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New Bridges Across the Chasm: Macro- and Micro-Strategies for Russia and other Transitional Economies

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Abstract: This paper deals with Russia's transition from communism to market economy which has been harder than anticipated just a decade ago. The rise in prosperity that the market economy had promised had not been materialised. But, in other transition countries from successes and failures, lessons have been learned, strategies devised and examples set which can serve as the basis for the success of transition not only in Russia but also in other countries of East Europe. This paper discusses these very aspects.

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Introduction

This century has been marked by two great economic experiments. The outcome of the first set, the socialist experiment that began, in its more extreme form, in the Soviet Union in 1917, is now clear. The second experiment is the movement back from a socialist economy to a market economy. Ten years after the beginning of the

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transition in Eastern Europe and the Former Soviet Union: How do we assess what has happened ? What are the lessons to be learned? Surely, this is one of the most important experiments in economics ever to have occurred, a massive and relatively sudden change in the rules of the game. As rapidly as the countries announced the abandonment of communism, so too did western advisers march in with their sure-fire recipes for a quick transition to a market economy.

A decade after the beginning of the transition in Eastern Europe and the Former Soviet Union (FSU), and two decades after the beginning of the transition in China, the picture is mixed. Each country started the course of transition with a different history, a different set of human and physical endowments. Some had lived under the yoke of central planning and authoritarianism for most of the century, while in others it was imposed only in the aftermath of World War II. Those countries bordering Western Europe with encouraging prospects of European Union integration were clearly in a different position than the landlocked countries of Mongolia and the former Soviet republics in Central Asia. Counterfactual history—what would have been but for the policies that were pursued—is always problematic, and no more so than when there are so many variables with which to contend. Yet, the disparity between the successes and failures is so large that it calls out for interpretation and explanation, and in any case, the public debate has already begun.

Some have formulated the public debate about the transition as a question of fast versus slow. But that seems an ill-formulation since one can find successes and failures on both sides of the fast-slow dichotomy. Some countries tried to 'jump over the chasm in one leap' such as Russia but their leap did not reach the other side and now they will take much longer to climb back out of the chasm. Other countries progressed more incrementally and found that well-designed incremental reforms, such as the Chinese agricultural reforms, can proceed quite rapidly. Other countries tried to just 'go slow' and sat on one side of the chasm erecting many half-bridges that went nowhere–many pseudo-reforms that were dead-ends.

The task now is build new bridges across the chasm which means to change institutions in a determined but incremental way. We begin by outlining four macro-strategies or bridges, and then we turn to a long list of 'micro' suggestions, many of them drawn from the experience over the last decade in transitional economies.

Four Bridges

Russia's transition from communism to a market economy has been far harder than most anticipated just a decade ago. The rise in prosperity that the market economy had promised has not materialised: far from it, as GDP has fallen by 50 per cent[1] and the fraction in poverty has soared from 2 per cent to 50 per cent[2]. We need to recognise these sad facts, even if we shy away from assigning blame. Most important at this juncture is designing a roadmap for the future: where does the country go from here.

At each stage of a country's history, it builds on what it has inherited from the past. The legacy of the Communist era was more than an ageing and inefficient capital stock and the absence of the institutional infrastructure required to make a market economy and a social democracy work: it included a disillusioned workforce, a broad sense of cynicism (especially towards the State), and an unhealthy disrespect for the rule of law.[3]

Today, almost a decade later, it has a new legacy: there is a growing group of young entrepreneurs, but perhaps a 'Mafia' that has grown even faster. As the institutions of the state have broken the social contract time and time again, failed to deliver on implicit and explicit promises, and been used as instruments for private gain at public expense–with a few becoming vastly enriched at the same time that the majority has become impoverished–the sense of cynicism towards the State and the rule of law is today perhaps even stronger than it was a decade ago. While a decade ago, the country looked forward to the prospect of creating a more egalitarian democratic capitalism–unencumbered by the inequalities inherited from a feudal past–today the country must face the task of creating a market economy with a level of inequality that rivals the worst in the world. And while there have been great strides in creating democratic institutions–as the recent elections bear testimony–they also show the power and dangers of an excessively concentrated media.

In these remarks, we do not address the political economy of reform. There are those who hoped that privatisation, no matter how it was done, would create demand for the institutional infrastructure of a market economy and the rule of law, replacing the grabbing hand of the State with the invisible hand of the market.[4] Neither history nor economic theory provided grounds for these hopes–the conventional wisdom is that it is the middle class that gives rise to the demands for these institutions, and the last decade has added another data point in support of that generalisation. If anything, the last decade has seen the evisceration of the Russian middle class and the creation of a new and even more concentrated oligarchy, with little interest in the rule of law, effective competition, or a fair bankruptcy regime. Speculating on how, in this milieu, future reforms are to occur would take us beyond the already ambitious task of this paper: What is the economic agenda which the country should pursue?

We argue that what is required are the following broad macro-strategies:

Recognising that the country needs a growth strategy, and not just fiscal consolidation;

Recognising that the current state of massive tax arrears (and other liabilities to the state, direct and indirect) provides a unique opportunity to rectify some of the mistakes of the past decade;

Recognising the importance of rebuilding the economy 'from the bottom up' with medium-sized and small enterprises both as start-ups and spin-offs from larger enterprises; and

Recognising that the creation of a vibrant social democracy will entail recreating social capital.

