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THE NEWSLETTER ABOUT REFORMING ECONOMIES

TRANSITION

Vol. 11, No. 2 World Bank/William Davidson Institute/SITE/BOFIT April 2000

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

by Jan Svejnar

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

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

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

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

What's Inside

the Russian economy to be stronger in five years, while about 40 percent expect performance to be the same as it currently is.

• ***Moderate economic growth is likely over the next 10 years.*** In contrast to the short run, respondents are relatively sanguine about Russia's economic growth over a 10-year horizon. Very few expect past declines to continue, two-thirds expect the average rate of growth to be about 1–3 percent a year, and 21 percent expect the annual rate of growth to reach 3–6 percent. The experts polled thus predict that Russia is likely to resume moderate to respectable economic growth in the next decade.

• ***Putin may be good for Russia's economic growth.*** Fully 60 percent of the respondents believe that Vladimir Putin will be a positive change agent for Russian economic growth. This is a strong but not unanimous endorsement by the experts: 30 percent of those polled hold the opposite view.

• ***The new Russian president should focus on establishing the rule of law, eliminating corruption, collecting taxes, and encouraging private firms.*** Most respondents identify the establishment of the rule of law as by far the most important priority. Yet 70 percent of them also indicate that it is unlikely that meaningful reform will be carried out in this area. The elimination of corruption and the institution of an effective system for collecting taxes are also deemed to be important policy initiatives by a majority of those surveyed. Interestingly, while almost all respondents indicate that the elimination of corruption is unlikely, half think that Russia will probably institute an effective system for collecting taxes.

• ***Russia represents a good investment in the natural resources and telecommunications sectors.*** Overall, the experts are by and large neutral on Russia as an investment opportunity. However, in the areas of natural resources and telecommunications, they tend to view Russia as a good investment opportunity. Consumer goods production and sales are viewed as a neutral investment opportunities, while financial services and producer goods production and sales are rated as areas that represent somewhat unfavorable opportunities.

• ***Increasing incentives for FDI is the most productive form of external assistance.*** Almost two-thirds of the respondents identify increasing incentives for FDI as the most productive form of external assistance for Russian economic growth. More than a third are in favor of technical (but not financial) assistance, and more than 20 percent believe that maintaining financial assistance through the international financial institutions would be most fruitful. Very few experts favor direct financial assistance from the United States or significantly higher levels of financial assistance from the international financial institutions.

• ***Russia will be relevant for global political stability but not for global economic stability or growth in the short and medium term.*** The experts believe that during the next five years Russia's political and economic stability will be relevant, though not highly relevant, for global political stability. However, they do not see Russia's stability as being relevant for either global economic stability or global economic growth. In the short term, Russia is hence viewed as having the potential to destabilize the world politically, but its economy is considered too unimportant to affect the global economy.

• ***Russian economic growth and stability should be a high priority for the next U.S. president.*** Almost 60 percent of the respondents believe that Russian economic growth and stability should be a high or very high priority for the next U.S. president. This presumably reflects their belief that Russia's economic stability and well-being have global political ramifications and that the President of the United States is a key player in interaction with Russian policymakers.

Summing up, our survey indicates that Russia's transition has fallen short of expectations, but that the new president is expected to turn the country around. While only a sizeable minority of our experts believe that the president will establish a rule of law, a large number feels that he will improve the collection of taxes and encourage the development of new private firms. Russia's economy is likely to improve over the next 5 years and register moderate to possibly respectable rates of growth over a 10-year horizon. Presently, Russia represents a good investment opportunity only in natural resources and telecommunications, the number of attractive investment opportunities will presumably increase over time. Providing incentives for foreign investment is seen as the most productive form of external assistance. In the short term, Russia will be important politically but not economically on the global scene. The new U.S. president should place high priority on economic growth and stability in Russia.

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Contents of WDI

Ten Years of Transition: Lessons Drawn, New Issues Discussed During World Bank Conference in Washington

Since 1988 leading academics, policymakers, and researchers have gotten together every spring at the Annual World Bank Conference on Development Economics to discuss the latest issues in development. This year 's conference—organized by Boris Pleskovic, Administrator of the Research Advisory Staff—was dominated by the new development thinking, but the new generation of transition issues received attention as well. In this issue we summarize the papers of János Kornai, who 10 years ago published the first comprehensive book on postsocialist transition; Paul Collier, who analyzes drawbacks and weaknesses of conditional aid and urges true partnership between donors and borrowing governments; and a paper of Joel S. Hellman, Geraint Jones, and Daniel Kaufmann, who analyze the roots and outcome of corruption and kickbacks in the transition economies based on survey data. These papers can be downloaded from http://www.worldbank.org/research/abcde/washington_12/agenda_12.html. As a follow-up to the Washington conference, the Second Annual Bank Conference on Development Economics in Europe will take stock of "Development Thinking at the Millennium." That conference will be held in Paris June 26–28, 2000.

