *Price liberalization, inflation and arrears*

When prices were liberalized they jumped, and inflation rates tended to persist. High inflation had strong redistributive effects in several countries in the CIS and South Eastern Europe (SEE), mainly at the expense of the poor. In a comparative perspective, inflation had some effects on income distribution in China, but in terms of magnitude, the effect was significantly smaller than in ECA.

## 5. *Asset transfer and growth of property income*

Many privatization programs have worsened the distribution of assets and income, at least in the short-term. But over time, policy reform and the elimination of subsidies have favored more equitable outcomes, generating higher tax returns to the state, with large differences across countries. One example is land privatization: as much as 90% of arable land was transferred to households in Albania and Armenia, but only 10 — 20% in Russia, Kazakhstan, and Ukraine. The transfer level was even larger in China where 200 million farmers now have land use rights for 99% of agricultural land. Equitable land reform is the major factor explaining why inequality in rural areas in China is lower than in the cities in striking contrast to any developing country.

## 6. *Technological change*

The rapid pace of organizational and technological change in both China and Russia was not only due to shifts in demand, but was also mediated by human capital endowments, the adaptability of existing skills to the new technology, labor market imperfections and the supply of new skilled labor. Generally its effect was to push inequality up, and its magnitude depended on the scale of restructuring and inclusion in global markets.

## 7. *Demographic transition and increased mobility*

Rapid changes in the average household size and living arrangements of dependants affected inequality in a complex way in both countries, combined with changes in fertility and migration. The vector of change has been generally towards reduction of inequality, with the population moving from less affluent to more prosperous regions. Different distortions weakened this effect, but the overall scale of population movement from rural to urban areas in China was unprecedented in history (several hundred million people moved in about 20 years) and it dwarfed any transitional factors that might have affected the distribution.

## 8. *Political process moving towards a preference for equality*

Democratic policy choices have become increasingly influenced by the preferences of the median voter, favoring more equality in post-transitional societies.

## Confronting Experiences in Russia and China

By decomposing inequality change in Russia and urban China and confronting their experiences, we find that the dominant driver of inequality has been wage decompression. While the share of wages has declined in the ECA transition economies and more modestly so in urban China their concentration coefficient has increased significantly.

One of the leading causes for China's growing inequality is the gap between urban and rural areas: this component makes up over a third of national inequality, and is driven mostly by the process of development. Compared to China and other developing countries, location plays a relatively minor role as a driver of inequality in ECA. While in general, income in rural areas is lower than income in urban areas, and capital cities have much higher income, the differences between urban and rural areas in Russia explain less than three% of national inequality.

In the same vein as the urban-rural factor is the process of structural change in transition. The uneven pace of enterprise restructuring in Russia is a key driver of its excess regional inequality. In China, the gap between the modern and traditional (agriculture) sectors increased from 20 to 35%, driving inequality up.

So would faster growth in transition countries be accompanied by increasing inequality on a scale similar to China's?

*Continued on page 7*

# Trade Liberalization, Inequality and Poverty Reduction in Latin America

Guillermo Perry and Marcelo Olarreaga

**C**ontrary to expectations, trade liberalization in Latin America was often accompanied by increases in wage inequality and higher premiums for workers with tertiary education. Is there a puzzle here?

In the second half of the 1980s and the 1990s most Latin American countries sharply reduced their tariff and non-tariff barriers. Many economists expected trade liberalization to reduce income inequality through an increase in the relative demand for unskilled labor. Instead, many Latin American countries experienced an increase in wage inequality and skill premiums for workers with tertiary education compared to those with a secondary one, and in many cases increases in overall income inequality. How can this puzzle be explained?

## Factor Endowments, Dynamic Effects and Initial Conditions

The answer may be related in part to Latin American countries' abundance of specific relative factors and their complementarities. Latin America is rich in natural resources (which are frequently complementary with capital and skilled labor), and has a relative abundance of capital (*vis a vis* unskilled labor), if compared to China and India, which started trade liberalization roughly at the same time. So Latin America has specialized in natural resource-intensive activities, and in some cases in moderate capital-intensive sectors. However, Latin America is not a homogenous area, which helps explain differences in outcomes across countries. For example, in 2000, Haiti had a capital to unskilled worker ratio of \$150 whereas Uruguay had close to \$80,000. In the same year, Jamaica had net exports of natural resources per worker equal to \$650, whereas for Venezuela this was close to \$2,600. So given the

differences in endowments, the consequences of trade reforms differed among countries in the region.

Furthermore, most studies on the consequences of the trade reforms have not found large labor reallocations across industries, in sharp contrast to US findings. At the same time, the share of skilled workers has increased substantially within most industries in the past two decades. The latter can be attributed to three dynamic factors:

- Development of new exports to developed countries that are relatively unskilled labor-intensive among OECD countries, but relatively skilled labor-intensive with respect to other activities in less developed countries. This has been the case, for example, with activities "outsourced" from the US to Mexico and Costa Rica.

- Enhanced competition that leads to faster "creative destruction": faster growth of more productive firms, which demand more skilled workers, and exit of less productive firms. There is indeed evidence that trade or exchange rate shocks have caused significant productivity increases and the reallocation of labor across firms within the same sector. In industries with higher import penetration there was more skill upgrading.

- Faster transmission of skilled-labor biased technological change after trade opening.

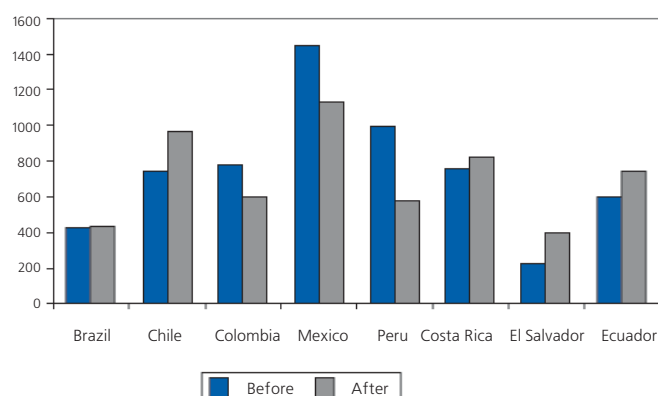
Finally, the structure of trade protection in most Latin American economies used to be biased in favor of unskilled labor-intensive activities.

## Impact on Wages, Employment, Poverty and Inequality

As a consequence of all the factors mentioned above, trade reforms usually led to an increase in relative demand for skilled labor, which was often not met by a corresponding increase in supply. Also, where trade reforms were accompanied by increases in demand for unskilled labor, this was easily met by a corresponding increase in supply due to the existence of large pools of unemployed unskilled workers in the region, which put downward pressure on the wage of unskilled workers. Hence the increase in skill premiums and wage inequality.

Regardless of whether wage inequality was rising in the region, trade reforms may have been accompanied by reductions in poverty. A casual look at the evolution of the income of the poor in Latin America before and after trade reforms gives a more optimistic picture than when focusing on wage inequality. Of the eight countries for which we have data, five show an increase in the real income of the poor, and the rest show a decline. The increases in the income of the poor (in spite of increases in wage inequality) were partly due to the impact of trade reform on average growth and unemployment. Moreover when the poor's large consumption gains due to lower prices for their consumption bundle are taken into

## Income of the Poor Before and After Trade Reform



Note: raw data from Dollar and Kraay (2002) for the income of the poor and Wacziarg and Welch (2003) for the timing of trade reform

account, they have almost unambiguously benefited from trade reforms in the region.

There is no single pattern for the effect of trade reforms on unemployment when one studies the evolution of unconditional averages: while unemployment increased after a couple of years in Argentina, Brazil and, transitorily in Peru, it declined in Chile and Colombia and did not change much in Mexico. However, if we condition the evolution of unemployment on GDP per capita and country and year dummies, then trade reforms seemed to have reduced the unemployment of unskilled workers in Latin America (at least in those countries without a very strong comparative advantage in natural resources).

Almost half of the Latin American labor force works in the informal sector. However, despite a rise in informal employment in some countries (e.g. Colombia and Peru) during the 1990s, it is unlikely that trade reforms contributed to the increase in informal work, as sectors more exposed to trade tend to have higher rates of formal employment. However, it may have contributed to other factors that led to currency appreciations and the relative growth of the non-tradable sector that has more capacity for informal labor. In any case, this would not have had any significant direct impact on poverty, while an indirect impact may have related to higher income volatility and lower protection against adverse shocks in the informal sector.

### Complementary Policies Needed

The effect of trade on poverty and income inequality depends largely on other policies being implemented simultaneously. The impact of trade on poverty reduction can be significantly enhanced (and the effects on inequality mitigated) by policies that increase the provision of and access to skills and

other productive assets for the poor. Such reforms may include measures enhancing labor market flexibility, promoting new entry, improving governance, and increasing secondary education enrolment.

For example, faced with changed wages for skilled and unskilled labor and, thus, higher incentives for continued schooling, individuals may review their decisions regarding educational attainment. But education policies need to follow to ensure that everyone can indeed invest in education.

In terms of production decisions, if prices of certain crops remain higher and production is sustainable and profitable, farmers may decide to upgrade their capital stock. Similarly, firms may exploit new trading opportunities by investing in physical capital, R&D, or adjusting the quality of their goods. These responses may lead to further growth in labor demand and further changes in wages and household welfare.

Thus, complementary policies in the areas of education, access to credit, insurance and infrastructure, as well as technical assistance to poor farmers, can help the poor to maximize the new economic opportunities offered by trade reforms. Government actions to increase the supply and quality of public education, to help overcome liquidity and informational constraints on poor families, and to move towards more competitive and efficient training and remedial education services, would play a key role in such a response.

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## 2006 ABCDE Conference: Focus on 15 Years of Changes

The theme of ABCDE St Petersburg focused on changes that have taken place in the last 15 years in transition countries after the fall of the Berlin wall. Four topics were discussed: Growth After Transition: Is Rising Inequality Inevitable?; Governance; Economic Space; and Judiciary Foundations of a Market System

Mikhail Oseyevsky, deputy governor of St Petersburg, opened the conference by welcoming the exchange of ideas to learn from each other's experiences, while Vladimir Mau of the Academy of National Economy in Russia emphasized the need for understanding the linkage between economic growth and governance. The World Bank's chief economist Francois Bourguignon discussed the progress made in understanding institutions, their history and evolution in different societies, and their influence on governance. However, more research needs to be done so as to understand the importance of institutions for economic growth. Anders Aslund observed "the surprise reversal" in the growth performance of CIS coun-

tries, resulting from overall low public expenditures in the region, similar to the East Asian model. Yegor Gaidar discussed market and political reforms that have been carried out in Russia, including some recent reversals. Gur Ofer of the Hebrew University of Jerusalem shared his experience on how modern economics was introduced in Israel and compared this experience with the transfer of modern economics to Russia.

The first session of the conference examined the question whether an increase in inequality is inevitable in transitional and other reforming countries. Pradeep Mitra and Ruslan Yemtsov compared inequality trends in China and Russia. The authors concluded that China's inequality is to a large extent a consequence of rural migration and rapid changes in the composition of the economy's output. On the other hand, Russia's inequality has more to do with recession in the 1990s, a trend which has been reversed by the early 2000s. Guillermo Perry and Marcello Olarreaga addressed the question why trade

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The analysis of possible drivers above suggests that a significant determinant of China's inequality derives from the rural-urban divide, namely, migration from the former to the latter, and rapid changes in the sectoral composition of output, a classic development phenomenon for which there is no obvious Russian analogue. Besides, faster growth in China did not drive higher inequality. Hence an acceleration of growth in Russia and other CIS countries will not automatically generate higher inequality.

Could inequality in Russia increase further? To some extent this is possible, reflecting increases in education premiums and perhaps, but not necessarily, a worsening of inter-regional inequality. So far Russia has been lagging behind Central and Eastern Europe countries in both the size and intensity of changes in the wage premium for education, and there is a potential for some widening of wage differentials between skilled and unskilled workers. While interregional factors might remain persistent (differences in incomes between regions explain up to a third of inequality in Russia), it need not aggravate an increase in inequality. On the contrary, to the extent that such inequality has roots going back to central planning, it can be mitigated through freer movement of goods and labor. In addition, depending on societal attitudes to inequality, intergovernmental fiscal transfers can play an equalizing role as well.

### Conclusions

There is no single driver of inequality in the different transition countries. Different drivers combine to create a

complex patchwork which is rich enough to allow a wide variety of outcomes across countries and over time. Inasmuch as transition related factors have not played themselves out in ECA, it is important to remember that existing trends can be influenced by policy. Such policies would include:

- Reforms of the investment climate that encourage the entry of new firms and restructuring and closure of unviable enterprises, together with the use of targeted safety nets to facilitate the associated job turnover.
- Policies which permit the freer movement of labor and goods to offset the legacy of central planning with respect to location. In addition, depending on societal attitudes to inequality, intergovernmental fiscal transfers can play a role.
- Strengthening service delivery in education.

Looking ahead, it is likely that transition related factors will become less important in the evolution of inequality in Russia compared to factors such as technological progress, global changes in skills premiums, the effects of demographic changes and migration. To the extent that China's income distribution is influenced by its greater integration in world markets, its experience is relevant for Russia in pointing to the role of such long-term factors.

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reform in Latin America has often resulted in higher inequality benefiting workers with tertiary education. Their main conclusion was that more should be invested in education to help the poor.

The second session dealt with governance and privatization. Mariano Tomassi and Ernesto Stein attributed slow growth in the Latin America region to weak state capacity, rather than to policies themselves. The authors recommended consistency and stability in policymaking and building strong institutions, legislatures, and judiciaries. Erik Berglof discussed conditions which are necessary for sustained growth. He argued that well-functioning corporate governance and bankruptcy legislation are critical to investment and growth, especially in emerging market economies. Sergei Guriev and William Megginson summarized empirical research on the effects of privatization. They concluded that privatization usually results in increased productivity. The effect of privatization, however, depends on economic institutions, such as rule of law, competition, and regulation.