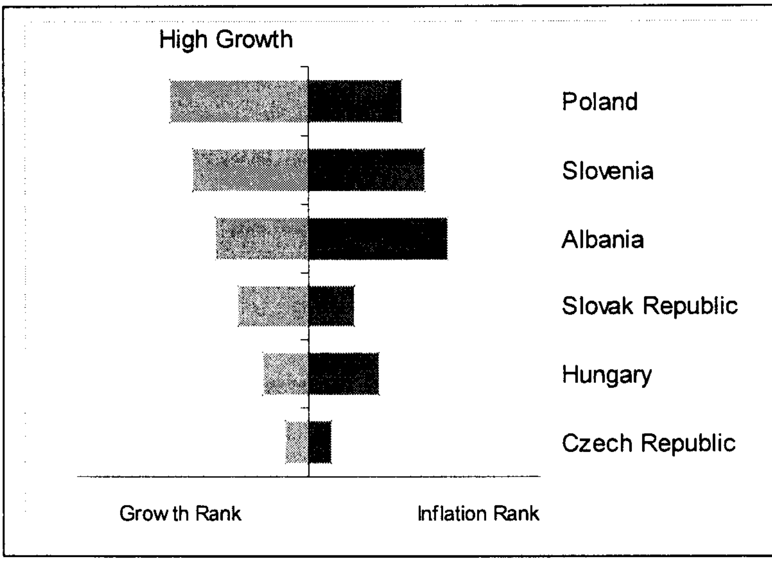
Growth and Inflation

There is a broad consensus among economists that growth would have been impossible if hyperinflation had continued; hence strong action–even shock therapy–to stop the hyperinflation was called for. But too often, policies went beyond simply bringing down inflation to reasonable levels. Cutting inflation to lower and lower levels–no matter what the cost–became a fetish, despite overwhelming evidence that there are little if any gains in productivity or growth from reductions in inflation below 20 per cent.[5] And the costs of pushing inflation to these low levels has not been inconsiderable. Some argue that the excessive tightening of monetary policy has been a contributing (but not the only) factor in the growth of arrears and of the barter economy–to the point where today, it is estimated that 70 per cent of all transactions are via barter.[6] While inflation may weaken the price system because individuals do not know accurately relative prices, barter may be even more effective in undermining the price system. Thus, the attempt to strengthen the price system by curtailing inflation may well have backfired. In addition, there is an argument that if there is some degree of downward wage and price rigidity, then moderate inflation may actually be desirable;[7] and the critical rate of inflation may increase with the magnitude of the adjustments in the economy that are required. Because the economies in transition require more adjustment, the 'optimal' rate of inflation may accordingly be higher than in other economies, so that results derived from other economies provide an underestimate of the critical rate. A glance at the countries in eastern and central Europe shows the countries that have grown the fastest have *not* been the countries with the slowest rates of inflation (see Figure 1).

Overall, macro-economic policy has been so contractionary–given the inflation paranoia–that it has probably played a significant role in the economy's contraction. (To be sure, misguided structural policies, discussed below, may also have played a role.) These contractionary policies have included an overvalued exchange rate, maintained by usurious interest rates that have choked off all new investment and entrepreneurial activities. The recent expansion of the economy (e.g., in import substitutes) can be directly attributable to the 1998 devaluation, bearing testimony that at least some of the economic downturn was due to misguided macro-economic policies.

It is now widely recognised that aggregate demand and aggregate supply are closely intertwined.[8] Excessively contractionary macro-economic policies, especially tight monetary policies, undermine the net worth of firms, forcing them

Figure 1: Rankings of inflation and growth in Eastern Europe



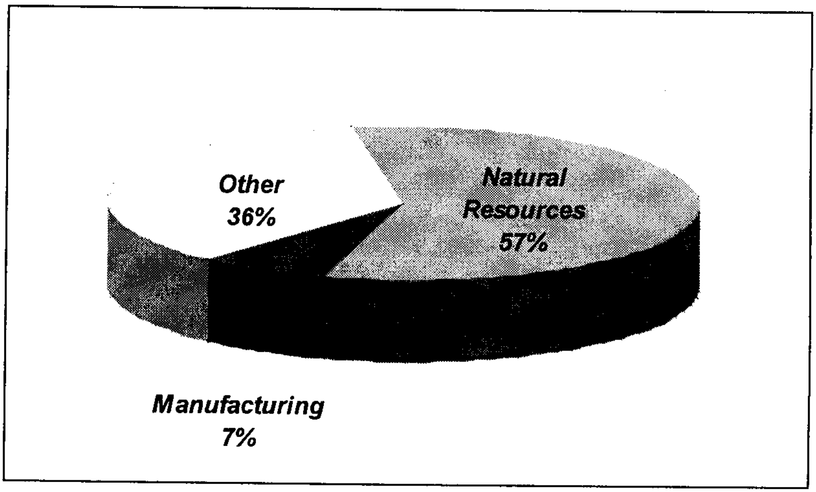
Sources: EBRD (1998) and Statistical Information and Management Analysis database.

into distress; even short of that, supply is reduced.[9] The adverse effect on aggregate supply means, of course, that even if and when aggregate demand is resuscitated, the economy will not immediately recover. It would be wrong to infer from this that the initial, underlying problem was insufficient aggregate demand. It is right, however, to conclude from this that addressing problems of aggregate demand will not *suffice* as a policy response.

Fiscal Policies and (Re)privatisation

A second major mistake of the preceding decade has been the focus on the *speed* of privatisation, without paying due attention to its manner or the presence of institutional infrastructure. The presumption underlining this was a version of Coase's conjecture: all one had to do to ensure eventual efficiency was to turn over the assets to private hands, and the profit motive would subsequently ensure that the assets were owned or managed by those most capable of doing so. Subsequent experiences have confirmed that incentives matter; but private markets, in the absence of appropriate institutions, can provide stronger incentives for asset stripping and diversion than for wealth creation. And the stronger version of this hypothesis, for which there was never any theory or empirical basis–that the creation of private property rights would automatically provide incentives for the creation of an appropriate institutional infrastructure–was equally misguided.

Figure 2: 1994 Composition of total foreign investment*



Source: Goskomstat.

* Natural Resources include fuel and energy, ferrous metallurgy, non-ferrous metallurgy, logs, wood, cellulose, and paper. Manufacturing includes the chemical & petrochemical industry, machine-building & metal-processing, construction materials, and light industry.

The manner of privatisation–with a few oligarchs accumulating huge amounts of wealth–has not only failed to generate the promised benefits in terms of efficiency, but has undermined social capital and led to a lack of confidence in the market economy, and even, to some extent, in democratic processes.

The focus on restructuring existing assets diverted attention away from creating new enterprises.[10] And the manner in which privatisation proceeded not only failed to pay due attention to issues of corporate governance,[11] but did not serve to facilitate the creation of new enterprises.[12] Moreover, the strategy did not make the enterprises that were put up for foreign sale attract many foreign bidders; and over time, the absence of the rule of law has further served to discourage foreign investment in sectors other than mining and mineral extraction (see Figure 2).

But these questions are not just 'water over the dam.' The massive arrears and non-payments, much of which is owed to the government directly or indirectly, provides an opportunity to rectify the mistakes of the past: the State may propose a 60-day ultimatum, that if the arrears and debts are not paid, assets will be turned back over to the State to be resold and reprivatised, but this time in a manner which is more likely to enhance efficiency and a sense of equity. (This is not the occasion to specify precisely how the reprivatisation should occur.) To be sure, there is always a possibility that some of the oligarchs and others will pay up; but to the extent that they do so, the government's fiscal problems will be addressed; it will provide financing for a more expansionary fiscal policy which in turn will strengthen the economy.[13]

While privatisation prior to establishing the institutional infrastructure of a market economy led to asset stripping rather than wealth creation, privatisation prior to establishing the mechanisms of tax collection deprived the country of needed fiscal resources for public expenditures, thereby further undermining the social contract, as pensioners saw their benefits decline while the wealth of the oligarchs increased.