The Road to a Free Economy—Ten Years After

By János Kornai

Ten years have passed since the publication of my book *The Road to a Free Economy: Shifting from a Socialist System—The Example of Hungary*. It was the first book in the international literature to put forward comprehensive proposals for the postsocialist transition. In this article I examine two issues I addressed in my book—ownership reform and macroeconomic stability—in light of 10 years of experience with transition.

Ownership Reform

The Road to a Free Economy supported creation of an economic system in which private ownership would dominate. In this respect, its views did not differ from many proposals originating in the West. This broad agreement on the need for private ownership left open the question of which is the best road to creating such a system, however.

Strategy A: Organic Privatization

Strategy A is based on four main tenets. First, the most important task is to create favorable conditions for bottom-up development of the private sector. The main impetus behind the growth of the private sector is mass de novo entry. Creation of new firms has to be facilitated by breaking down barriers to entry, ensuring the security of private ownership, establishing institutions to enforce private contracts, and, cautiously, promoting the development of the private sector (through tax and credit policy, for instance).

Second, most state-owned companies must be privatized. The basic technique for doing so is sale. State assets must be sold mainly to outsiders, with preference given to those who offer a fair price and make a commitment to invest in the company. If the buyer is an insider, a genuine price must still be paid: insider privatization cannot be allowed to degenerate into a disguised form of give-away. Give-away distribution of state property must be avoided.

Third, preference must be given to sales schemes that produce an ownership structure with a majority owner. The majority shareholder may be a businessperson, a group of owners, or a privately owned company (owned by nationals or foreigners). A particularly desirable type of owner is a strategic investor who is prepared to inject a significant amount of new capital into the company. If the company is held publicly, there is no need to prevent the shares from being dispersed across a large number of shareholders. Where possible, however, it is desirable to have a core owner.

Fourth, the budget constraint on companies has to be hardened. This is key to ensuring the financial discipline essential to operating in a market economy. A set of new laws must be passed, including bankruptcy, accounting, and banking laws. Following the legislative phase all these laws should be consistently enforced.

Strategy B: Accelerated Privatization

Strategy B focuses on the rapid liquidation of the state sector. It stresses eliminating state ownership as quickly as possible. The main technique for privatization is some form of give-away, such as a voucher scheme, in which property rights in state-owned companies are distributed free and equally among the country's citizens. This approach may be linked with toleration or even encouragement of takeovers by managers. In many cases this kind of privatization turns out to be a pseudo management buy-out, as the managers pay a very low price, almost tantamount to receiving the property rights in the company free of charge. Under Strategy B, dispersed ownership may actually be preferred to ownership by a dominant owner. All citizens share in the property rights of the formerly state-owned companies, so that "people's capitalism" develops.

What Lessons Can Be Learned from Experience?

Ten years after the onset of transition, I am convinced that strategy A, which promoted organic growth of the private sector, was the correct position to take. Strategy B proved inferior at best and harmful at worst.

The state socialist system left behind a legacy of mass unemployment on the job. Strategy A is prepared to reverse this legacy, even if it means taking painful and unpopular measures. Strategy B shrinks from doing so.

Hungary and Poland followed strategy A. In Hungary hundreds of thousands of small and medium-sized firms were created. Tightening of the budget constraint in the first half of the 1990s allowed a process of natural selection to sweep over the corporate sphere. This coincided with a strengthening of financial discipline. The chains of mutual debt among companies were broken and the standing of private contracts improved. A start was made to consolidate the banking sector. All these developments helped attract foreign capital. The strong inflow of capital was one of the main factors responsible for the improvement in Hungary's productivity and export performance.

At the beginning of the 1990s Václav Klaus, economist-prime minister of what became the Czech Republic, championed the voucher scheme (strategy B), arguing for its adoption in the international arena. The program was applied energetically in Czechoslovakia. In the first phase the assets of state-owned enterprises were dispersed among millions of voucher owners, but they were soon concentrated among investment funds. These funds lacked the capital to develop the backward companies. Moreover, the funds were closely linked to the large commercial banks, which were dominated or owned by the state.

Such an ownership structure was incapable of building up strong corporate governance. Restructuring dragged on. Despite the strident Chicago-style free enterprise rhetoric directed at the outside world, budget constraints remained soft. Whereas privatization by sale engenders natural selection, the transfer of property rights by give-away distribution conserves the existing structure. Performance has been disappointing. Adoption of Strategy B seems to have been a significant factor behind the privatized companies' poor performance.