The third session dealt with economic space. Karolina Ekholm focused on the obstacles that distant regions face in

development. She outlined necessary policies for success, such as reducing internal trade costs. Xiaobo Zhang, Kiran Gajwani and Ravi Kanbur compared spatial inequalities in India and China. The authors observed that due to barriers to migration, China's inequality is much higher, particularly the inland-coastal disparity, while India's states have become clustered into more educated and less educated ones.

The fourth session addressed the importance of judiciary foundations for a market system. Matthew Stephenson focused on three issues in undertaking legal and judicial reform: the resource constraint problem, the incentive compatibility problem, and the tradeoff between optimum and second best solutions, taking into account weak institutions. James Anderson and Cheryl Gray reviewed the experiences and remaining challenges of transition countries to reform their judicial institutions. The authors concluded that transition countries share many of the same priorities and concerns as other countries, whether developed or developing.

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## Patterns of Regional Inequality in India and China

Kiran Gajwani, Ravi Kanbur, and Xiaobo Zhang

**W**hat have the patterns of regional inequality been in China and India over the past five decades? Our analysis shows that China's regional inequality has an inland-coastal dimension, while the regional comparative advantage in India has shifted from land quality to the level of human capital.

Constituting more than one-third of the entire world population, and six% world gross domestic product, China and India play a major role in the future of the world economy.

The most populous country and the seventh largest economy in the world, China has achieved annual GDP growth of around 9% since the 1970s. According to the World Bank, China's achievements in poverty reduction have accounted for nearly three-quarters of all developing countries' poverty reduction. Despite such successes, 100 million Chinese still remain income poor, according to the US\$1 per day poverty line. Rising inequality may play a part in explaining the disappointing recent performance in poverty reduction.

India has the second biggest population and the tenth largest economy in the world with a GDP in 2004 of US\$691 billion. After instituting major economic reforms in the early 1990s, India has proceeded along a path of strong economic growth, averaging 6.8% annually since 1994. Yet over 25% of the population — approximately 260 to 290 million people — live below the poverty line, half of whom are concentrated in three of India's poorest states: Uttar Pradesh, Bihar, and Madhya Pradesh. Three-quarters of the poor live in rural areas, and many empirical studies have found increasing regional inequality — particularly since the 1991 economic reforms of liberalization and deregulation.

According to the prevailing growth theory of convergence, differences in growth across regions should decrease over time as the rates of return on capital and labor equalize across regions and sectors. What are the patterns of regional inequality over a long period of time in these two countries? What are the major driving forces behind the observed patterns across economic spaces?

Using data from national and provincial levels over almost 50 years in China and India, we examine the patterns of regional inequality and place them in relation to the major stages of development. The spatial decomposition of regional inequality is focused along rural-urban and inland-coastal components in China, and rural-urban, inland-coastal, north-south, literacy, and land quality components in India. Our analysis finds that:

- In terms of levels, China's regional inequality has been consistently higher than India's. The degree of restrictions on migration (the so-called "Hukou" system) might be a key reason for the observed pattern. Hukou was introduced in the 1950s as part of the heavy-industry development strategy, and created an enormous rural-urban gap. With the suc-

cess of rural reforms in the 1970s and 1980s and increase in farmers' incomes, the gap has narrowed to about 60%. India has never created institutional barriers to prevent rural people from migrating to cities. However, with the start of reforms in the early 1990s, India's rural-urban inequality rose to a level similar to China's.

- Patterns of regional inequality in China are more variable than in India, particularly before 1978. Three peaks of inequality coincide with the major events in China's modern history: the Great Famine in the late 1950s, the Cultural Revolution in the 1960s and 1970s, and booming global integration starting in the 1980s. India, being a democratic regime, has not undergone such extreme events as China, and has exhibited a smoother pattern in regional inequality during the period.

- The acceleration of regional inequality coincides with the timing of economic liberalization in the two countries. This started in China after the success of rural reforms in the mid 1980s, while in India economic liberalization sped up after 1991.

- The decomposition of inequality in China shows a strong correlation between openness and inland-coastal inequality in China. When a spatially large country opens up, certain regions with certain geographic advantages benefit more from easier access to the international market. In a country dominated by trade in manufactured goods, such as China, proximity to a port becomes a critical factor, and indeed coastal regions have attracted most of the FDI.

- India's trade patterns are different from China's in that India's service sector plays a larger role than the manufacturing sector. In countries with intensive trade in the service sector, physical geographic requirements may become less important than the value of soft human capital. The widening polarization between the south and the north since the early 1990s may be due to differences in initial education levels: the literacy rate in the south was 54% compared to 39 in the north in 1981. The southerners, being more educated, are better placed to exploit new economic opportunities in the wake of globalization.

- Prior to the mid 1980s, the end of the Green Revolution period, land quality in India may have been a more important factor in determining a region's comparative advantage, but in an increasingly integrated world, the rate of returns from education in India may have risen, and literacy has since become a more prominent reason for divisions.

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# Corporate Governance and Bankruptcy in Emerging Market Economies

Erik Berglof, Patrick Bolton, Sergei Guriev, and Ekaterina Zhuravskaya

**T**he design of corporate governance and bankruptcy reforms in emerging market economies should account for these countries' specific conditions, trade-offs and priority issues.

Corporate governance is critical to corporate investment and growth, particularly so in emerging market economies (EMEs) where corporations often are important actors in the economy and politics. While in principle all major corporate governance and bankruptcy issues in advanced economies are relevant to EMEs, the latter have a different set of priorities. The main concern in EMEs is credit rationing caused by the poor enforceability of debt contracts, stemming from corrupt and malfunctioning courts, police, and law enforcement. There is also the problem of asymmetric information. While corporate governance and bankruptcy in advanced economies are normally treated separately, in EMEs it makes sense to merge the two topics into a general discussion of corporate finance.

## Overcoming Corporate Governance Problems

How could corporate governance problems be overcome in emerging economies? This crucially depends on the particular institutional environment, and is heavily influenced by the prevailing ownership structure, costs and benefits of specific mechanisms, market structure, political economy, and the role of the state. Some specific mechanisms include:

- *Controlling shareholders.* Ownership concentration outperforms other mechanisms whenever monitoring is costly, and courts and regulators fail to protect investors. Shareholders with large stakes have strong incentives to monitor management and are less inclined to dilute firm value given that they bear a substantial share of the cost. So with all the justified attention on the protection of minority investors, the basic property rights of controlling shareholders are critical. Once the property rights of major owners are protected, they should have stronger incentives to develop good corporate governance, at least if they want to raise external capital. Needless to say, this requires a competent and uncorrupt bureaucracy and judiciary.
- *Corporate control market.* Takeovers are considered to be a rather blunt instrument for corporate governance, involving disruptions of corporate activity, and may not be socially efficient. In EMEs takeovers may work even less well, as the imperfections of the judiciary may result in takeovers by less efficient owners.
- *Boards, executive compensation, fiduciary duty, managerial labor market* are all "institutions-intensive" and require enhanced reputation mechanisms, liquid markets, and efficient

courts, that are still underdeveloped in EMEs. In other words, while we should not ignore building these institutions, we should not expect too much from them in the short and medium-term.

- *Taxes.* As government is essentially a large shareholder in every company through the tax claim on the corporate profits, the effect of taxes is similar to the effect of ownership concentration. If the government is benevolent and is interested in collecting all taxes due, it will monitor the management and penalize asset stripping and tunnelling. However, in many EMEs the government may be willing to collude ex post with management or majority owners to expropriate outside shareholders, or the government officials may settle for a bribe ex ante for not monitoring at all.

- *Bank monitoring.* Many EMEs rely on banks as the major source of funding. Yet, the domestic banking system is not necessarily very strong. In Central and Eastern Europe, it is only in the last few years that banks have begun to fund investment and have therefore gotten involved in monitoring corporate management. Banks often do and should play an important role in corporate governance and in bankruptcy. Often the most effective way to improve corporate governance in EMEs is through better bank governance.

- *Bond markets.* Bank-based finance also has important shortcomings, as it easily leads to crony lending and potential soft budget constraints. In many advanced economies, bond markets serve as a useful tool on overlending and misdirected credit. Bonds are often the only reasonably safe assets available to foreigners on a sufficiently large scale.

These mechanisms are not independent of each other. Some are based on conflicting goals, while some reinforce each other.

## Designing Corporate Governance Legislation

In designing corporate governance legislation some important tradeoffs should be considered:

- *Broad stock market vs. consolidated ownership*  
Stock market development involves the protection of minority shareholders, which may reduce mobility in the corporate control market and slow down ownership consolidation. On the other hand, policies promoting delisting, such as squeezeouts, freezeouts, and breakthrough rules encourage more efficient takeovers but undermine broad share ownership.
- *Business secrecy vs. transparency*  
Enforcing disclosure is one of the major tools for reducing the costs of outside financing. While disclosure in general may constrain managerial initiative and increase the risks of expropriation by the government, disclosure of corporate governance arrangements should be enforced.

- *Courts vs. regulators*

In some cases politically motivated regulators may be better suited to a weakly institutionalized environment. In particular, strong regulation did help the Polish stock market overtake the Czech one in the 1990s. Yet the analysis also implies that the optimal solution is therefore very different in different EMEs. The Czech system has improved dramatically in recent years.

- *Corporate law vs. corporate charters*

In EMEs corporate governance may be voluntarily improved by individual firms. Yet, even as uniform regulation is too blunt, decentralized charters impose a substantial burden on courts. The intermediate solutions are codes that are more flexible as companies can push for stricter or softer corporate governance rules according to their preferences and needs.

### Designing Bankruptcy Legislation

Compared to developed countries, EMEs are characterized by poor information sharing; a simple structure of debt, primarily as closely monitored bank debt, the risk of asset substitution as the main concern of creditors; and the inefficiency and costliness of the judiciary. This explains why the use of bankruptcy in emerging markets is rather low. Of all bankruptcy filings in the world 96.4% take place in rich countries, 3.1 in middle-income countries, and only 0.5% in poor countries.

In trying to mitigate conflicts within insolvent firms, bankruptcy laws have to determine several key rights: to trigger a bankruptcy proceeding, to control the assets during the proceeding, to issue new debt with higher seniority than the existing debt, and to propose a reorganization plan.

Based on how these key rights are allocated we can identify at least four key dimensions distinguishing existing bankruptcy systems from each other: the degree of friendliness towards debtors (or creditors); firms' orientation towards liquidation or reorganization; bias among creditors (e.g. secured vs. unsecured creditors; banks vs. bondholders); and the extent of court involvement.

Bankruptcy systems around the world, including developed market economies, vary a great deal in how they allocate these rights, and there is no such thing as a "one-size-fits-all" system. Bankruptcy law in emerging market economies should:

- Probably have a liquidation bias because reorganization procedures are much more complex than liquidation procedures. Reorganizations, to be effective, necessarily require a more effective judiciary and more competent bankruptcy practitioners. The distributional consequences of the choice between reorganization and liquidation bias depend on the distribution of political power and wealth among the conflicting parties; yet, the overall losses associated with reorganization procedures on average are larger than those of the liquidation procedure.

- Specify how much discretionary power to give to the judge, taking into account such common features of EMEs as judicial corruption, politically motivated appointments, low quality of information and the poor qualifications of judges. The most efficient procedures should be those that facilitate negoti-

ations of informed private parties, and limit the choice of the judge to a range of outcomes that result from these negotiations.

- Limit the time required to go through the procedures, as this affects the possibilities for asset stripping. According to World Bank estimates, delays account for one half of the difference between the average recovery rates in rich and poor countries. This is both because the value of claims may erode in turbulent macroeconomic environments, but, more importantly, because delays are used to tunnel assets out of the insolvent debtors. Limiting appeals, both at the beginning of and during the procedures, would significantly increase recovery rates.

- Take into account important stakeholders, such as the state, labor unions and various citizen groups. Bankruptcy could be a potential device for exercising political control over private firms or even nationalization or renationalization. When firms are unable to pay their claimants, and government is the most senior claimant, the temptation to use the threat of nationalization to pursue political objectives in private firms is great.

Other features of the EME environment, that need to be considered in the development of bankruptcy legislation, are: the coexistence of a modern, primarily urban, manufacturing sector, and a much less developed, often rural, agricultural sector based on small and medium-sized enterprises; the geographic fragmentation of finance, where individual financial institutions often dominate a particular region; and the propensity to macroeconomic volatility.

### Conclusion

Our analysis of the tradeoffs of both corporate governance and bankruptcy design emphasizes the hazards of designing one-size-fits-all solutions, and also offers some insights that would ease most of the tradeoffs in every economy.

The general framework for enforcement is of overriding importance for corporate finance. Improving enforcement is not easy, but substantial progress is possible, and most countries in Central and Eastern Europe, for example, have radically improved their general enforcement environment in little over a decade. The variation in progress among these countries also shows that enforcement does not come automatically.

An important feature of EMEs is their propensity to macroeconomic volatility. When shocks are strongly correlated across firms, the bankruptcy system, the banks, and ultimately the entire financial system comes under immense pressure. It is understandable that these countries try to incorporate the prospect of macrovolatility into their institutional arrangements, particularly in bankruptcy law. However, we believe that while these shocks do need institutional responses, they are best handled outside the court system.

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# The Institutional Determinants of Effective Policies in Latin America

Ernesto Stein and Mariano Tommasi

**E**ffective public policies are facilitated by institutionalized and programmatic political parties, legislators with sound policymaking capabilities, independent judiciaries, and strong bureaucracies. Such "institutional blessings" develop slowly over time, and the incentives of politicians and government officials, as well as their interaction with other societal actors, are crucial for their development.