It would have been a relatively easy matter to enforce revenue collection from a substantial fraction of the GDP–that part generated by natural resources–had the government had the will and had the international financial institutions made this a pre-condition of providing funds. There are well established methods of monitoring, and international benchmark prices, on the basis of which it would be easy to levy taxes. This should be done now. Moreover, such taxes come as close to being pure rent taxes as any other except those imposed on land, and are accordingly less distortionary than other forms of taxation.

New Enterprise and Job Creation

This brings us to the third major pillar of the new strategy: enterprise and job creation. Previous policies not only did not focus on this, but seemed almost deliberately designed to suppress new enterprise and job creation–high interest rates made borrowing prohibitively expensive; an overvalued currency put domestic firms at an unfair trade advantage in tradables, whether exports or import substitutes; and the low revenues achieved from privatisation, and obtained from the large privatised enterprises, sometimes led to high implicit taxes on the newer, less powerful firms.

Rebuilding Social Capital

The fourth pillar is perhaps the most difficult: re-establishing the social contract and re-investing in social capital.[14] Rebuilding social capital is not a task that can be done from Moscow. Too many, both inside and outside Russia, think hope can only come in the form of the 'good Czar' finally getting into the Kremlin. We might draw an analogy with the Civil Rights Movement in the US during the 60's and 70's. How are people who have been held down and who have been socially passive finally able to mobilise themselves to become socially active and to gain some measure of control over their own affairs? Certainly not by just waiting for the right president in the White House. Local bottom-up organisations of civil society are necessary–the new atoms and molecules of social capital. But local mobilisation is rarely sufficient since local and subnational governments are often part of the problem. Thus there needs to be a pincer movement of pressure from below and pressure from above to break the old moulds and allow new forms to evolve.

Thus any strategy for economic rejuvenation designed in Moscow should have as a key component the ways and means for facilitating local empowerment through employee-owned enterprises, rejuvenated unions, new co-operatives, and other people-based 'third sector' associations of civil society.

Public-Private Partnerships

Reform Based on Credible and Effective Government

We want to begin by dispelling the idea that one can base a transition strategy on weakening the government (the 'grabbing hand' theory) and then expect a vibrant market economy to rise up automatically in its place.[15] We have seen from the Russian experience alone that there is no automaticity in the development of market institutions in the post-socialist environment. Nor can we wait until there is a full complement of institutions before moving forward.

It is as if you are at sea and your ship is in distress. If you just abandon the ship, another ship will not automatically appear to save you (only East Germany had that option). Nor can you just pull into a dry dock and repair the ship before going back to sea. You must learn to repair your ship at sea, starting with the most pressing problems and moving forward increasing your self-confidence in resolving your problems and staying on a true course.

Instead of focusing on abandoning or weakening the state, the focus should be on redirecting government (which may well involve down-sizing) which might involve a variety of public-private partnerships and support for 'third sector' non-governmental organisations. Market failures are too extensive for the private parties to develop the institutions automatically. But government failure is the legacy of the socialist past, so we must explore new avenues, partnership between public and private sectors and the intermediate third sector of non-governmental organisations that are neither purely public nor private.

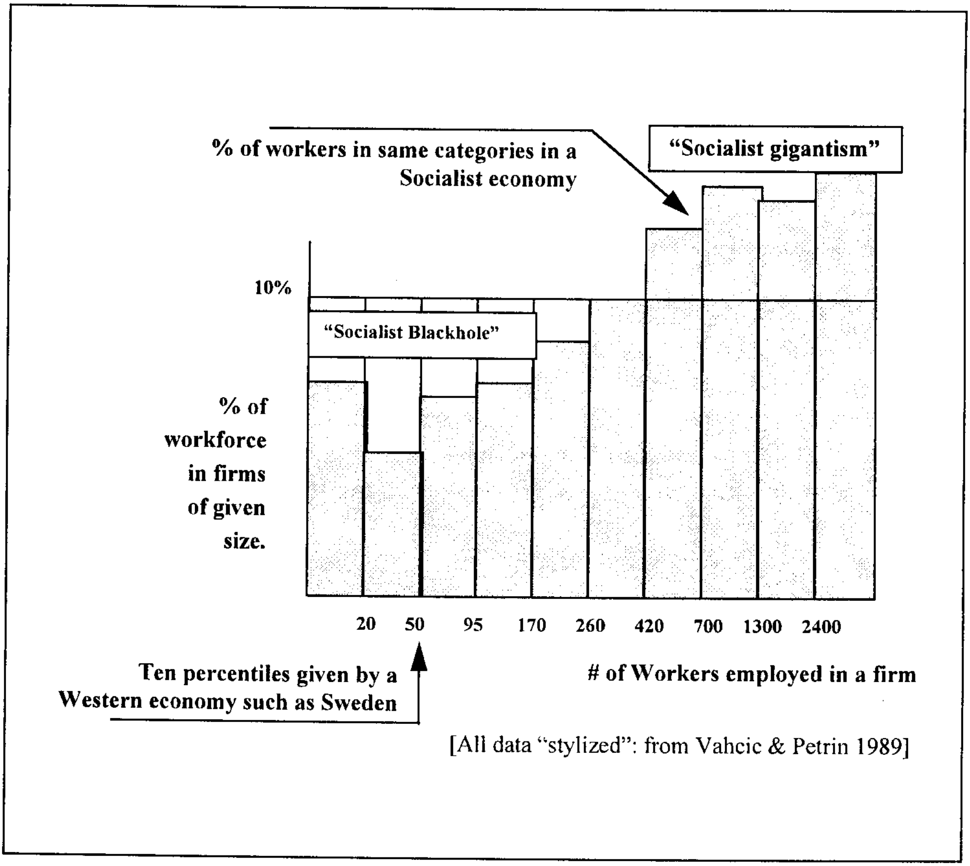
Filling the 'Socialist Blackhole'

The post-socialist economies suffer from the legacy of the 'bigger is better' mania of their socialist past. In the advanced western economies, we see the finished products and the advertisements of the big firms, but it is not as widely known that each large firm is supported by many small and medium-sized firms. For example, fully one half of the German GDP is produced by the small and medium-sized firms called the 'Mittelstand' companies. They are largely insider or family-owned and do not appear on the stock markets.

In the socialist post-socialist economies, there was a preponderance of huge vertically integrated 'firms' while smaller firms hardly went beyond the kiosk-economy of small traders. The missing SMEs represented a huge hole in the size distribution of firms that was called the 'socialist blackhole.'[16] (see Figure 3) One of the larger goals in restructuring large 'production units' (one hesitates to call them 'firms') should be to help fill the socialist blackhole by spinning off smaller 'planets' or 'satellites' as SMEs.