Perhaps the saddest example of the failure of strategy B is provided by the Russian Federation. There every feature of the strategy appeared in extreme form: a voucher scheme was imposed on the country, coupled with mass manipulated transfers of property into the hands of management and privileged bureaucrats. In the unprecedented ownership reform that occurred, ownership of natural resources, especially oil and gas, was expropriated by the "oligarchs."

All these failures are closely connected with the survival of the syndrome of the soft budget constraint, which has infiltrated and done damage to every cell of the economy and body politic. Russia has become a nonpayment society. Companies do not pay their suppliers, employers do not pay their employees, borrowers do not repay their loans. All of this is tolerated by the executive and the judiciary. In fact, the state sets a bad example by often falling behind with wages and insurance contributions owed to state employees and pensioners. Labor productivity in Russia in 1998 was 33 percent lower than in 1989. In the Czech Republic productivity was just 6 percent higher than in 1989, the last year of socialism. In contrast, labor productivity in Hungary in 1998 was 36 percent higher than in 1989, and Poland's productivity had risen 29 percent.

Macroeconomic Stability

My book recommended immediate macroeconomic adjustment in Hungary (that is, adjustment within the next year or two). I still think that position was correct. In the event, adjustment was postponed several years. Most experts agree that if postponed, macroeconomic stabilization costs more. There is an ethical and political dilemma posed here by the intertemporal distribution of pain and gain and the acceptance of the political price of unpopular measures.

I did not predict the deep recession that followed the system change; I was too optimistic in my expectations of future growth. The socialist system left a badly distorted structure of input and output. Correcting this structure called for creative destruction. Because destruction is rapid, whereas creation proceeds much more slowly, the two processes led to a deep recession.

My book recommended implementing a radical action program by one stroke. In retrospect, I do not reject the notion of a radical adjustment package, in which several measures are taken simultaneously. Such a policy is appropriate if it will restore equilibrium in several important dimensions of the economy at once—or at least bring the economy closer to a tolerable degree of disequilibrium (by reducing the deficit on the current account or the budget deficit to a sustainable level, for example). But I paid too little attention to how to consolidate this quick fix and produce lasting improvement.

Sustainable growth requires not just one macroeconomic intervention but a deep, comprehensive program of institutional reforms. It is easy to improve the budget balance at a single stroke by raising the rates of existing taxes. But lasting improvement requires radical tax reforms: broadening the tax base, introducing new taxes, and improving the tax collection system. And that is just one element, perhaps the easiest, of the fiscal reform. More difficult is reducing state expenditure, which could involve reorganizing the state apparatus and reforming the education, health care, and other welfare systems. It is relatively easy to declare that the currency is convertible. It is much harder to organize an effective system of international payments, develop well-functioning connections between the domestic and international banking systems, and guarantee that international payment agreements will be observed.

Macroeconomic stabilization is not a battle but an endless war. Stabilization cannot be achieved by a blitzkrieg. Institutional reforms can be obtained only step by step, by a series of larger and smaller blocks of reforms. I see that now and regret that I did not feature this idea in *The Road to a Free Economy*.

Gradualism? Shock Therapy?—Wrong Question

The polemics of the early 1990s concerned the choice between "gradualism" and "shock therapy." In those days that was one of the favorite topics of classroom discussion in courses on comparative economics. That was what many students had to write about in their exam papers.

In my view, the question was badly put, and so I am not going to try to answer it. The question itself implies a yardstick: speed. I am convinced that speed, while important, is not the primary measure of success. The transformation of society is not a horse race. The main indicator of success is not who passes the winning post first. Excessive emphasis on speed leads to impatience, aggressiveness, and arrogance.

Ironically, the expression "mass privatization," used as a synonym for give-away and voucher schemes, is the inverse of the mass collectivization imposed by Stalin. Stalin did not want to waste time with voluntary collectivization. Using brutal, merciless violence, he imposed collective ownership on the peasantry in a matter of two or three years. I do not want to exaggerate the comparison; luckily, no gulags were required and no brutality occurred in the 1990s. Change was forced by milder means. Nonetheless, there were similarities: the subordination of the ownership reform to political and power purposes, the horror of gradual change, the impatience, and the obsession with speed.

Transition from socialism to capitalism has to be an organic development. Transition is a curious amalgam of revolution and evolution, a trial-and-error process in which old institutions are either retained or liquidated, new ones tested and accepted or rejected. Different elements in the process may be very rapid, fairly rapid, or slow. Each has its own appropriate speed. Some changes call for a one-stroke intervention; many others advance by incremental changes. The emphasis has to be placed on consolidation, stability, and sustainability of growth.

Excerpted from Janos Kornai's paper: "Ten Years After the Road to a Free Economy—the Author's Self Evaluation." *The author is professor of economics at Harvard University and Collegium Budapest.*

Toward Europe

"Prices are already EU compatible, only the wages remain Hungarian."

From the Hungarian daily *Népszabdság*.