In the past few decades, Latin America has experimented with a wide range of policies and reforms. Yet, the success of those reforms and more generally, the quality of public policy, has varied considerably. Some countries have been able to maintain the basic thrust of their policies for long periods of time, thus creating a predictable and stable policy environment, while others experienced frequent changes in policies. Some countries could adapt their policies rapidly to changes in external circumstances, while others reacted with great difficulty, hanging on to inappropriate policies for long periods of time. Some countries adopted policies that focused on public interest, while in others policies are filled with special treatment, loopholes, and exemptions.

What determines the ability of countries to design, approve and implement effective public policies? The policymaking process is at least as important, and as complex, as the specific content of the policy itself. It can be understood as a process of bargains and exchanges among political actors with diverse powers, time horizons, and incentives. The important features of public policies depend crucially on the ability of political actors to cooperate. Policies are more effective when:

- There are good "aggregation technologies" so that the number of actors directly impacting on the policymaking game is relatively small.
- There are well-institutionalized arenas for political exchange.
- Key actors have long time horizons.
- There are credible enforcement technologies, such as an independent judiciary or a strong bureaucracy, to which certain public policies can be delegated.

These conditions are associated with some characteristics of key players and arenas such as congress, the party system, the judiciary, and the bureaucracy.

## Chile Leading on the Quality of Public Policies

We explore the cross-country evidence on the quality of public policies, using two main sources of data: the Executive Opinion Survey of the World Economic Forum Global Competitiveness Report, which covers more than 100 countries, and an opinion survey of more than 150 experts in 18 Latin America countries conducted at the Inter-American Development Bank. The following features of public policies have been included in the analysis:

- *Stability* — the extent to which policies are stable over time. In countries with stable policies, changes tend to be incremental and done through consensus.
- *Adaptability* — the extent to which policies can be adjusted when they fail or when circumstances change.
- *Coherence and coordination* — the degree to which policies are consistent with related policies, and result from well-coordinated actions among the actors who participate in their design and implementation.
- *The quality of implementation and enforcement.*
- *Public regardedness* — the degree to which policies pursue the public interest.
- *Efficiency* — the extent to which policies reflect an allocation of scarce resources that ensures high returns.

The various indices have been combined to come up with an overall index of the quality of public policies, which in our study was an average of the other key features. Chile appears as a clear leader, with high values for all characteristics, followed by Brazil, Costa Rica and Mexico. Venezuela's policies come out as the least effective (see Table).

In the international context, Latin American countries as a group do not rank well in indices of policy quality. Chile ranks highly in international comparison, showing a higher index than Italy, Greece, Japan, France, and Belgium. A few countries — Uruguay, Costa Rica, Mexico, El Salvador, and Brazil — appear around the median internationally, and countries, such as Paraguay, Guatemala, Nicaragua, and Ecuador are at the lowest end of the distribution.

## What Can Enhance Good Policymaking?

As per the analysis above, good policymaking can be facilitated if key political actors have relatively long time horizons, and arenas for the discussion, negotiation, and enforcement of political and policy agreements are relatively encompassing and well-institutionalized. It turns out that countries with high policy index values tend to have high values in many of the institutional variables, such as the policymaking capabilities of congress, well-institutionalized and programmatic political parties, independent judiciary, and development of civil service.

Chile — the country with the highest policy index value — also has high values for each of these categories, with the exception of party institutionalization. More generally, the analysis clearly shows that some of the main behavioral characteristics are interrelated. For instance, countries with stronger congresses tend to be countries with more independent judiciaries, and also with better policies.

These processes in some cases can lead to virtuous dynamics. Executives will not tinker with the composition of the supreme court, and this will help increase the court's independ-

## Features of Public Policies in Selected Latin American Countries

Country	Stability	Adaptability	Enforcement and Implementation	Coordination and Coherence	Public Regardedness	Efficiency	Policy Index
Chile	3.0	3.4	3.0	3.0	3.0	2.9	3.0
Brazil	2.7	3.0	2.2	2.6	2.2	1.9	2.4
Costa Rica	2.3	3.0	2.4	2.3	2.5	2.1	2.4
Mexico	2.5	2.8	2.2	2.2	2.2	2.2	2.3
Argentina	2.3	1.8	1.7	1.7	2.1	1.5	1.9
Nicaragua	2.3	2.0	1.8	1.6	1.8	1.8	1.9
Venezuela	1.9	1.6	1.8	1.2	2.1	1.2	1.7

Note: The key features of public policies are classified using cluster analysis such that blue represents a "high" value of that particular variable, gray is "medium" and white is "low".

ence and reputation. Strong and independent judiciaries will tend to adequately enforce the domain and prerogatives of other institutional arenas such as congress, which will then enhance the incentives of legislators to invest in their individual and collective capabilities, and so forth.

But these processes can also result in vicious institutional dynamics, where the opposite will tend to happen. In such cases, executives may be inclined to tinker with the judiciary and to meddle in the domains that should be left to congress, lowering the incentives to invest in important legislative careers and in the institutionalization and strengthening of congress.

So if for any reason a particular political system enters into a virtuous circle, it is likely to build up its strength over time.

The opposite will tend to happen when such virtuous circles do not have time to build or are broken. Thus, particular historical events or critical political junctures, including personalities and leadership qualities, matter.

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## Governance Indicators for Selected Transition Countries (Percentile Rank 0-100), 2004

Country	Voice and Accountability	Political Stability	Government Effectiveness	Regulatory Quality	Rule Law	Control of Corruption
Armenia	29.6	34.0	41.8	53.7	36.2	37.4
Belarus	7.3	38.3	16.8	5.4	7.2	16.3
Bulgaria	65.0	51.5	54.8	69.5	55.1	56.2
Czech Republic	81.1	73.8	71.6	81.8	69.6	66.0
Estonia	85.0	79.1	81.3	93.6	81.2	80.3
Hungary	87.4	75.2	72.6	86.7	78.7	74.4
Kazakhstan	13.6	45.6	29.8	18.2	17.4	9.9
Russia	25.7	21.8	48.1	30.5	29.5	29.1
Ukraine	31.1	37.9	28.4	33.5	23.2	18.7
Uzbekistan	3.4	9.7	13.9	2.0	7.7	5.9

Source: Kaufmann D., A. Kraay, and M. Mastruzzi 2005: *Governance Matters IV: Governance Indicators for 1996-2004*.

Note: As discussed in detail in the accompanying papers, countries' relative positions on these indicators are subject to margins of error. Consequently, precise country rankings should not be inferred from this data.

## Three Dilemmas for Judicial Reformers

Matthew Stephenson

**Three difficult problems often impede efforts to design and implement effective legal and judicial reforms in developing economies: the unavoidable tradeoffs imposed by limited reform resources; the difficulty of creating appropriate incentives for decision-makers in the legal and judicial system; and an institutional version of the General Theory of the Second Best.**

Courts may play an important role in economic development by providing reliable and efficient dispute resolution, enforcing contract and property rights, correcting various market failures, and making commitments, particularly those by governments, more credible. Specifying the optimal set of judicial and legal institutions for any given country is a very difficult and context-specific task. But even if we could do that, reformers would still face three challenging problems: resource constraints, incentive compatibility, and the "second best" problem.

### Resource Constraints

Because the resources — human and financial — for development projects are limited, it is impossible to do everything one would like to do in the field of legal and judicial reform. So difficult tradeoffs must be made. Yet there is often insufficient attention paid to issues of prioritization and the sequencing of judicial reforms. Despite more than a decade of experience with programs of all types, knowledge about what factors are conducive to success, and why, remains scarce. Without more robust data on judicial systems and reform experiences the ability to set appropriate reform priorities is unlikely to improve.

### Incentive Compatibility

In order for the judicial system to contribute to economic development, the relevant parties must have appropriate incentives. Individuals must have incentives to rely on the courts to adjudicate their disputes; those with the power to subvert judicial independence must have an incentive to refrain from doing so; and the judges themselves must have an incentive to carry out the functions assigned to them. Creating such incentives, however, is often difficult.

Private parties may lack incentives to rely on the court system if the courts fail to provide dispute resolution services of acceptable quality. There may also be more subtle disincentives to reliance on the courts, such as fear of disclosing sensitive corporate information in court hearings. Yet another potential deterrent are cultural attitudes that hold the use of courts to be inappropriate, though the evidence supporting such cultural theories is problematic.

The government must have incentives to abide by adverse judicial decisions to which it is a party and to enforce judicial decisions with which it disagrees. But creating such incentives is difficult. One explanation for why governments might have an incentive to respect adverse judicial decisions involves political competition. When political competition is robust and the

competitors are long-lived political parties, holders of political power may prefer to respect the limits imposed by independent courts so long as their rivals do the same when they are in power. If this hypothesis proves correct, the implication may be that democratic reforms must precede, or proceed in tandem with, rule of law reforms.

Judges must also have appropriate incentives. The most obvious problems with judicial incentives in developing countries are judicial coercion and judicial corruption. Furthermore, judges' incentives may be misaligned when judges are unduly influenced by their political or ideological commitments, or by loyalty to a particular class or ethnic group.

### The Institutional Version of the General Theory of the Second Best

Judicial reform must often be partial or incremental. But, a well-known principle of economic theory demonstrates that the correction of certain market failures may lead to worse outcomes overall when other market failures go uncorrected. This General Theory of the Second Best applies to institutional failures as well as market failures. Individual reforms that look good when considered in isolation can have unintended negative consequences. Consider the question of the optimal complexity of legal rules. Many simple legal rules may be thought, with justification, to be too crude. "Improving" the legal rules to make them more complex and nuanced might appear to be a move toward the first-best world. However, the overall effect might actually be negative if unsophisticated judges make more welfare-reducing errors when attempting to implement complex legal rule.

As another example, consider a case in which a country's law is growth-retarding rather than growth-promoting, and the judiciary is under the government's thumb. Reforms that strengthen the independence of the judiciary without altering the legal rules may make matters worse because the courts may impede efforts by the government to adopt socially desirable legal reforms. Possible real illustrations of this problem might be the behavior of several new constitutional courts in Eastern Europe, which have flexed their newly-independent muscles to block, usually on constitutional grounds, neo-liberal economic reforms important for economic growth.

In sum, scholars and practitioners who hope to address the problem of global poverty through the reform of legal and judicial institutions need to pay greater attention to the inherent tradeoffs induced by resource scarcity, the importance of making sure that individual incentives are properly aligned, and the danger that particular institutional reforms that appear to be welfare-improving when considered in isolation, may in fact have counterproductive effects if other institutional reforms are unachievable.

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# Transforming Judicial Systems in Europe and Central Asia

James Anderson and Cheryl Gray

**J**udicial reform is a critical challenge for most transition countries. They need to strengthen accountability, fairness, and honesty, which requires broad actions on many fronts. In this, they share many of the same priorities and concerns with developed countries.

When looking from the vantage point of 1990, the magnitude of the changes needed to adapt the judicial systems of transition countries to the needs of a market economy seemed daunting. While on the face of it they had many of the elements of western judicial systems — courts, judges, lawyers, prosecutors, bailiffs, etc. — the roles, capacities, and expectations of these were fundamentally different. For example, courts and judges were part of the executive branch and fully subordinated to the political leadership of the communist party, and laws in the commercial sphere dealt primarily with relationships between administrative agencies and the regulation of production by state-owned entities.

## Judicial Reforms Put On the Backburner

After the collapse of communism, judicial reforms took a back seat to political and economic reforms, which was arguably understandable given the pressures of declining output, rising inflation, and the scramble by some to appropriate state property.

There is some logic to this sequencing. Institutions do not change in a vacuum, but rather they change in response to pressure from within or without. Economic liberalization led to an increasing demand for more objective dispute resolution mechanisms, and a flood of new cases followed. In Russia, for example, the total number of cases filed with the commercial courts nearly doubled between 1995 and 2000, with tax and bankruptcy cases rising particularly quickly. In Ukraine some 6 million new cases enter the courts each year. Increasing demand has spurred training and investment in judicial systems that have slowly increased their capacity, and broader economic growth has made more resources available to the legal system.

For countries with low demand for judicial services (dependent on the extent of economic reform) and a low capacity to deliver judicial services (approximated by a country's per capita GDP, see Figure), the priorities should be to build basic demand for impartial dispute resolution through continued market reforms and to create or reinforce the independence and accountability of the judiciary. As countries move in both directions, the demand for more extensive and far reaching judicial reform strengthens and there is a greater likelihood that efforts at reform will succeed. In Romania, Bulgaria, and Macedonia the demands for reform — both internally from the business community and externally from the EU — is very strong and the likelihood of improvement high.

## Progress to Date

The first years of transition saw little real change in the judiciaries in transition countries. The efforts focused on constitutional change, judicial independence, and the rapid adoption of commercial legislation. By the late 1990s, it became increasingly clear that weak capacity in the legal and judicial system was impeding investment and growth and contributing to corruption and poor governance. In many countries, strong and concerted efforts at change began in earnest. In some less advanced countries those efforts are only just beginning. Progress along various lines of judicial reform is outlined below.

### *Judicial Independence and Accountability*

Most countries began reform by making their judiciaries independent from the executive branch of government. Judiciaries are now legally independent in virtually all European transition countries and are moving strongly in that direction in many CIS countries. The principal issue at present is ensuring judicial accountability. Judicial corruption seems to have increased during the 1990s along with the increased role and discretion of judges in the market economy. According to the 2005 BEEPS survey, the only transition country where a majority of firms saw courts as honest in mid 2005 was Estonia. On average about one-third of business managers viewed courts as honest, and even fewer in some of the new EU members such as the Czech Republic, Lithuania, Poland, and Slovakia.