We will point out some success stories of similar countries in the region as well as to successes from long ago in western countries at an early stage of development. We want to look at methods of restructuring large companies that are short of bankruptcy, and to look at the institutional infrastructure necessary to actually implement bankruptcy laws (without creating social chaos). We want to look at all the government assistance that countries have found to be necessary in order to foster the small and medium-sized enterprise sector. And we want to look at changes in the education system for both the student and adult populations that will help develop the skills and mind-sets that are fruitful in a market economy. Development can be approached as a transformation[17] of society. The transition from communism to a market society is no less a transformation of society, entailing not only changes in institutions but changes in ways of thinking. A crucial question is how best to bring about these changes.

Figure 3. Socialist Blackhole



Rethinking Restructuring

But before beginning a detailed discussion of the strategies of restructuring, we want to stress the issue of restructuring in the economies in transition in perspective. Much confusion has been caused by the fact that certain words were used under communism with totally different meanings from how those words are used under capitalism. Consider the word 'bank.' Under capitalism, banks garner funds, then allocate them, based on a process of screening among different applicants. They then monitor that the funds are spent in the way intended, and finally, they take actions to see that the loans are repaid. Under communism, banks did only one of these: they collected funds. Other than that, they were engaged basically in bookkeeping; the real allocation decisions were made elsewhere (e.g., Gosplan). By the same token, firms under communism had little to do with the concept of firms under capitalism. There the concept is fundamentally a legal one, a locus of decision making authority, with certain rights and obligations, including (residual) control of certain assets. The rights of others to intervene in the decision making the firm was restricted—though to be sure influence could be exercise by a variety of means. By contrast, under Communism, the State, particularly through the ministries, could intervene in any decision, though in practice much was delegated to lower units. And while the lower units may have had certain *de facto* property rights, they had no *de jure* rights, and so the central authority could override any allocation decision they made.

In a sense, one could think of the national economy as a single large firm, with the President of the country acting as the CEO or the Chairman of the Board, the heads of ministries being heads of different subsidiaries, and the banking system being the accounting department. 'Debts' were simply intra-firm bookkeeping entries. The transition from Communism to the market economy can be thought of as a national bankruptcy, in which the debts of the separate units, being nothing more than intra-firm bookkeeping entries, could simply be ignored. Only the deposits of households into the banks were of importance—they were part of the 'social contract' that had to be preserved. (Ironically, it was these obligations that were in fact wiped out through hyperinflation in the period immediately following the end of the Cold War.)

The principles guiding such a national bankruptcy are similar to those guiding a more conventional bankruptcy: the essential question is how should various assets be best deployed. But the circumstances of the two situations differ sufficiently that one must be careful to rethink how to answer that question. For instance, two guiding principles in corporate restructuring in well functioning economies are the following: First, it makes less difference who is the owner than that there be well defined owners. That is because so long as there are well defined owners, they will have an incentive to re-redeploy assets in ways which maximise market value. This is the essence of the Coase theorem (or, as it is more aptly called, the Coase conjecture). Even in well functioning capitalist economies there are strong caveats to the Coase theorem; important corporate governance problems can arise with dispersed ownership, with managers using their discretionary powers to advance their interests at the expense of shareholders, or majority shareholders doing so at the expense of minority shareholders. But good legal structures and a strong banking system typically puts important checks on abuses. But in the economies in transition, incentives to maximise value are attenuated, when there are no markets on which to sell shares, or those markets are far from competitive or well-functioning. Corporate governance problems are further exacerbated by the inadequacies of the legal structure and the weaknesses in the banking system. Many of the specific proposals noted below are intended to address these concerns.

The second guiding principle is the preservation of social, organisational, and informational capital—when it has positive value. That is why there is a presumption for keeping intact production units within a firm; the value of an enterprise as an ongoing production unit is greater than the value of the underlying capital goods (this is sometimes referred to as the firm's goodwill). On the other hand, there are economies and diseconomies of scale and scope, and there are transactions costs and other costs associated with using markets and non-market mechanisms—all of which affect the boundaries of a firm, in particular, what should go on within a firm. Again, though the principle remains the same, the differing contexts have strong implications: much of the 'goodwill,' the informational and organisational capital, related to a quite different economic system. The differing institutional infrastructures—including the problems of corporate governance referred to earlier—imply differing organisational solutions.

Restructuring Large Firms

From 'Bigger is Better' to 'Small is Beautiful'

Why do SMEs tend to work well and overcome some of the endemic problems of large firms? When there are many people in a firm, each person might feel they could only have an effect inversely proportional to the number of people in the firm—which would be such a small effect that they are not strongly motivated. The firm is just too huge to feel that you can make a difference. Even a Senior Vice President in a 10,000-person organisation might feel this way sometimes–so one can imagine how it must feel for a rank-and-file worker in gigantic post-socialist firm, just a small cog in a gigantic wheel. In a small or medium-sized firm (say, up to 500 workers), an individual might be able to see the difference that he or she, or the team they work in, might make. That alone should call forth more individual effort. Moreover, people can more easily see what others are doing, so that non-cooperative behaviour will face more social approbation.

From the viewpoint of decision-making, small firms have less bureaucratic hierarchy and are thus more agile in responding to changing conditions. In America, they are called 'gazelles' because they can change direction so quickly. Information has a shorter distance to travel from top to bottom and from bottom to top. And management will tend to be newer and more entrepreneurial in a small and medium-sized firm. This is especially true in the transitional economies where those in charge of the 'subunits' are likely to be younger than those at the top of the larger organisations. They will be building for the future–rather than, as in some of the larger firms, just trying to hold together the remnants of the past.

Spin-offs have the incentive to add new customers and new suppliers. They are no longer a captive part of a vertically integrated firm. For instance, the trucking part of business, once spun off, has the incentive to look for new business. And the spin-off is a competitive market environment stimulates innovation. With the prospect of new customers, there needs to be innovation and learning to get and to hold the new clients. The empirical evidence from the successful early reformers (e.g., Poland) points to the crucial role of a vibrant sector of small and medium-sized enterprises.[18]

How to do Spin-Offs?

The big advantage that the economies in transition have, once they recognise the distinction between a socialist production unit and a market firm, is the potential for beginning with a relatively clean slate. They can in principle undo some vertical or horizontal over-integration which was, in any case, motivated by quite different considerations than those underlying such structural decisions in a market economy [e.g., Coase 1937]. Every factory does not need its own exclusive parts-producing shop, its own trucking fleet and vehicle repair shops, its own food service, its own printing and reproduction shops, and so forth. If there are different factories producing a product for different regions of the country, there is probably no good reason why they have to be in the same firm. There could even be some competition in adjacent territories. Some factories have found that they have to start producing several new products, but those products could just as well be produced in new spin-offs.