A myriad of individual steps is needed to establish true accountability in the judiciary, including:

- ensuring merit-based systems for judicial appointment, promotion, and disciplinary proceedings, as well as adequate judicial salaries;
- promoting transparency in all judicial proceedings through open access to court hearings by the public, the media, and through publication of judicial decisions;
- prosecuting some high-profile corruption cases in the judiciary or in government.

Significant steps are being taken to address corruption in judiciaries in many countries. In Romania and Russia, for example, judicial salaries have been raised substantially to a level that compares reasonably to average private sector salaries. Georgia was one of the first countries to introduce examinations for judges, and other transition countries have followed suit. As a complement to merit-based selection of judges, Slovakia has put major efforts into strengthening the government's capacity to prosecute cases of judicial corruption, including setting up a special court and prosecution office.

### Improving Public Information and Transparency

Websites to publicize laws, judicial calendars, and decisions in individual cases are being established in many countries. In Armenia, for example, a television show called "My Rights" has become the most popular show on television. In Croatia (and many other transition countries), the courts are adopting an automated case management system that will not only improve efficiency but also produce better statistical data to monitor performance.

### Judicial Infrastructure and Management

The courts faced enormous infrastructural needs in the 1990s, including rundown courthouses, an insufficient number of courtrooms, the relatively low status and minor role of judiciaries, and the lack of necessary equipment. Economic downturns in the 1990s contributed to these problems by severely limiting the resources available. Fortunately, the economic upturns since 2000 have provided more resources to government budgets, some of which are going to judicial systems, both for infrastructure and for increases in judicial salaries.

### Judicial Education and Training

In the past year not only have new kinds of cases related to a market economy emerged, but the sheer volume of cases has expanded dramatically, meaning that both better trained judges and more efficient ways of handling the case load are needed. The demand for places in law schools has expanded tremendously, and many new private law schools have opened. The best law graduates typically seek lucrative positions in private law firms or international companies, but recent increases in judicial salaries have made the judicial profession more attractive. Unfortunately, endemic corruption can be a major problem in higher education, as in other areas. Some countries—such as Albania and Georgia—have responded to this concern by instituting new written entrance examinations to allocate university positions.

### Supporting Professions: Lawyers, Notaries, and Bailiffs

In the past few years, private attorneys have arguably developed the furthest, thanks to strong market incentives and significant investments from abroad. Most transition economies have a large and growing number of law firms, both domestic and foreign, with significant competition among them. The notary profession has similarly flourished in some settings, however, in some cases the mix of complex legislation and the heavy regulatory role of notaries have added to the duration of judicial proceedings. The role of bailiffs is to enforce judicial decisions, and this is a particularly problematic area in transition economies. According to the BEEPS survey, only about 40% of firms believed that courts could enforce judicial decisions. Regulating bailiffs appropriately involves combining incentives for vigorous collection with supervision to be sure that even the smallest case receives attention. Some countries have moved toward private incentives for bailiffs, but not always with a governance framework to ensure accountability.

### Access to Justice

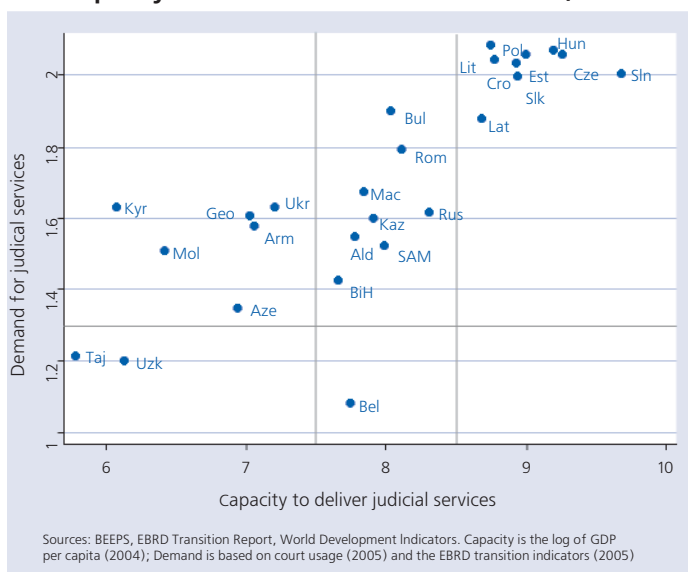
There has been insufficient progress in promoting access to justice. The high cost of both lawyers and notaries are significant reasons why judicial proceedings are considered by many firms, especially, in South Eastern Europe, to be unaffordable. Providing legal services is beyond the reach of many public budgets and has not been given significant emphasis by most transition governments. Thus access to justice for the broad population is likely to grow only slowly, as the economies and the judicial systems continue to grow and develop.

### Is There a Standard? Comparisons with Advanced Countries

Most transition countries look towards western European countries as models for the future. Yet efficiency, honesty, and affordability are still challenges for judicial systems in Western Europe as well. Comparing transition countries to Ireland, Germany (East and West), Greece, Portugal, and Spain that were included in the BEEPS survey in 2004 and 2005, provides some illuminating findings:

- The most notable differences between transition countries and western European countries are in perceptions of honesty and fairness. Germany scores much higher than any other country on honesty, followed by Greece, Ireland, Estonia (the highest scoring transition country), Spain, and Turkey, with Portugal scoring below a number of transition countries.
- Firms in all countries have major concerns about speed. Fewer than half of the firms in any country evaluate courts as being quick. Turkey, Armenia, Azerbaijan, and Tajikistan score slightly better on quickness, due to still lower demand for judicial services by firms. The new and prospective EU members appear to have the slowest courts, and the situation may be getting worse. Transition countries can take some comfort, however, from the fact that Spain, Ireland, and Portugal fare no better overall.

Capacity and Demand for Judicial Services, 2005



Continued on page 23

## Privatization: Lessons from a Quarter of a Century

Sergei Guriev and William Megginson

**P**rivatization has generally "worked" in most countries. However, in Russia it seems to have produced few benefits, whereas in China impressive economic growth has taken place without mass privatization. Are Russia and China cases against privatization? Not quite!

Privatization is a very recent phenomenon by historical standards. Until a quarter of a century ago, state ownership of business enterprises was pervasive, and growing. In OECD countries, this was a result of the Great Depression, which inspired a profound critique of private ownership, the two World Wars, during which governments established (or reestablished) public ownership over "strategic" industries, and widespread acceptance of social democrat philosophies stressing the strategic need for state control of an economy's "commanding heights". In socialist countries this was a part of ideology.

Since 1984, the share of SOEs in the GDP of industrialized countries has fallen by almost half, to less than 5%, in middle-income countries from 11 to 5%, and in low-income economies from 15 to 3%.

### Policy Challenges: Sequencing, Speed, and Methods

In privatizing firms, governments should decide on three important factors: sequencing, speed, and the method of privatization.

- *Sequencing.* The fundamental problem of privatization is that the need for it is stronger in countries with less competent and accountable governments, yet these are exactly the countries that lack mature economic and political institutions. Hence, a government that cannot run its SOEs well has to design and implement privatization and to carry out the complementary reforms, assuring property rights protection, competition, good corporate governance, optimal regulation, etc. Some Central and Eastern European (CEE) countries started with institutional reforms, others with privatization, and ultimately both approaches succeeded — probably because of the external anchor of possible EU accession. In the former Soviet Union, both approaches were attempted but neither seems to have succeeded. In some countries, both privatization and institutional changes have been delayed indefinitely. In others, privatization has happened but institutional change is still slow and has eventually resulted in policy reversals, including renationalizations.

- *Speed.* On the one hand, in order to maximize privatization revenues and find the most efficient owners, privatization should be administered case by case rather than en masse. However, as privatization often has to be undertaken by a divided government, the window of opportunity is very narrow, and mass privatization may assure the transformation's

irreversibility. However, if the government fails to design the mass privatization process well, this may undermine public support for further reforms and the legitimacy of the emerging private property rights.

- *Methods of Privatization.* Government can privatize firms through three major approaches: share issue privatization (SIP), asset sales to a single buyer, and non-cash, or "voucher" privatization. Smaller firms are sold via private markets (usually auctions) to a single buyer. Larger firms are harder to sell in their entirety, since the lack of financial intermediation precludes buyers from raising sufficient funds to pay a high price for the asset. Such firms are usually privatized via public capital markets. Voucher privatization is usually suboptimal to SIPs and asset sales but is often the only politically feasible option.

Another important decision is whether to allow foreigners to bid. For an economist, increasing competition among bidders should raise privatization revenues and eventually attract a more efficient owner. However, foreign participation is often ruled out due to political or nationalistic sentiment. In many cases, the sentiment is promoted by the incumbent bidders, who benefit from the ban on foreign ownership at the expense of the public.

### Increased Productivity and Unemployment Reduction

The results of studies, which either compare the performance of firms under private and public ownership, or pre- and post-privatization performance of privatized firms, show that:

- Privatization usually results in increased productivity but also in a reduction or no change in employment. Privatization to foreign investors results in higher productivity gains.
- Privatization is complementary to the institutional reforms introducing rule of law, hard budget constraints, and investor protection. If these institutions are not developed, privatization's impact on economic performance is absent or negative.
- It does not pay to restructure the firm before privatizing; privatization makes sense precisely because governments are not good at restructuring firms.
- Larger and more profitable firms are more likely to be sold via public capital markets. Better protection of property rights leads to a higher chance of asset sale privatization. In share issue privatization the issues are substantially underpriced, perhaps reflecting the fact that governments pursue multiple goals rather than just revenue maximization. Investors who buy the privatization share issues earn excess returns of about 30% both in the short and long-term.
- Privatizations have contributed not only to the rise of global capital markets but, more importantly, to the increase in

the capitalization and liquidity of almost all national stock markets. Each privatization raises the stock market liquidity by 2.3% in the next year and by a further 1.7 the year after that.

### Russia: Relevant Institutions Necessary

If the general lesson from privatization research is that privatization usually "works," how should one explain the failure of privatization in Russia and some other CIS countries?

The evidence suggests that privatization succeeds only if relevant institutions are in place: private property rights protection, rule of law, hard budget constraints, competition and regulation. In this respect, Russia and other CIS countries did not have the benefit of prospective EU accession to force the pace of necessary reforms. While the EU accession made privatization irreversible in CEE, in the CIS policy reversal was a risk, which did in fact materialize in some countries, including Belarus and, to some extent, Russia. The other major problem in the CIS arose from the decision to rule out foreign participation in privatization for ideological reasons. Given all the constraints, Russian privatizers had to adopt fast non-cash privatizations.

Non-cash privatization is inferior to other types of privatization. It results in insider ownership, which implies that demand for institutional reforms develops very slowly. Since market institutions are not in place, secondary market trading results in ownership concentration in the hands of a few politically connected owners. The larger the insider's ownership stake, the more he or she is protected from expropriation and regulation, and the more market power the company has. Therefore it is not surprising that the post-privatization redistribution in Russia, Ukraine, and other CIS countries results in economic domination by a few large business groups.

The other implication of non-cash mass privatization is the resulting fragility and ambiguity of private property rights. As the owners have paid relatively little for the assets, voters believe that privatization has not been fair and politicians can always find support for expropriation. This risk undermines incentives to invest.

Yet, it may be premature to argue that privatization in Russia has not worked. Although Russian transition is taking longer than in CEE, it is still happening. It is also important to put the Russian experience in perspective. Even though the examples of the Czech Republic and Poland show very different privatization policies, the resulting ownership structures are quite similar and are driven by similar factors.

### China: Another Exception?

According to common knowledge, China has been growing very fast without mass privatization, or even due to the decision not to privatize. However, the evidence shows that it is not quite true that China has not privatized. While the government initially decided to improve SOE performance without privatization, these hopes faded, and China began privatizing smaller SOEs or leasing them to managers in exchange for a fixed share in the resulting profit. This arrangement can be likened to partial privatization. Much privatization has also occurred

via foreign direct investment into China. As a result, employment at Chinese industrial SOEs fell by half during the 1990s.

China has also undertaken case-by-case privatizations of minority blocks in several hundred large SOEs. According to the World Bank Privatization Database, there were about 200 large privatization deals between 1991 and 2003 that yielded revenues of more than US\$18 billion — about as much as the entire Russian privatization.

However, China's partial privatization has not resulted in substantial efficiency improvements. This is partly due to the prevalence of soft budget constraints and issuing of non-performing loans to SOEs by state banks. While further privatization is certainly needed, the Chinese government is delaying the full privatization of all SOEs out of fear of high unemployment and the attendant negative political implications.

### Policy Implications

- Privatization can deliver substantial benefits. In some cases productivity doubles, in other cases it increases by single percentage points. The "weighted average" productivity increase is probably around 20%.
- Privatization is usually accompanied by either no change or a reduction in employment, and privatizers should be prepared to handle this increased unemployment.
- Privatization usually produces welfare gains beyond the increased productivity at the firm level.
- Mass privatization is usually inferior to the case by case approach. Non-cash privatization is generally worse than asset sales and share issue privatization. The choice between share issue privatizations and asset sales is driven by the firm size, the need to develop national stock markets, and the tradeoff between better governance under concentrated ownership versus the difficulty of finding a single buyer for a large company.
- Policy tradeoffs are resolved most effectively when privatization is transparent and open to foreign investors. However, insiders and domestic investors always lobby against allowing foreign participation and often stir up nationalistic sentiment. Precluding foreign ownership always results in lower privatization prices and lower post-privatization efficiency.
- Share issue privatization brings an important side benefit of contributing to the development of the national stock market.
- Privatization works well wherever there are good institutions.
- China and Russia should not be considered outliers. China's growth has come from private sector development, even as many SOEs are still destroying value. Russia lacked good institutions at the time of privatization, yet the demand for institutions has started to emerge.

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## Objections to Voucher Privatization: Not So Valid?

Marek Louzek

**P**rivatization voucher schemes have been widely used in the Czech Republic and in other transition countries. A review of six arguments raised against voucher privatization casts doubts that alternative privatization methods would be of lower cost and bring better results.

Six critical arguments, listed below, are usually raised against voucher privatization (VP). While each of these complaints is not without reason, realistic alternatives have very often not been taken into account.

### 1. VP did not bring any new management or any new capital

This is one of the most frequent arguments and, at the same time, one of the weakest ones. What are the alternatives? Employee co-ownership would have brought neither new management nor capital. Local investors may have provided enterprises with new management, but as they were buying enterprises predominantly on credit, they had to milk enterprises of funds or use expensive operating credits to be able to meet obligations to the state. Foreign investors demanded that enterprises were cleared of debts before being sold and were provided tax breaks or other advantages. Besides, not all sales to foreign investors were considered successful (such as of Czech Airlines to Air France) and extracted profits might have even exceeded foreign investments in some cases.

### 2. VP did not facilitate enterprise restructuring

In reality, between 1991 and 1994, as a result of organizational restructuring, the number of employees in industrial enterprises decreased by 23% and the number of larger enterprises more than tripled (see Table). Restructuring is a permanent process, which took place during as well as after privatization. The first Czech government took the right decision not to restructure enterprises up for sale, leaving this to new owners.

### 3. VP was "formal," as it did not look for strategic owners

The purpose of VP was indeed not to find final, strategic owners but to denationalize enterprises and make it possible for private investors to buy shares in the capital market. Only during the so-called "third wave" of privatization did ownership become concentrated in the hands of final (strategic) owners. Had VP not taken place, enterprises could have been drained by managers or spontaneously privatized by insiders.

**Restructuring of the Czech Industry During Privatization**

	1991	1992	1993	1994
The number of larger enterprises*	1,245	2,416	3,109	4,024
Number of employees	1,724,000	1,522,000	1,409,000	1,342,000

Source: Czech Statistical Office, \*enterprises with more than 25 employees

### 4. VP was carried out without a proper legal framework, making asset stripping possible

Some admit that certain post-privatization "tolerance" should have not lasted so long, and the legal framework should have been created sooner. This argumentation mixes up two different things: legal framework and market regulation. The legal framework, in the form of approved privatization laws and regulations, was already in place at the time of privatization. The diversity of the financial market's monitoring and regulation systems that first emerged in the West, reflects not only specific economic development but also different political views on the optimal extent of government intervention. Since capital markets in transition countries are immature, they should be regulated less, not more, than developed markets. Regulation may create a moral hazard for investors looking for higher returns in transition countries.

### 5. VP created distributed ownership, preventing the effective exercise of ownership rights

While VP did not immediately generate strong majority owners, in fact, in the first wave of privatization, investment privatization funds controlled 72% of all issued vouchers; and in the second wave as much as 60%. After completing VP, the Czech equity market was comparatively liquid, enterprise ownership relatively dispersed, and managerial influence quite strong, which resembled the US or UK model. When majority holders gradually bought shares in Czech companies, the liquidity of the equity market decreased, the influence of minority shareholders diminished, and managers became dependent on the interests of the majority holders. This resembles the continental European model with strong controlling shareholders and weak managers and less liquid capital markets. Various models seem to be working in the West, so transition countries should have the right to choose any of these.

### 6. VP did not generate any fiscal gains

Considering that VP involved mostly low-performing enterprises, which would have otherwise been constantly pressuring the government for financial help, VP symbolized the fact that such enterprises no longer had any right to demand that the government foot the bill for bad management.

Privatization in the Czech Republic was a unique process, though was certainly not perfect. The key question remains whether other privatization methods would have brought better results and would have incurred lower transition costs. This can be seriously doubted.

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# The Dynamics of Institutions, Development, and Elites

*Francois Bourguignon*

**C**onsiderable progress has recently been achieved in understanding the central role of institutions in development. More research is needed, however, to understand the dynamics of institutions: the ways they arise, what makes them change and how we can promote this change where needed.

Many of these institutional dynamics are linked to the key role played by elites. Thanks to the control they often have on political power, they can promote reforms or block them. In both cases they act in their own interest or according to their own view of some superior principle of social justice in the case of "benevolent" elites. The dynamics of institutions — in the economic or political spheres — depends crucially on the way these elites think and behave and, of course, on the degree of control they have on the public decision-making process. As discussed in the World Development Report 2006 "Equity and Development," democracy or equality in political rights may play a crucial role in economic development and poverty reduction precisely by facilitating the reform of economic institutions captured by the elites. But, of course, democratization and the equalization of political rights themselves depend on the power of the elites.

In developing countries where democratization has not yet been fully achieved, the nature of institutions and the way they evolve over time depends very much on the attitude and the behavior of the elites. The fact that elites can capture political and economic power does not mean that institutions cannot change. Exogenous changes in the economic environment (technology, international trade, etc), perceived threats of domestic collective action against the elites and the costs of resisting it, and conflicts of interest within the elites may all be powerful factors bringing change in economic and political institutions.

This text briefly examines some of these factors. It does so within a simple framework that links the quality of institutions, the role of elites, and economic growth. The discussion is restricted to economic institutions and economic governance.

## General Framework: Institutions, Policy, and Growth

The recognition of the role of institutions and governance has been a major advance in the theory and empirics of economic growth. Of course, economic growth is ultimately determined by changes in a country's environment and technology and by policy decisions in various areas, including trade, regulation, public infrastructure and macroeconomic stability. But

there is a political economy behind those policy decisions, in which the interests and power of the elites are confronted with those of the rest of the population, or of other elites. The way political economy mechanisms work — and the decisions they produce — ultimately depends on the institutional framework of the country. What economists call a "reduced form model" would directly link governance factors, exogenous economic factors, and the rate of growth of an economy. Several empirical papers have shown the significance of governance as a determinant of growth in conventional cross-country regressions — see among others Rodrik, Subramanian and Trebbi (2004), Acemoglu, Johnson and Robinson (2002), or Knack and Keefer (1995).

In the preceding argument, however, governance is exogenous. But this raises questions about the dynamics of institutions, and about institutional change. Is it possible to change institutions in an exogenous way, for instance because economists say that some kind of governance is better for growth than another? Or is it the case that institutions change endogenously during the growth process and alongside the accompanying transformation of society? These are the questions we need to answer for a better understanding of economic growth and all its social consequences. More precisely, we need to discern the ways in which elites may affect governance institutions, either single-handedly when they control enough economic and political power or through their interactions with the rest of the population.

## Who are the Elites and How do They Behave?

Following Mancur Olson (1971), elites may be defined as groups of individuals that share, give, and obtain political and economic power; groups with partial or total control over policy or the economy. There are many groups that could qualify as elites, for example, large landowners or business-owners, bureaucrats, politicians (at least in authoritarian regimes), but also union leaders, and in some cases regional leaders. Elites are not necessarily homogeneous and may, at times, have conflicting interests depending on what sector of the economy they control.

Elites choose policies that maximize their payoffs. Similarly, elites will attempt to maintain institutions that maximize their welfare over the long-run, or they will promote institutional reforms with the same aim. Because of their power, these groups are able to extract rents from the economic system. This rent-seeking behavior prevents competition and entry of more efficient agents, reducing the efficiency of the economy. Note,

however, that some elites may be benevolent, in which case their interests may coincide with the interests of non-elite groups.

Reducing the efficiency loss from rent-seeking may require the development of institutions including democracy at the national or local level, the rule of law, protection of property rights, contract enforcement, accountability, press freedom, regulation, trade openness, or anti-corruption mechanisms. Non-benevolent elites will resist such change if it reduces their rent-extraction power. Also, elites may be constrained by social norms, such as religion or solidarity within a social group broader than the elite. But social norms may also reinforce the power of the elites, as with the caste system in India.

### Measuring and Explaining Institutional Strength and Change

Considerable efforts have been devoted to determining if democracy, the rule of law, and the other institutions mentioned above actually contribute to the efficiency of an economy by restricting the power of elites. How do we measure the strength of these institutions and their impact on growth? A lot of indicators have been used to measure the quality of institutions and compare them across countries. We can distinguish between so-called objective and subjective indicators. "Objective" indicators are based on outcomes or behavior. For instance, in the investment climate assessments done by the World Bank and the EBRD, firm managers are asked factual questions about institutional factors that impair their efficiency and their relative importance. Other indicators are "subjective" in the sense that they measure expert perceptions of some aspect of the institutional environment of a country. Examples include, among many others, the corruption perception index by Transparency International, or the Country Performance and Institution Assessment (CPIA) by the World Bank. Kaufman, Kraay and their coauthors in the World Bank have also built summary indicators of the quality of institutions by combining a large number of indicators from various sources (Kaufmann, Kraay and Mastruzzi, 2005).

These indicators have been extensively used to show the role of governance institutions in economic development. The inefficiency of weak institutions is demonstrated using cross-country regressions in which long-term growth rates are shown to depend significantly on preceding indicators. More important, however, is understanding these determinants of institutional strength and change. Various attempts have been made to take into account the endogeneity of governance indicators in cross-country work. However, they are generally based on the assumption that institutions are persistent and the product of some initial conditions in the distant past. For instance, Acemoglu, Johnson and Robinson (2001) measure governance indicators observed today by the mortality of settlers in developing countries in the 16th century. Other authors use geographical instruments, the nationality of colonizing powers, or the ethnic composition of societies.

These exogenous factors might well be valid instruments from a statistical point of view. The problem is that they only permit an extremely rough and completely deterministic view of the development of institutions. They do not explain how institutions have changed to permit an economic development process that was impossible before — for example, the Meiji restoration in Japan, the 1978 reform in China, or the transition in Eastern and Central Europe in 1989. The models that describe the relationships between governance and development are missing the equation that explains the evolution of institutions, and the possible role of the behavior of elites in that evolution.

Simple analysis suggests that an institutional change should take place spontaneously in cases which are perceived by the elites and the population to be Pareto-improving, for instance, as the consequence of some exogenous event. Reciprocally, resistance to change will arise in situations with potential winners and losers, in particular where the elites are among the latter. This may happen even when there is a potential overall gain from the reform. Even if the losing side can be compensated for the loss, a commitment device is needed to guarantee them that compensation. In the absence of such a device, institutions will remain unchanged unless collective action is taken, possibly supported by a dissident elite group. Collective action may be violent. The French Revolution, for instance, may be seen as resulting from a conflict between two elite groups: the nobles, who controlled political power, and the bourgeoisie who controlled an increasing share of economic power. Eventually, collective action was successfully taken against the former with the non-elite brought in by the latter.

Open conflicts may be avoided if agents are rational. The threat of a conflict may be sufficient to trigger institutional change. If an elite group is threatened by a conflict, and the cost of avoiding the conflict is higher than the cost of accepting an institutional change, the elite should accept the change. This is the analysis of Acemoglu and Robinson (2000) on the extension of the franchise in western countries in the 19th century. But, of course, for such a peaceful or possibly negotiated institutional change to take place, it is necessary that all agents be correctly informed.

The preceding examples refer to fundamental institutional changes in the political sphere. The dynamics of economic institutions lead to less radical situations but they obey the same logic: consensual changes in Pareto-improving situations; the use of political power or some kind of collective action to force the change or to oppose it; negotiated changes when commitment is possible or the cost of resisting collective action is too high.

### Some Examples of the Role of Elites in Institutional Change

Dramatic institutional changes — marketization, privatization, and democratization — have taken place in transition countries. In other parts of the world, changes have been no less impressive: the drive towards universal suffrage in Africa, unilateral trade liberalization in Chile, land titling in some sub-Saharan countries, and affirmative action against the caste sys-

tem in India. In each, the changes can be traced back to the behavior of elites or the implicit threat felt by the elites in facing some domestic or foreign-led action.

Institutional reforms in the USSR and China in the 1980s are good examples of the role of elites in promoting and resisting institutional changes aimed at enhancing the efficiency of the economy. Following Aslund (1989), the perestroika process in the USSR may be seen as two stages. The first stage resulted from the realization on the part of the leadership that the inefficiency of the Soviet economy was creating a growing gap in economic and military power with respect to the US. In response, a first set of measures was introduced to "marketize" the economy. This first set of reforms was quickly opposed and even reversed by the existing bureaucracy, which was trying to protect its rents in the command economy. The second stage of the reform then involved moving towards more democracy in the choice of managers, and more transparency in the management of firms in an attempt to bypass the bureaucracy. But increased democracy freed centrifugal forces that eventually led to the dissolution of the USSR and the full shift to market economies in both the CIS and the former satellite states. The institutional change in the USSR thus resulted from a complex combination of forces including the decision by a benevolent elite to make economic institutions more efficient, and resistance by another part of the elite trying to protect its rents.

The reform process in China initially paralleled that in the USSR. A benevolent leadership launched reforms aimed at making the economy more efficient, using neighboring countries (Taiwan or Singapore) as models. The bureaucracy could see clear advantages in the expansion of economic activity and therefore of its rents. The reform process has been progressive, preventing outright opposition from the bureaucratic elite and showing that it could benefit from new opportunities. Although grossly simplified, this description of the reform process in China fits the Pareto-improving model mentioned earlier.

In Africa, several elite-driven reforms have responded to inefficiencies and/or post-conflict situations. To some extent, the situation observed today in Ethiopia and Madagascar is a post-socialist transition similar to that observed in Eastern and Central Europe 15 years ago. The situation in post-conflict countries such as Mozambique, Rwanda or Uganda is different. There, a benevolent elite was able to promote efficiency-enhancing reforms mostly because the conflict permitted it to eliminate the purely rent-seeking elite and the perpetual fight for the appropriation of rents. This process may have been facilitated by the international development community and some implicit institutional conditionality by donors. It is not clear, however, that these reforms are irreversible. And many African countries are still run by rent-seeking elites, with negative effects on growth and development and reforms that are slow or absent.