Who does the spin-offs? The lease-buyout reforms of the Gorbachev era are one model that might be refined and used.[19] It is best to start with middle managers and their staff and production personnel. It is important to preserve the organisational capital of well-functioning teams. Once dispersed, it is hard to put a good team together again. There might be other partners local or more distant partners either in the beginning or later. Since it is the middle manager that might become the top manager in a spin-off, the manager would tend to be younger and more disposed to build new value (rather than just grab what one can in the face of a rapidly approaching retirement—as has happened in the case of some older managers).

Following out this scenario, the middle managers and as many as possible of the workers in the spin-off would form a new company (perhaps in conjunction with other partners to round out the firm in terms of purchasing, marketing, and distribution). Why is it important to have broad ownership of the staff in the spin-off? Doesn't concentrated ownership on the part of the manager create sharper incentives? One of the under-appreciated problems in the transition economies has been the 'no exit' problem for concentrated owners. In the post-socialist environment and even in the West, SMEs with concentrated or family ownership have an exit problem. The firms are usually unsuitable for floatation on a stock market and in any case, the occasion of the retirement of a tried and tested owner-manger is hardly the time to attempt a floatation. Often the only buyer for a firm might be the competition that wants to reduce competitive pressures.

Without a market for small and medium-sized companies, the standard theory–invest, create new value, and sell–does not apply. Without some mechanism of 'exit' in the post-socialist environment, controlling owner-managers will be tempted to slowly liquidate or 'tunnel' the firm to get their retirement nest-egg, all to the detriment of the workers, suppliers, customers, and local community.[20] This problem of ownership transition in America has been addressed by over 10,000 employee stock ownership plans or ESOPs wherein a closely-held company itself buys back the retiring owner's shares over a period of years and redistributes the shares to the current employees. The broad internal ownership in an insider-owned firm helps to prevent that sort of 'tunnelling' (see section of corporate governance). In the case of firms already privatised, the firm could use something like the ESOP mechanism to slowly buy out the retiring owners and redistribute the shares.

An already privatised mother firm might remain a minority shareholder in the spin-off, but it would defeat much of the purpose to make it a controlling shareholder. The remainder of the lease-purchase payments would be made by the spun-off firm over a period of years. Ordinarily the payments might be made to the mother firm, but if the mother firm had bad debts to a local bank or another creditor, then the lease payments might be made to the creditor. In that manner, the spin-offs can be part of a restructuring of both the assets and the liabilities of the mother firm.

Role of the Government

This sort of spin-off restructuring is possible now; it does not necessarily require new physical or financial resources. But it does require new initiatives and new mind-sets. It requires the middle managers and the workers in the unit to see that their prospects are brighter and their fate more in their own hands if they do the spin-off into a quasi-separate firm than if they remain part of the 'empire' of the large mother firm. And it requires a change in the top managers of the mother firm to let the 'empire' transform itself into a looser complex of contractually-related small and medium-sized firms. Above all, it means moving away from the strategy that bigger is better either in terms of market power or lobbying power with the ministries for subsidies and favours.

If ambitious middle managers have to wait for the top managers to voluntarily agree to a part of their empire to become partly independent, then they might have to wait a very long time. Here is where government support might be crucial. There has to be a pincer action on the top management of the large socialistic dinosaurs to promote the spin-offs: middle managers pushing from below and government pushing from above. There might be large discrepancies between top manager's private returns and social returns (which requires the governments assistance to overcome). Governments have many levers of action, such as the threat (or reality) of enforcing tax, utility, and wage arrears as well as promises of any future assistance. Indeed, given the magnitude of such arrears, even governments that have aggressively pushed privatisation have this option for encouraging restructuring. Governments cannot and should not allow firms that have outstanding tax obligations or debts to the government-owned banks simply to continue operating as is. In the reorganisation that should be a standard part of bankruptcy procedure in the economies of transition, spin-offs of the viable parts of a firm should be a standard option.

Thus there could be a public programme, perhaps sponsored by a ministry for promoting small and medium-sized firms, where spin-offs would be fostered in any large firm (say over 1000 workers) which had tax, utility, or wage arrears or 'required' some form of government assistance, i.e., in most if not all large firms. If the middle managers and the workers in a unit could satisfy certain objective requirements, then the top management in the mother firm would be *obliged* to negotiate in good faith to arrange the spin-off (or have default terms imposed by law).

What about Foreign Investors?

One of the great disappointments of the transition so far has been the rather subdued role of foreign investment in spurring the process of transformation (aside from West Germany's 'foreign' investment in East Germany). In retrospect, this should not have been a surprise. Few people get married on their first date, and few serious investors would buy into a company before having a long-standing business relationship. Early expectations that foreign companies would rush in were not fulfilled, and the problems of the few companies who did rush in served as object lessons for the others that hesitated.

What is more important is an openness to knowledge and experience from the successful market economies. One of the most important forms of interchange is a simple business relationship such as exporting a product to a western firm or to make a locally sold product under contract to and using specialised inputs from a western firm. At first knowledge will flow in from the western firm to the eastern partner. Then the western firm might fund the purchase of new machinery to improve the product. The payback for the investment could be arranged through the transfer pricing of the business relationship. After the experience of such a successful relationship, then a western firm might consider a more direct form of investment or 'marriage' with the eastern firm. If 'investment follows trade' is the more normal sequence, then the government should actively promote foreign trade relationships that might eventually lead to a more direct form of investment.

Rethinking Corporate Governance from Scratch

The institutions of corporate governance in the market economies have evolved over this entire century.[21] Expectations that these institutions could simply be transplanted to the transitional economies have been widely disappointed.[22] In the slow-reforming post-socialist economies, it is best to go back to basics and rethink corporate governance from scratch.

There are two intertwined problems: managers who act in an opportunistic and self-dealing manner as agents of the shareholders, and controlling shareholders who ignore and violate the interests of the other non-controlling minority shareholders.

In the agent-principal relationship between the managers and shareholders, the agent has a fiduciary role to act in the interests of the principal. Ordinarily the agents' actions are hidden from the scrutiny of the principals, and the agents have specialised information not available to the principals. This being the case, there is always the temptation for the agents to exploit their informational advantage and the non-transparency of their actions to step out of their fiduciary role and to engage in self-dealing opportunistic behaviour. Sometimes the agency relationships are stacked up in a chain of relationships. The worker is the agent of the manager, who in turn is the agent of an investment fund as the main shareholder (the fund is run by a fund management company), and the fund is the agent of hundreds of thousands of shareholders in the investment fund. In such an agency chain, a minority interest might nevertheless be controlling and there is plenty of room for self-dealing.