The numerous institutional changes that took place in developing countries as well as aborted reforms or the persist-

ence of inefficient institutions should be studied in more depth to better understand whether these changes led to a Pareto-improvement, and if not then who the winners and losers were; furthermore, what kind of arrangements were made for institutional changes to take place or, on the contrary, why no such arrangements could be implemented.

### What Can International Organizations Do?

Institutional change is highly political and country-specific. This makes external intervention impossible, in particular by international organizations, without violating the sovereignty principle. So, what can be done?

The preceding arguments suggest a simple basic principle: ensure that all actors in society are aware of the distributional impact of the institutional reforms being envisaged. A lot of progress could be achieved simply by making information available to agents, if the international development community had a better understanding of the role of institutions based on its work in monitoring reforms, comparing experiences across countries and, of course, appropriately processing data on institutional indicators. In some cases, Pareto-improving reforms are not undertaken because information on the direct and indirect effects of the reforms for all actors is not available. In other cases, negotiated decisions are not taken because of the lack of information on the identity of those who would gain or lose, how much they would gain or lose, and ways to make up for those losses.

Of course, there may be some scope for more direct action by international organizations. Some loose conditionality may be exerted on resources provided to a country when institutional change may be part of the discussion on optimal poverty-reducing strategies. Actually, something of this type is already taking place today through the role of the Country Policy and International Assessment (CPIA) in the allocation of the aid dispensed by the International Development Association. The Cotonou agreement signed in 2000 between the European Union (EU) and African, Caribbean and Pacific (ACP) countries also included this kind of conditionality. The development of universal suffrage in Africa owes very much to it. Yet it is unlikely that such channels can be as effective as making institutional reforms truly consolidated and held by recipient countries, possibly through providing the relevant information to them.

All this points to the need for the international development research community to go beyond the analysis of the development impact of governance. It must now try to gain a better understanding of the consequences of institutional reforms and of the dynamics of institutions.

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## Joined at the Hip: Economics and Politics in Russia's Transition

*Yegor Gaidar*

**T**he last few years have seen important economic reforms carried out in Russia. These include the legalization of private land ownership and land sale, and the tax reform, which dramatically cut the tax burden and increased the amount of tax collected by the state. But simultaneously the imperfect, yet functioning system of democratic institutions, in place by early 2000, has been dismantled piece-by-piece. This system included elections that made a real difference, a free and influential media, a parliament that was loyal to the president yet independent, relative autonomy in regional political decision-making, and influential entrepreneurial organizations.

The underlying ideology of recent developments is clear. Hundreds of books and thousands of articles have been published around the world describing the advantages of the "Chinese way" over the "Russian way" in solving the problems of post-communist development. I take the view that the thesis that China was right in separating economic and political reforms, while the Soviet Union was wrong in trying to combine these reforms provides a simplistic picture of events.

### Coercion as the Basis of the Socialist System

Socialism is a system in which politics and economics, the state structure and day-to-day economic life, are closely intertwined. Within the framework of the stable socialist system formed in the late 1920s and early 1930s, the availability, for example, of bread in the shop round the corner depended not on the interest of the producer or the seller of bread (as it should, according to Adam Smith), but on the fact that both the producer and the seller of bread were aware that if there was no bread in the shop they would be severely punished. As long as economic agents are convinced that the authorities have unlimited power to force people to do what they would otherwise not do in a market economy (for example, to work for free or for fictitious pay, or to surrender grain at non-market prices), then this system will work. As soon as the authorities and society come to doubt whether the regime is capable of using force to coerce the population to behave in a way that contradicts its economic interests, the system stops working. As a consequence, bread disappears from the shops.

The problem with the socialist system is that economic development and industrialization undermine the foundations of stable governance. As experience shows, given the political will, brutality, and a messianic ideology, it is a feasible task to kill several hundred thousand people and send millions to labor camps. But this is only possible in an agrarian country where the majority of the rural population is illiterate. It is more difficult to do the same in a literate, developed and urbanized country. As the level of development rises, the

authorities, society, and the security agencies gradually lose their confidence that soldiers, in the event of disturbances, will agree to fulfill the orders of a regime which they did not really choose, and shoot at the crowds.

In 1989 Beijing was the capital of a then largely agrarian and not very highly educated nation. During the demonstration on Tiananmen Square, the authorities did not trust the Peking garrison. In order to crush their own people with tanks, the authorities had to move in troops from near the Soviet border. In the USSR in 1991, there were no troops ready to shoot at their own people.

That this could happen was brought home to the Soviet leadership much earlier, during the events in Novocherkassk in 1962. At the time a comparatively modest rise of prices (by 30%) triggered unrest in the city, and the authorities lost control of the situation. The troops sided with the people and refused to use force. Only Interior Ministry troops brought from Rostov, after being given direct orders by the authorities, opened fire on the crowds. The Soviet leadership remembered that the communists had come to power because soldiers had refused to shoot at the people in February 1917, paving the way for turmoil from which they had emerged the winners. So, as many documents of the period attest, the fear that something similar might be repeated in their own case was an important factor in the making of key political decisions. For example, after the events in Novocherkassk the topic of raising retail prices for staple consumer goods was taboo for decades.

### From Major Exporter to Major Importer

As archive records of the Politburo meetings show, the key issue for the Soviet leadership in the final decades was how much grain could be mobilized and how much grain the country needed. When it became clear that there were limits on the capacity for using coercion, the amount of grain controlled by the state began to diminish. In the 1980s, the Soviet Union became the world's biggest importer of grain; this was an economic and political turning point that determined the development of the USSR in the last years of the communist regime. The Soviet leadership, forced to meet urbanized society's growing demand for food, was wrestling with this problem against the background of a chronic agricultural crisis and uncompetitive domestic industry. The share of engineering products in the total volume of Soviet exports for convertible currency was about 3%. When the currency crisis in the Soviet Union became obvious, the topic of increasing the exports of the engineering industry was never brought up. Everybody in the Soviet leadership knew that it was unrealistic.

The discovery of vast oil fields with unique production characteristics and shallow oil deposits in Western Siberia came

as a magic cure. The development of these fields took place at a time of anomalously high oil prices. From 1973 to 1985, oil exports in nominal terms increased by more than 10 times. From that time onward, food supplies of major Soviet cities became hostage to the situation in the world oil market and Soviet crude production.

### Three Pillars of the Soviet Economy

By 1985 the Soviet economy was dependent on three factors:

- the weather in the main agricultural region and, consequently, the size of the crop;
- the situation on several major oilfields;
- world oil prices.

A large trade shock and falling oil prices made clear that the seemingly solid totalitarian regimes in industrialized countries with a highly educated population did not have all that many resources to shore up their stability. The mid 1980s was a difficult period for all oil-producing countries, not only the USSR. In Mexico the policy of "managed democracy" started to be dismantled. In Venezuela the democratic regime collapsed. But no country suffered a crisis on the scale that hit the Soviet Union.

In a country dependent on commodity price fluctuations, a trade shock worsens the terms of trade not by several percentage points, but by several times. This affects the financing of the army, education, health, science, and culture. Nevertheless, with time many countries have managed to adapt themselves to this situation. However, the legitimacy of the socialist regime is based on the idea that wise leaders, equipped with Marxist ideology, know what direction to lead the country in better than the people. For such a regime to recognize its own inefficacy is a political impossibility amounting to a decision to dismantle the regime. It is very clear from the archive materials that the Soviet leadership never even discussed such a possibility.

This explains why the Soviet regime, when facing a large-scale trade shock, was moving toward its own demise and state bankruptcy as a calf being led to slaughter. It hardly tried to do anything to stop the imminent disaster, instead it watched currency reserves shrinking, payments toward foreign debts falling, the consumer market suffering a crisis, the grain stocks depleting — in short, everything that preceded its demise. In August 1991, like in February 1917, soldiers refused to shoot at the people. From that moment on, the regime was not only doomed, it ceased to exist. From that moment the question as to whether it was possible to separate, in time, political and economic reforms became irrelevant. The collapse of the socialist political system made it impossible to preserve the economic system.

I have described the factors that led to the demise of the USSR because I see dangerous trends in Russian policy that are creating the risk of past mistakes being repeated. For the first time in recent years, oil prices in real terms have almost reached the level of 1985, the time just preceding the collapse of the Soviet economy. When oil prices are high it is all too easy to assume a multitude of budgetary commitments, to launch nation-scale projects, to raise the wages of public-sector employees, and to implement social programs. To go back on these commitments if prices plummet would be difficult or impossible. The Soviet leadership could not do it. It makes no sense to step on the same rake again, but it is a temptation difficult to resist. This is not only Russia's problem, but a problem for all countries that depend on world commodity prices. If we do not want to live through another grave economic crisis, we must become aware of the seriousness of the risks connected with the volatility of commodity prices and their impact on the national economy.

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*Continued from page 15*

- Transition countries also compare poorly to Greece, Turkey, and Germany in their ability to enforce decisions. However, Portugal's scores are among the lowest of all countries.
- Transition countries fare relatively well in affordability in comparison with Western Europe, although on average only about one-third of all firms surveyed agreed that courts are affordable. The highest marks were given to Estonia, Belarus, and Latvia, while most central and southeastern European countries trailed behind and have deteriorated even further from 2002 to 2005. The two countries where firms considered courts to be least affordable were Ireland and Portugal.

### Conclusions

Judicial reform is a critical challenge for most transition countries. Meaningful progress requires strengthening accountability, fairness, and honesty, calling for broad actions

on many fronts to select the right judges and support staff, train, remunerate, and evaluate them adequately, and provide the infrastructure and IT systems to promote efficiency and transparency. More generally, transition countries share many of the same priorities and concerns as other countries, whether developed or developing. Even more advanced countries in which citizens trust the honesty and competence of their judges must grapple with problems of judicial delay, affordability, and the ability to enforce decisions. Judicial strengthening may not be perceived by businesses as the highest priority in all societies, but it will be a continuing challenge almost everywhere for years to come.

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## The Eurasian Growth Paradox

Anders Aslund and Nazgul Jenish

**S**ince 1999, CIS countries have had higher annual growth than Central European countries — a direct reverse of the situation in the 1990s. Lower public expenditures and oil seem to be the main factors behind this "growth paradox."

Immediately after the collapse of communism in 1989, economic output fell sharply in all countries of the former Soviet bloc. In 1992, however, Poland recorded growth, and other countries followed. Various studies on the 1990-1998 growth have come to approximately the same conclusions:

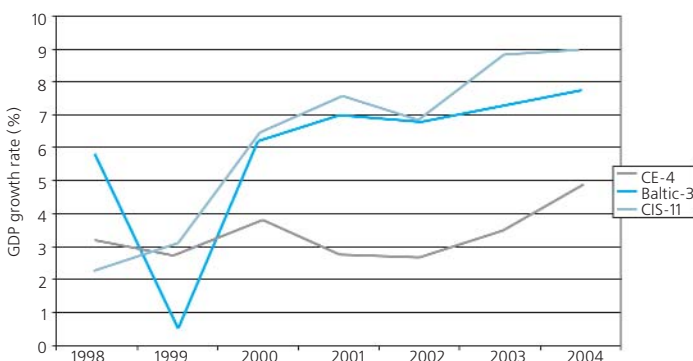
- Radical and comprehensive reforms lead to early and strong growth;
- Most relevant in these comprehensive reforms are macroeconomic stabilization, deregulation, and privatization;
- The Washington Consensus has worked where it was applied, notably in Central Europe. The problems persisted where the principles were not applied, for example in the former Soviet Union.

However, developments after 1998 have been rather perplexing. In the six years from 1998 to 2004, the former losers turned into winners. In the CIS, 11 countries (excluding Turkmenistan, which is not included anywhere in this article due to its poor statistics) recorded an annual average growth rate of 7.8%, while four central European countries — Poland, the Czech Republic, Slovakia, and Hungary — only recorded an average 3.6% growth. The Baltic countries were doing almost as well as the CIS. How can the CIS lead of 4.2 percentage points a year be explained?

The composite Transition Index compiled by the EBRD, which explained much during the early part of the transition, has remained almost flat for all groups of countries after 1998. Other plausible explanations — investments, human capital or technology — can hardly provide an explanation either.

Turning to other factors, direct causes related to the Russian financial crash of 1998, may be at work. Events after

### GDP Growth Rates in CE-4, Baltic-3, CIS-11, 1998-2004



Source: World Bank Development Indicators 2005, UNECE Online Statistics

the crisis included a significant devaluation, an immediate commodity boom, a massive expansion of exports throughout the region, a substantial fiscal tightening that also meant a sharp decline in barter and non-payments, and perhaps most importantly, a critical mass of market reforms and private enterprise. Another often mentioned and politically neutral explanation refers to the laggard effect, meaning that countries with a lower level of development grow faster than other countries, other things being equal.

However, striking systemic differences have developed in recent years. The CIS countries have drastically cut their public expenditures and budget deficits. Public expenditures, as a percentage of GDP, amounted to 26% in the CIS and to as much as 46% in Central Europe in 2003. Budget deficits in Central Europe are around 6% of GDP and slightly less than 1% in the CIS.

The CIS countries have de facto freer labor markets than Central Europe. Being a part of the CIS also implies access to different markets with more exports to Asia and less to the EU. We could call this the "CIS factor."

Oil is another important factor. Among 20 transition countries there are three major oil exporters: Russia, Kazakhstan, and Azerbaijan.

A regression analysis that includes government expenditures, lagged GDP in PPP, investment as a share of GDP, oil, corruption and the "CIS factor," shows that:

- Government spending and energy exports have the strongest explanatory power. A reduction by 1% in government spending increases the growth rate by 0.14%. This factor alone explains about two-thirds of the difference in the average growth rates between the two groups of countries.
- Corruption and the "CIS factor" are marginally significant. The latter implies that, contrary to the conventional wisdom that lasted up to 1998, it is better to be further from Brussels in order to achieve higher growth rates.

So, following John Stuart Mill more than 160 years ago, our analysis implies that more state is bad for economic growth, and less state is better, at least among the postcommunist countries at their current stage of development. The proven means to boost economic growth is to cut public expenditures, especially in the case of a big, bad, corrupt state.

Also, one should not treat Central Europe or the EU as an ideal model but rather look at what has worked. The CIS countries seem to have followed the East Asian model, for better or worse. And we know that such a model has delivered more growth than the EU model has done. This should be reflected on preferably in the policy of international financial institutions.

*Anders Aslund is a Senior Fellow at the Institute for International Economics, Washington, DC. Nazgul Jenish is a Ph.D. student at the University of Maryland, College Park, US. The article is based on the keynote address delivered by Anders Aslund at the 2006 ABCDE Conference in St. Petersburg.* ■

## Lessons from the "Slavic Tiger"

Yudit Kiss

**Slovakia is the new success story of Europe. Most observers attribute the Slovak "economic miracle" to recent government measures, which aim to encourage foreign direct investment. The ground for Slovakia's economic rise, however, was prepared by the preceding long and painful transformation process.**

Newspapers talk about a "Slavic tiger" as a recent World Bank study lists Slovakia among the 20 most attractive countries in the world for doing business and Bratislava played host the last Bush-Putin summit. The Slovak "economic miracle" is often put down to recent measures taken by the Dzurinda government, aimed at encouraging foreign direct investment, offering investors a 19% flat tax rate, preferential treatment and revised (business-friendly) labor laws. The ground for the somewhat unexpected economic rise of Slovakia, however, was prepared by the preceding long and painful transformation process. And therein lies a useful lesson for our miracle-hungry world.

Following WWII, Slovakia went through a forced Soviet-style industrialization, focusing on the heavy arms industry. In the late 1980s, Czechoslovakia was the second largest arms producer within the Warsaw Pact, and the world's seventh largest arms exporter. Slovakia produced 65% of these weapons, with 80,000 persons employed directly in the sector. After the Velvet Revolution the Czechoslovak government elevated conversion — swords into ploughshares — to the level of state policy. From 1992-93, however, the project was gradually abandoned and the affected companies were left to themselves. Conversion nevertheless became the perfect pretext to fuel separatist ambitions in both parts of the Federation. Czech political demagoguery presented Slovakia as a hopelessly backward country clinging to its obsolete weapon industry; in Slovak rhetoric arms production became the symbol of national sovereignty. During his terms as Prime Minister of independent Slovakia, Vladimir Meciar did his best to preserve and promote the sector, but was unable to reverse the decline.

Ironically, the process initiated by Vaclav Havel and his fellow trailbreakers, driven by ethical arguments and pacifist convictions, was accomplished by the generals of NATO. The promise and later reality of membership in the Alliance gave an unexpected push to the sluggish transformation of the Slovak defense sector. However, according to revised military doctrine, national armed forces need new types of products not necessarily supplied by the domestic industry. NATO membership only brought a few, modest military contracts, which were, principally, offset deals. Exports to non-NATO countries are restricted, due to the lack of domestic references, fierce competition on the weapons markets, and the introduction of strict arms exports controls. Thus, at present the defense industry produces approximately one-tenth of its 1988 peak output, and employs 776 persons. Many compa-

nies were forced to close down, and several teeter on the brink of bankruptcy.

The way Slovakia coped with this heritage is rather instructive for countries struggling with similar burdens. It can be illustrated through the case of Martin (60,000), a typical defense industry town, whose fate was inseparably tied to its main company, ZTS TEES Martin, one of the principal arms producers of the former Czechoslovakia. In the mid 1980s the enterprise had nearly 16,000 employees and a capacity to produce 250-300 tanks a year. In the early 1990s Martin became a showcase for conversion policy, then it was forgotten and had to face ZTS Martin's drawn out agony alone. Employees, subcontractors and the whole region were pushed into a desperate struggle for survival.

By 2005 the company had failed, but the city had succeeded in making a gradual shift from a state-run heavy arms industry monoculture to a diversified local economy, based on foreign direct investment and domestic SMEs. Some of the conversion projects survived, and many new private companies were set up by former ZTS managers and workers. The process started slowly and locally, but was suddenly accelerated by the Dzurinda governments' measures. Today the major employers in Martin are Volkswagen (cars, Germany), Ecco (shoes, France) Glacier Garlock Bearings (bearings, US), TrimLeader (car parts, US-Japan), Francesca Creation (paper, Belgium). The city has two industrial parks and a business incubation center. The automobile industry — the principal engine of the present Slovak growth — is often among the first choices for converting military companies or their redundant workforce.

Similarly impressive changes took place in other former strongholds of the Slovak arms industry, showing that regional development might offer solutions to the problems of industrial adjustment. With integration into the European Union, local mayors and government officials hope to turn the former Slovak military industrial triangle — Dubnica-Martin-Detva — into a prosperous industrial zone. Depending on their age, they evoke a new Ruhr-region or a Silicon Valley.

The transformation of the Slovak defense industry had a very high price in terms of wasted human resources, development opportunities, production assets and know-how. The present situation might compensate for some of these losses. The investment boom, however, might be short-term if the comparative advantages of the country erode quickly, particularly in the face of eager competitors further east in Europe or in Asia. The next challenge for Slovakia is to turn the economic "miracle" into a long-term development path.

*Yudit Kiss is a Hungarian economist based in Geneva. She has contributed this article to BT. The article is based on the materials of the book "Defense Industry Transformation and European Union and Nato Enlargement. The Choices of Central Europe" forthcoming in 2007 in Oxford University press. ■*

### Europe and Central Asia Trade Study Launched

*From Disintegration to Reintegration: Eastern Europe and the Former Soviet Union in International Trade* analyzes the evolution of trade in 27 transition countries since the fall of communism. It finds that most of the region's countries are better integrated into the global economy today than at any time since the Russian Revolution. Over the past 10 years, exports have tripled, imports have increased two and a half times, and trade has grown at a faster pace than any other region worldwide. However, the region is dividing into two blocs: the prosperous, fast-growing countries oriented toward the European Union, and the more closed countries centered around Russia. However, this bipolarity is not inevitable. To avoid this divergence, reforms require not only more liberal trade policies, but they must also encourage competition and improve productivity. The study was launched on January 31. To view the report, visit: <http://www.worldbank.org/ecaltradereport>

### Bank Recommends Phased Increase in Ukraine Gas Price

The crisis between Ukraine and Russia over gas supplies and prices at the beginning of the year was met with a quick response by the World Bank. ECA External Affairs featured a December 2005 publication on the impact of higher natural gas prices placed prominently on their Ukraine website. The Ukraine Country Office held a press conference on January 19 to present recent Bank research on the topic. For some time, researchers have been recommending that to cope with the increased gas prices that accompany a market economy, Ukraine must undertake energy sector and economic reforms that will ultimately make the country a more efficient and competitive producer on the international marketplace. Experts predicted a 2% decrease in Ukraine's GDP as a result of the price increases. Bank staff presented the history of Ukraine's weaknesses in the energy sector, a full analysis of the current situation, and detailed recommendations for the future. A thorough press release can be found at: <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/UKRAINEEXTN/0,,contentMDK:20790539~menuPK:328539~pagePK:141137~piPK:141127~theSitePK:328533,00.html>

### Economists Reveal New Findings on Growth and Inequality at the World Bank Conference

Transition, economic growth, and inequality were among the key themes discussed by world-class economists and other specialists at the World Bank's Annual Conference on Development Economics (ABCDE), held in St. Petersburg, Russia, on January 18 — 19. The conference, organized by the World Bank's Development Economics Vice-Presidency, is an opportunity for researchers to present and discuss new research on the factors behind development and poverty reduction.

Anders Aslund, of the Carnegie Endowment for International Peace, delivered the keynote address. Participants included Mikhail Oseyevsky, Deputy Governor of St Petersburg; Vladimir Mau, Rector of the Academy of National Economy at the Government of the Russian Federation; and Francois Bourguignon, the Bank's Chief Economist and Senior Vice President for Development Economics. To view the press release, visit: <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/0,,contentMDK:20784695~menuPK:258604~pagePK:146736~piPK:146830~theSitePK:258599,00.html>

### World Bank Leads Fight against Avian Flu

The outbreak of avian flu in six ECA countries has created a flurry of activity throughout the region, as well as at the World Bank. The Bank participated in the International Ministerial Pledging Conference on Avian and Human Pandemic Influenza in Beijing, China on January 17 — 18, where the global community pledged US\$1.9 billion, of which the Bank will contribute US\$500 million. The new Bank funding program is designed to allow countries access to funds at short notice to strengthen their veterinarian and health services to deal with avian flu outbreaks among animals, and minimize the threat posed to people. The support will help prepare for, and respond to, any potential human flu pandemic. The Kyrgyz Republic is expected to be the first country to obtain financing under the new program. Bank officials have been working on a project for the Kyrgyz Republic worth about US\$4 million, due to be reviewed by the Board of Directors in February. Turkey will likely be the next to draw from the fund, and Armenia is also in negotiations for funding. Detailed information can be found at the World Bank's avian flu website: <http://www.worldbank.org/avianflu>. For more detailed information on avian flu in ECA, read: <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/0,,contentMDK:20785606~menuPK:258612~pagePK:146736~piPK:146830~theSitePK:258599,00.html>

### World Bank Supports Judicial Reform in Romania

On December 15, to help Romania meet the requirements for European Union membership, the World Bank approved a loan worth US\$130 million for the Judicial Reform Project. This project supports the country's objectives to increase the efficiency of Romanian courts and improve the accountability of the judiciary, resulting in reduced corruption and a more transparent justice system. To achieve efficiency and accountability in the justice system, the project will support court infrastructure and automation, court administration reform, and institution-building for the main judicial governing bodies. A significant amount of the project funds will be used to fund rehabilitation and, in some cases, new construction of court

buildings. This will improve public access and enhance security, among other things. Another important component deals with the strengthening of administrative capacity under which a special program will be developed and implemented to reduce case delays and backlogs. The project will also contribute to the implementation of a court information system. Last but not least, the project will provide assistance for the development of judicial institutions. This component will focus on training judges, developing long-term judicial policies, and internal and external communications, which will contribute to the increased independence of the judiciary in Romania. A press conference for the loan signing on January 27 received wide press coverage. For more on the project, visit: <http://www.worldbank.org.ro/external/default/main?pagePK=64027221&piPK=64027220&theSitePK=275154&menuPK=287326&Projectid=P090309>

### **New Opinion Polls on Roma in Central and Eastern Europe Released**

In February 2005, eight countries in Central and Eastern Europe, in collaboration with the World Bank and the Open Society Institute, launched the Decade of Roma Inclusion. In order to ensure that the Decade achieves its objectives of promoting social inclusion for Roma in the areas of education, health, employment, and housing, the World Bank and OSI organized a qualitative opinion poll in all eight countries to gauge attitudes of both the Roma and non-Roma populations. The results were to serve as a benchmark for future Decade efforts. Focus group results provide interesting insights into the reasons for prejudice toward the Roma, and also how Roma view themselves in the context of the social exclusion they face. Results of a quantitative study, also done in all eight countries and based on the findings of the qualitative survey, will be available in early 2006. For a summary of the findings, country-by-country breakdowns of the results, and a PowerPoint presentation on the subject, visit: <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/EXTROMA/0,,contentMDK:20749979~pagePK:64168445~piPK:64168309~theSitePK:615987,00.html>

### **Report on High Mortality in Russia Projects Losses for Economy**

Despite strong economic growth, Russia is facing an alarming population decline, due in large part to untimely deaths from heart disease, traffic accidents, and alcoholism. A continuation of current trends means a shrinking adult workforce, destabilization of families, growing regional disparities, and national security risks, warn Bank experts. *Dying Too Young: Addressing Premature Mortality and Ill Health Due to Non Communicable Diseases and Injuries in the Russian Federation* explores the socioeconomic impact of a sharp rise in ailments such as heart disease, cancer, traffic injuries, alcohol poisoning, suicides, and violence. These non communicable diseases (NCDs) are taking an insidious toll on Russian workers. The new report outlines options to prevent NCDs

and mitigate their impact so that people, particularly men, can live longer and so that ill health does not take a toll on the population and on the country's economy. Current life expectancy for women in Russia stands at 66, while for men it is 58. A key finding is that policies to reduce deaths from NCDs and accidents to the current level among wealthy western European countries (the EU-15) by 2025 could confer socioeconomic benefits equivalent to close to 30% of the 2002 Russian GDP. The report was launched on December 8, 2005. To download the report, visit: <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/0,,contentMDK:20661159~pagePK:146736~piPK:146830~theSitePK:258599,00.html>

### **World Bank Announces New Approach to Fighting AIDS on World AIDS Day**

To mark World Aids Day, the World Bank launched a new action plan on December 1 to fight the epidemic, amid warnings current national strategies are struggling to adequately curb the spread of HIV/AIDS. A key focus of the new action plan will be helping countries devise better national strategies to combat the epidemic. The Bank will remain one of the major financiers of AIDS activities globally, and use its flexibility to fund countries and activities that others cannot or will not finance, in line with the "Three Ones" principle, which is now widely adopted by the international AIDS community, calls for one national HIV/AIDS authority, one national strategic plan, and one monitoring and evaluation system within developing and middle-income countries to eventually defeat this disease. The ECA region has its own specific needs. HIV/AIDS is on the rise there because of injecting drug users and forms a deadly pair with tuberculosis, particularly in prisons. For more information on how the ECA region is working to combat HIV/AIDS, visit: <http://www.worldbank.org/ecal/aids>

### **IFC Celebrates 50 Years of Development**

The International Finance Corporation (IFC) is commemorating its 50th anniversary during 2006. The creation of the IFC on July 24, 1956 represented the first concerted effort by the global community to foster private sector investment and create markets in the developing nations. IFC coined the term "emerging markets" for its client countries and has pioneered economic, financial, and capital market development worldwide. More information at: <http://www.ifc.org/50th>

### **Banner Year for Emerging Markets in 2006**

IFC predicts that 2006 will be a banner year of performance for the emerging markets, but major challenges remain on macroeconomic stability, corporate governance and environmental and social issues. IFC says that capitalization of emerging stock markets is set to exceed US\$5 trillion for the first time. See more: <http://web.worldbank.org/WBSITE/EXTERNAL/NEWS> ■

## New Books and Working Papers

### World Bank Working Papers

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

Thomas W. Hertel and Alan Winters

**Poverty Impacts of WTO Agreement: Synthesis and Overview**  
WPS3757, October 2005

The paper reports on the findings from an international research project investigating the poverty impacts of the potential Doha Development Agenda (DDA), paying particularly close attention to potential reforms in agriculture. The paper consists of 12 country case studies on the national poverty impacts of DDA scenarios focusing on Bangladesh, Brazil, Cameroon, China, Indonesia, Mexico, Mozambique, the Philippines, Russia, and Zambia. An additional study provides a 15-country cross-section analysis. Some of the findings include: (a) assuming an ambitious DDA, near-term poverty impacts are mixed: some countries experience small poverty rises and others more substantial poverty declines. On balance, poverty is reduced; (b) allowing minimal tariff cuts for just a small percentage of special and sensitive products virtually eliminates the global poverty reduction due to the DDA; (c) deeper cuts in developing country tariffs would make the DDA more poverty friendly; (d) in order to generate significant poverty reductions in the near term, complementary domestic reforms are required; (e) sustained long-term poverty reductions depend on stimulating economic growth.