In the West, informal norms of managerial behaviour and formal institutions of governance have evolved over the 20th century. Financial accounting and auditing standards have been devised, and whole professions of accounting and auditing have developed to maintain the public trust in implementing those standards. That brings a measure of transparency so that principals can better monitor their agents. Corporate law and related criminal law fraud statutes have evolved so that there are more effective sanctions for gross misconduct.

We cannot simply assume that all these institutions are up and running in the post-socialist environment. In that environment, it is best to reduce or collapse the agency chains back to the level where the principals are close to the agents (if not identical with the agents as in the family farm or small owner-operated business). The up-close parties who can better monitor the managers are the parties who have some implicit or explicit contracts with the firm such as the workers, suppliers, creditors, customers, and local government. They are called the 'stakeholders' of the firm, so when the stakeholders are also shareholders, then the up-close principals have both the ability and the incentives to monitor better their agents.

Monitoring needs to be coupled with enforcement. Enforcement of good corporate governance through the whole system of courts, judges, juries, and lawyers is rather inefficient even in the western economies. When the principals are not just absentee and unrelated shareholders but are up-close principals with a direct relationship with the firm, then there is a more practical means of enforcement. The firm is embedded already in relationships with workers, suppliers, creditors, customers, and the local government, and these relationships provide a forum for discussions of mutual interests and instruments for adjusting those interests (e.g., the terms of all the contracts between stakeholders and the firm). The stakeholders don't ordinarily need to rely on the courts to deliver their messages or protect their interests since they have an on-going relationship of give-and-take with the firm. They, in effect, have 'mutual hostages.' Only in very exceptional cases would the parties need to resort to the courts to adjudicate and enforce the interests of the principals.

'Going back to basics' in agent-principal relationships means having principals who are 'up-close' to the agents (if not identical) for better monitoring, and who are transactionally-related so that the principals can use the give-and-take nature of the relationship (on-going discussions plus bargaining power) as the means of corporate governance. Many decades of evolution were necessary to establish the viability of a system of absentee ownership where the shareholders have no up-close informational relationship and no direct business relationship with the firm aside for the bare ownership of shares. The on-going debate in the US about shareholder suits is evidence that even then, there are widespread perceptions that the system needs further tuning. It should come as no surprise that these 'advanced' corporate codes transplanted to the post-socialist environment have not provided a basis for adequate corporate governance.

The techniques of restructuring described here (e.g., spin-offs with stakeholders as shareholders) will also increase stakeholder ownership so that corporate governance should at the same time be improved.

Infrastructure for Bankruptcy and Restructuring

More than just Bankruptcy Laws

Bankruptcy, like death, is a possibility that no one likes to contemplate. Yet, as the species reproduces itself through birth and death, so the system of private enterprise must have some mechanism through which it accomplishes the business equivalent of transformations caused by death and rebirth. There is much confusion about what bankruptcy is and does. Bankruptcy does not destroy physical assets. It rearranges and restructures management and control, and in that process organisational capital is destroyed and recreated. Since corporations do not have a fixed lifetime, timely and appropriate actions can induce restructuring and deep-seated transformation of a company. That may be painful, but not as painful from the overall social viewpoint as liquidation (where the assets are sold separately and the production unit ceases to exist), particularly in a post-socialist environment without strong traditions of entrepreneurship to create new jobs.

Bankruptcy laws are only the tip of the iceberg in a whole system of bankruptcy-related transformations of businesses. A country cannot just install the formal laws of bankruptcy from the West when the surrounding infrastructure and social habits are missing. Where are the courts, judges, and trustees to carry out a bankruptcy proceedings? If firms are liquidated, how will workers be re-employed and where is the social safety net for the interim period? Where in the post-socialist environment are the entrepreneurs or the expanding firms to snap up the released assets and where are the sources of finance to re-employ the assets and workers? These questions about 'the rest of the iceberg' are not easy to answer, and that is why governments have been slow to actually implement bankruptcy laws—even when good laws are on the books.

Where the complementary institutions are not in place to rapidly re-employ discharged workers, then the bankruptcy mechanism should be implemented together with programmes of restructuring to preserve or recreate as many jobs as possible. They should be two sides of the same coin. The bankruptcy/restructuring programmes described below illustrate this idea.

Reorganisation versus Liquidation Bankruptcies

There are essentially two types of bankruptcy that need to be considered: reorganisation bankruptcy ('Chapter 11' in the US) and liquidation bankruptcy ('Chapter 7' in the US). In the first case, there is a procedure to hold off the claims of creditors (that would otherwise force liquidation of a business that could be saved) while a restructuring plan is devised by a trustee, management and a committee of creditors, and is legally approved. The implementation of an approved restructuring plan may or may not succeed. Failure would push the company over into liquidation bankruptcy.

Enterprise Restructuring and Support Centres (ERSCs)

We will describe one way to develop some of the bankruptcy infrastructure by setting up Enterprise Restructuring and Support Centres (ERSCs). Our description is based on a World Bank project that helped develop the centre called ARIA in Moldova. The description is not a 'blueprint' but it will indicate some of the principles that could be adapted elsewhere.

The ERSC (ARIA) was not a government agency, but rather a separate non-profit corporation founded and partly supported by the relevant parts of the national or regional government. It had certain legislated powers that enabled it to act essentially as the trustee in reorganisation bankruptcies.

Aside from the director and small support staff, all staff were essentially trainees who after a fixed period (e.g., one year) went off payroll and started or joined consulting practices in the private sector. The idea was to seed the private sector with people capable of helping companies restructure, not to create cushy jobs for politically connected people.

Foreign consultants (often financed through Bank loans) were hired not to do local restructuring jobs but to train local counterparts to be restructuring consultants. There were no long-term contracts for foreign consultants with aid money. Their role was the time-limited one of creating local capacity. If they created a strong enough private sector counterpart to pay them to come back and offer further assistance, then that could be quite an agreeable outcome.

Reorganisation Bankruptcy through the ERSCs

Insolvent companies would volunteer to join the ERSC bankruptcy programme if they liked the mixture of carrots and sticks. Their creditors would be held in abeyance while the creditor committee, management, and ERSC draw up a restructuring plan which might well involve some uniform debt reduction, reduction or cancellation of tax arrears penalties, and spin-offs (with the accompanying restructuring of liabilities described above). Acceptance of the restructuring plan by the creditors committee would legally force all creditors to go along (that is why the ERSC needs these legal bankruptcy-related powers in its founding legislation).

Liquidation Bankruptcy through the ERSCs

A reorganisation bankruptcy might involve selling off certain assets either to other companies or through spin-offs of internal units. But when the restructuring plan falls apart and the core of the company cannot be saved, then the company moves under ERSC into the liquidation phase of bankruptcy. In the post-socialist environment, liquidation bankruptcy should be avoided if possible, and if necessary, should be conducted with the primary goal of re-employing the workers of the firm. If some other firm had been willing to take over the facilities and re-employ the workers, then presumably it would not have gone to the liquidation phase. Hence once the liquidation phase is reached, the strategy might be starting up micro and small businesses out of the shell of the old company. When pushed to the wall, middle managers can be quite creative in finding ways to start up micro-businesses if they have premises and some initial resources. Here again, the ERSC can facilitate this as a part of their small business support function.