Giorgio Barba Navaretti and David Tarr

**Introduction and Summary to the Handbook of Trade Policy and WTO Accession for Development in Russia and the CIS**  
WPS3726, October 2005

The paper explains the potential importance of World Trade Organization (WTO) accession as a development tool, and discusses recent successful development models and the role of trade policy in their development. Three parts of the paper treat respectively: trade policy (with applications to Russia and the CIS); WTO institutions and disciplines, again with Russia and CIS applications; and various aspects of the impact of WTO accession on Russia. The handbook is intended to be non-technical and accessible to a wide policy audience.

Adam Wagstaff and Magnus Lindelow

**Health Shocks in China: Are the Poor and Uninsured Less Protected?**  
WPS3740, October 2005

Health shocks have been shown to have important economic consequences in industrial countries. The authors explore how health shocks affect income, consumption, labor market outcomes, and medical expenditures in China. They find that health shocks are associated with a substantial and significant reduction in income and labor supply. They also find evidence

that negative health shocks are associated with an increase in unearned income for the poor but not for the better-off. Finally, negative health shocks are associated with a significant increase in out-of-pocket health care expenditures. The findings suggest that households are exposed to considerable health-related shocks to disposable income, both through loss of income and health expenditures, and that health insurance offers very limited protection.

Tao Wang and Louis Kuijs

**China's Pattern of Growth: Moving to Sustainability and Reducing Inequality**  
WPS3767, November 2005

The authors study the sources and pattern of China's impressive economic growth over the past 25 years and show that key issues currently of concern to policymakers such as widening inequality, rural poverty, and resource intensity are to a large extent rooted in China's growth strategy, and resolving them requires a rebalancing of policies. Using both macroeconomic level and sector data and analyzes, the authors extend the growth accounting framework to decompose the sources of labor productivity growth. They find that growth of industrial production, led by a massive investment effort that boosted the capital to labor ratio, has been the single most important factor driving GDP and overall labor productivity growth since the early 1990s.

### World Bank Publications

**World Development Report 2006: Equity and Development**  
September 2005, ISBN: 0-8213-6249-6 SKU: 16249

This year's World Development Report (WDR), the 28th, looks at the role of equity in the development process. It defines equity in terms of two basic principles. The first is equal opportunities: that a person's chances in life should be determined by his or her talents and efforts, rather than by pre-determined circumstances such as race, gender, social or family background. The second principle is the avoidance of extreme deprivation in outcomes, particularly in health, education and consumption levels. This principle thus includes the objective of poverty reduction. The report's main message is that, in the long run, the pursuit of equity and the pursuit of economic prosperity are complementary.

**International Migration, Remittances, and the Brain Drain**  
Maurice Schiff, Caglar Ozden (Ed-s)

October 2005, ISBN: 0-8213-6372-7 SKU: 16372

International migration, the movement of people across international boundaries, has enormous economic, social and cultural implications in both origin and destination countries. The volume deals essentially with economically motivated south-

north migration, the principal cause of which is, in most cases, the difference in (the present value of) expected real wages, adjusted for migration costs. This volume contains four country case studies on the impact of remittances on poverty and expenditure patterns, and four chapters on the brain drain, including the largest existing data base on the brain drain, analyses of the brain gain, brain waste, and the impact on productivity in destination countries.

### **Global Economic Prospects 2006: Economic Implications of Remittances and Migration**

November 2005, ISBN: 0-8213-6344-1

The themes of the 2006 Global Economic Prospects are international remittances and migration, their economic consequences, and how policies can increase their role in reducing poverty. The report also considers policy initiatives that could improve the developmental impact of migration, with particular attention to remittances. It reviews recent developments in and prospects for the global economy and their implications for developing countries; evaluates the potential global welfare gains and distributional impact of an increase in high-income countries' labor force caused by migration from developing countries; investigates the size of remittance flows to developing countries, the use of formal and informal channels, the role of government policies in improving the development impact of remittances, and their macroeconomic impact; addresses the impact of remittances at the household level.

### **Where Is the Wealth of Nations? Measuring Capital for the 21st Century**

December 2005, ISBN: 0-8213-6354-9 SKU: 16354

The book presents estimates of the total wealth for nearly 120 countries, using economic theory to decompose the wealth of a nation into its component pieces: produced capital, natural resources, and human resources. The book's basic tenet is that economic development can be conceived as a process of portfolio management, so that sustainability becomes an integral part of economic policy-making. The analysis, presented in accessible format, tackles issues such as growth, development and equity. The book is organized into four sections. The first part introduces the wealth estimates and highlights the main facts on the level and composition of wealth across countries. The second part analyzes changes in wealth and how they matter for economic policy. The third part deals with the level of wealth, its composition and links to growth and inequality. The last part reviews existing applications of resource and environmental accounting.

### **EBRD Working Papers**

[www.ebrd.org](http://www.ebrd.org)

Libor Krkoska and Utku Teksoz

### **Accuracy of Growth Forecasts for Transition Countries: Assessing Ten Years of EBRD Forecasting**

December 2005

This paper analyzes the accuracy of GDP growth forecasts prepared by the EBRD for 25 transition countries between 1994 and 2004. It finds that EBRD forecasts are mostly unbiased and efficient, and that forecast accuracy has improved as transition has progressed and as the range of data sources have expanded.

Zbigniew Kominek

### **Filling the Gap in Urban Transport: Private Sector Participation in Transition Countries**

December 2005, WP93

This paper reviews private sector participation (PSP) in urban transport in Central and Eastern Europe and the Commonwealth of Independent States. It documents how the private sector is helping to address service gaps in poorer countries and identifies a strong negative relationship between GDP per capita and the degree of PSP. It also shows that decisions to involve the private sector in public services are driven by resource constraints and the general reform process.

### **WIDER Research Papers**

[www.wider.unu.edu](http://www.wider.unu.edu)

Fabrizio Carmignani and Abdur Chowdhury

### **Does Financial Openness Promote Economic Integration? Some Evidence from Europe and the CIS**

RP2005/74

The paper studies whether financial openness facilitates the economic integration of formerly centrally planned economies into the EU-15. Two dimensions of economic integration are considered: cross-country convergence of per-capita income and bilateral trade in goods and services. It appears to be that more financially open economies catch up faster and trade more with the EU-15. These integration-enhancing effects occur over and above any effect stemming from domestic financial deepening and other factors determining growth and trade.

Ravi Kanbur, Anthony J. Venables, and Guanghua Wan (Eds.)

### **Spatial Disparities in Human Development: Perspectives from Asia**

January 2006, ISBN 92-808-1122-3

This book contains a selection of papers from the UNU-WIDER conference on Spatial Disparities in Asia, held in March 2003 at the UNU headquarters in Tokyo. It focuses on poverty and inequality, which are directly related to the Millennium Development Goals. Specifically, it is a cross-country study, covering a number of countries and regions that are attracting considerable professional and political attention such as China, Russia and Central Asian countries. It addresses a wide range of issues including conflict-inequality interconnections, poverty mapping, causes and consequences of inequality. In so doing it applies the latest research techniques such as regression-based decomposition, poverty decomposition and computable general equilibrium models.

**G8 Global Security Agenda: Challenges & Interests. Towards the St Petersburg Summit International Conference**

April 20 — 22, 2006, Moscow, Russia

The conference is organized by PIR Center for Policy Studies in Russia two months in advance of the G8 2006 summit. Government officials, nongovernmental experts and business representatives will convene for discussions and drafting of concrete recommendations on the issues that will be considered at the summit in St. Petersburg; threats to international security, including new challenges to the nonproliferation treaty, the threat of megaterrorism, energy security, as well as the implementation of the G8 Global Partnership and possible G8 influence on the security situation in such regions as Central Asia, the wider Middle East, and East Asia.

*Information and contact:* <http://www.pircenter.org/g8conferencengl>, Mr. Anton Khlopkov: [khlopkov@pircenter.org](mailto:khlopkov@pircenter.org)

**BOFIT/CEFIR Workshop on Russian Macroeconomic and Financial Issues**

April 7 — 8, 2006, Helsinki, Finland

The Bank of Finland Institute for Economies in Transition (BOFIT) and the Centre for Economic and Financial Research (CEFIR) will organize a workshop on macroeconomic research for Russia and other transition countries. The workshop will cover various topics in macroeconomics, including exchange rate policies, monetary and fiscal policy, the role of financial markets in transition, and growth sustainability. An emphasis will be given to applied and econometric papers, but theoretical papers will be considered as well. Young economists are especially encouraged to submit papers.

*Information and contact:* Mr. Iikka Korhonen, [iikka.korhonen@bofi.fi](mailto:iikka.korhonen@bofi.fi) <http://www.bofi.fi/bofit/seminar/index.stm>

**Annual Bank Conference on Development Economics (ABCDE)**

May 29 — 30, 2006, Tokyo, Japan

*Welcome Address:* Sadakazu Tanigaki, Minister of Finance, Japan

*Opening Address:* Francois Bourguignon, Chief Economist and Senior Vice President, World Bank

*Keynote Addresses:* Carlos Ghosn, Chairman, Renault and Nissan Motors, Inc.; Joseph Stiglitz, Columbia University, USA; Sadako Ogata, President, Japanese International Cooperation Agency (JICA)

*Infrastructure for Growth, emerging Issues:* Infrastructure for Growth Emerging Issues, Antonio Estache, Infrastructure Vice Presidency, World Bank.

*Sustainable Development and Infrastructure: Climate Change, Clean Energy, and Energy Efficiency:* Michael Grubb, Chief

Economist, UK Carbon Trust and Senior Research Associate, Department of Applied Economics, Cambridge University; P.R. Shukla, Indian Institute of Management, India and Jiang Kejun, Energy Research Institute, China.

*Rural Infrastructure and Agricultural Development:* Per Pinstrup Andersen, Chair of the Science Council, Consultative Group on International Agricultural Research (CGIAR); Masahisa Fujita, Professor, Kyoto University

*Infrastructure and Regional Cooperation:* Haruhiko Kuroda, President, Asian Development Bank

*Information:* <http://www.worldbank.org/research/abcde>. For ABCDE sessions contact Jean-Christophe Bas, Manager Development Policy Dialogue, World Bank, 66, avenue d'Iena, Paris France, telephone: +33 1 40 69 30 58; email: [jbas@worldbank.org](mailto:jbas@worldbank.org) or Boris Pleskovic, Research Manager, Development Economics, World Bank, 1818 H Street, NW, MSN MC4-402, Washington, DC; telephone: +1 202 473 1062, fax: +1 202 522 0304, email: [bpleskovic@worldbank.org](mailto:bpleskovic@worldbank.org).

**WIDER Conference on Aid: Principles, Policies and Performance**

June 16-17, 2006, Helsinki, Finland

The conference is intended for policymakers and for researchers from the academic, government, and development communities. Among others conference topics will include:

- Aid and poverty reduction
- Linking aid effectiveness and aid allocation together
- New sources of finance and development aid
- Aid to countries emerging from conflict; and funding disaster recovery
- Increasing aid: absorptive capacity issues, Dutch-disease effects
- Aid volatility and aid predictability

*Information and contact:* <http://www.wider.unu.edu/conference/conferences.htm>, [aid-1@wider.unu.edu](mailto:aid-1@wider.unu.edu)

**Central European University Summer University**

July 3 — 14, 2006, Hungary

The following courses have been announced for university teachers, advanced Ph.D. students, researchers and professionals in the social sciences and humanities:

- 1) Intergovernmental fiscal relations and local financial management
- 2) Strategic approaches to urban challenges
- 3) The market and the city: commercialization and urban restructuring — in theory and in the field
- 4) Strategic corruption control and organizational integrity

*Information:* <http://www.ceu.hu/sun>; apply online: <https://online.ceu.hu/olosun>, [summeru@ceu.hu](mailto:summeru@ceu.hu) ■

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