Other Functions of ERSCs

The ERSC can run programmes to expose enterprise managers to similar but more successful enterprises in nearby Central European countries (Poland, Hungary, Slovenia, and so forth). Visits to western companies are not as relevant since those companies do not operate in a post-socialist environment. Prior experience with enterprise visits shows that their fruitfulness is vastly improved if the trips are preceded by a 1-3 month training programme for the selected managers. The preparation about what to expect and how to learn from it needs to be complemented by structured meetings during the trips to capture and discuss the lessons. Some of the trips might be short secondments with the host companies. Moreover, the managers privileged enough to go on these educational trips should do so only on the condition that they give a series of seminars arranged by the ERSC for other managers on the lessons learned. Thus the lessons are better disseminated through the country.

The ERSC itself can run courses, seminars, and training programmes for managers. Topics range from languages and business planning to modern management methods (e.g., steps towards Japanese-style quality improvement programmes). For instance, the ARIA centre in Moldova purchased a number of language-teaching machines to create a language learning centre with the ARIA facility. Managers paid to come almost around the clock to learn business English and other international languages so that they can travel abroad on learning or sales trips.

Finance for Entrepreneurs and Small Businesses

Special Problems in Transition Economies

The financial systems in most transitional economies have failed small and medium-sized businesses. Much western attention and donor aid has gone to building largely symbolic (if not totemic) institutions such as stock markets when the countries do not even have banks that can service the SME sector. The banks do not know how to screen loan applications, how to judge the risks of loans, how to secure collateralised property, and how to monitor the borrowers to better ensure loan performance. But perhaps the biggest problem of all is that the interest rates are much too high (e.g., 30 per cent or more in real terms) for serious SMEs to survive. At those rates, there is the adverse selection of only 'gamblers' who plan to default if the gamble doesn't pay off—all of which causes the banks to keep their rates up to cover their losses. It is a self-reinforcing vicious circle that will kill the possibility of a vibrant SME sector. This is aggravated by macroeconomic policies that maintain high interest rates and high exchange rates, and that pretend the prevailing interest rates are an 'equilibrium' in a perfect capital market.

Let me be clear: these misguided macroeconomic, exchange rate, and monetary policies impede the creation of a viable market economy. They are the opposite of what is required for a successful transition. Somehow, in the fight against hyperinflation, the central message of good macro-management has been lost. It is not the case that because hyperinflation is bad that the lower the inflation level the better off the economy. One must always consider the price of a single-minded focus on lowering inflation.

In many of the transition economies, tax rates on enterprises are as punishing as interest rates. The punitive tax rates push some enterprises into the gray or black economy, and create opportunities for graft. When taxes stifle enterprise and distort decisions, economics argues for reallocating the tax incidence to inelastic sources of income such as natural resources and land [see Arnott and Stiglitz 1979]. Since the owners of urban land can be objectively determined, it might be worthwhile to devise a programme, perhaps piloted in a city or region, where urban land taxes were increased *pari passu* with the reduction in enterprise taxes to judge the overall economic impact.

Capitalising Social Capital

There is considerable experience in providing finance to micro - and small businesses in developing countries. Many of the conventional and unconventional techniques (e.g., peer group or mutual guarantee lending institutions and rotating savings and credit associations) may eventually find application in the transitional economies. But one approach is to emphasise methods of 'capitalising social capital' to minimise the need for financial capital in the beginning of a startup.

Conventional economics focuses on market relations and thus it tends to assume that co-operation must be purchased with money. If we refer to habits of teamwork, co-operation, and reciprocal trust as 'social capital', then it is too often assumed that social capital must be purchased with financial capital.

Consider a business startup involving a leader/entrepreneur and ten workers. If the ten workers have only a market (i.e., employee) relationship to the venture, then they might well demand that the venture be sufficiently financed to guarantee several months salaries. Their social capital would have to be purchased with a sizeable investment of upfront financial capital. If, on the other hand, the workers were involved as co-venturers with an equity stake in the enterprise, then a substantial amount of the upfront finance would be replaced by their 'sweat equity.' Their social capital (teamwork, cooperation, and trust) would have been obtained by other means.

Family-based startups, as seen with the overseas and mainland Chinese, provide other examples where social capital is obtained (based on familial relations) outside of expending financial capital in market relationships.

In a transitional economy with little or no system of entrepreneurial finance, it is imperative that every means be developed to obtain social capital for startups other than with financial capital. Sweat equity and familial relations are two methods already mentioned. Social capital in the form of trust between the venture and its suppliers and customers can serve to greatly reduce the need to finance working capital through banks. Suppliers can give credit to the venture, and customers might partially prepay their orders.

Many post-socialist societies are quite impoverished in social capital; communism corrupted and destroyed many of the normal forms of social co-operation leaving behind a confused, cynical, and sullen individualism. In a semi-desert area, it is all the more important to conserve the few sources of water, and similarly in the post-socialist landscape, it is all the more important to conserve and build onto any remaining pockets of social capital.

In market economies, firms may be seen as local non-market solutions to collective action problems where transaction costs prevent co-ordination by market contracts [Coase 1937]. In the new post-socialist market economies, as in the established market economies, the primary example of extensive social co-operation in daily life is found in the workplace. Thus entrepreneurial efforts that arise out of or spin off from existing enterprises may be particularly effective in post-socialist societies. Other social organisations that might support entrepreneurial efforts include local township governments (e.g., the township-village enterprises in China), unions, co-operatives (housing, consumer, credit, and producer co-ops), mutual aid associations, guilds, professional associations, churches, veterans associations, clubs, schools, and extended family groups.

SME Finance Support Programmes

When the government provides financial and other assistance to the real sector, there is an argument that such assistance should be given to the most dynamic parts, the SMEs, not to the most inert parts, the unrestructured dinosaurs (who often use the threat of social turmoil to extract subsidies from the government). Without some financial assistance, the SME sector will be 'smothered in the cradle' by the sky-high interest rates.

Those who argue against such assistance on the grounds that it interferes with the efficient allocation of capital typically–and wrongly–think of capital as an ordinary factor of production to be allocated by an auction process to the highest bidder. They fail to recognise the special consequences that follow imperfections of information and the probability of default. Does really believe that the marginal product of capital in Russia was 150 per cent prior to the crisis? In general, there are potential government interventions–subsidies or taxes–that improve the efficiency of the market allocation of capital.

In Ireland, Scotland, Wales, and a number of other western countries, qualifying SMEs can receive financial assistance in the form of interest rate subsidies or matching grants on certain purchases of assets or specialised services. The Bank is starting to experiment with similar programmes in Latin America, the Middle East, and in South East Asia. An interest rate subsidy to qualifying enterprises would reduce the effective rate paid by the firms, so that they would be more likely to pay back the loans rather than default. This would combat the adverse selection and incentive effects of high interest rates, reducing the loan losses to the banks so that rates could be pushed down. Moreover, this financial assistance would bring enterprises out of the gray or black economy and normalise their relationships with the banks and government–including turning the enterprises into taxpaying 'citizens.' Stiglitz [1999b] shows that the market may be characterised by multiple equilibria–one with high interest rates and high defaults, and one with a lower interest rate and lower defaults.

A matching grants scheme could be used to promote specific expenditures such as specialised machinery, international consulting necessary to establish export contracts, standards and metrology services necessary to qualify for certain contracts, and so forth. Some schemes could require, say, five or more firms to put up funds to encourage cluster-based SME development as in Northern Italy. Another type of matching grant programme might be designed to entice multinational corporations (MNCs) to make a large investment (perhaps greenfield) so that local SMEs could array themselves around the MNC to supply inputs and components.

These are the types of programmes that the World Bank group has supported in regions of the developing world to promote SME development. These programmes need to be developed for transitional economies but not without due attention to possible abuses. As in the Argentine programme, it might be possible to have initial oversight provided by consultants who ran similar programmes in OECD countries. One way or another, ways and means must be found to strongly promote the SME sector in the transitional economies.

Finance for Export Promotion

Experience in Latin America and in other developing countries demonstrates that traditional export promotion rarely has been effective in expanding exports. Either the macroeconomic conditions and the overall policy environment have not been conducive to exports, or project designs were flawed. Services provided through a single public service supplier were supply- rather than demand-driven and were rarely organised to focus directly at the enterprise level. But some countries such as Great Britain and Ireland have been successful in stimulating exports by providing support and assistance to enterprises in export marketing and related tasks and by helping finance export-related services provided by private sector firms. The Bank has supported this innovative approach in India, Kenya, Indonesia, Philippines and Mauritius, and has similar projects planned for a number of other countries. Information from a sample of 36 grant-supported activities in Indonesia shows that the first year of implementation achieved additional exports of US$36 for every US$1 of grant received. A group of 180 firms that received cost-sharing grants in India achieved exports worth 25 times the grants disbursed within three years.

In the fall of 1994 the Argentine Government requested Bank support for an export development project. An Argentine project preparation team conducted focused interviews and an enterprise survey of 400 exporters and potential exporters to identify their problems and needs. Members of the team travelled to several countries, including Ireland, Great Britain, South Korea, and Japan to review exporter support schemes. Together with Bank staff they formulated a project to help increase the international competitiveness of small and medium scale enterprises in Argentina and to improve the performance of export-related public agencies, thus facilitating export growth. The project works through three avenues: (i) cost-sharing grants to cover up to 50 per cent of the cost of consultant's services required to improve the international competitiveness of enterprises, particularly SMEs-offered only in response to private sector demand; (ii) the services of a worldwide Directory of Consultants and Market Information Suppliers to ensure easy access by Argentine exporters to information about the availability of export-related services worldwide; and (iii) improvement of agencies providing quality control and certification services. The project also facilitates export growth by supporting the simplification and reduction of export procedures.

Agricultural Finance and Support Programmes

Agricultural production faces special financing problems. In a developed economy, financial institutions are the third parties that finance the purchase of farm machinery and required production inputs. Where the financial system is less developed, machinery and input manufacturers may themselves have to supply the credit through lease-purchase arrangements. They might also set up specialised credit institutions to fund machinery purchases.

In agriculture, creditors may have to wait to take their payment out of the harvest. Foreign suppliers of scarce agricultural inputs are particularly vulnerable to political interference. The local political authorities may force the sale of the crop at a controlled price or may even confiscate part of the harvest in payment of 'new emergency taxes' making it difficult if not impossible for farms to meet their debt obligations. This is a form of political risk over and above the usual risks of farming (bad weather or pests). The Bank has pioneered a form of insurance or guarantee to control for such political risks so that MNCs would be able to enter these markets to supply needed inputs and take their payment out of the harvest.

The family farm is perhaps the most productive and durable agricultural production unit (as Deng Xiaoping learned from Confucius: 'The best fertiliser on a farm is the footprints of the owner'). But there is often a market failure between banks and small farms. The transactions costs of dealing with so many small borrower outweigh the benefits to banks. The small farmer also faces market problems in finding a good price for cash crops and in buying inputs with cheaper bulk purchases. The traditional solution was for farmers to join together in producer and marketing co-operatives. Unfortunately, 'co-operatives' in the post-socialist countries and indeed in many developing countries were more creatures of the government and were not genuine farmer-owned and controlled organisations.

Hence a new Farmer Ownership Model (FOM) [23] has been developed at the World Bank to reinvent producer and marketing co-operatives in a more modern and private-sector-oriented form where output and input markets are linked. The FOM is being successfully implemented in a number of poor countries of sub-Saharan Africa, Mexico and Central America. The FOM can also be adapted to restructure collective farms into private family farms joined together in legally registered producer organisations. In this way they gain commercial access to the same elements that create successful, profitable agriculture in western countries. The elements at the heart of the FOM are: business structure and organisation, competent day to day management, access to working capital finance, and access to competitive output markets. The FOM empowers farmers to professionals and commercialise their farming activities as they (1) repay the World Bank loan with interest and (2) substantially increase their incomes and living standards on a financially and ecologically sustainable basis.

Entrepreneurship Promotion and Education

Entrepreneurship Culture

In a developed market economy, substantial entrepreneurial knowledge is transmitted as a part of the ambient culture. Successful entrepreneurs are praised in the mass media. Some ethnic subcultures are particularly rich with examples and role models so that children easily come to have entrepreneurial hopes and expectations. But in socialist societies, neither the system nor peer pressure/values supported entrepreneurship so anything resembling entrepreneurship was usually limited to handicrafts, the service sector, or agriculture.

Incremental Entrepreneurship

History provides a wealth of lessons that myopia is more the norm than clairvoyance. When the way forward is unclear, then it is better to proceed by small steps than by great leaps. It is better to 'cross the river feeling for the stones as one goes' because small missteps can be corrected without great losses. Successful entrepreneurs usually have behind them a trail of several small failures usually called 'learning experiences.'

An incremental small-start approach to entrepreneurship is particularly important in post-socialist economies due to the culture of risk-avoidance nurtured by socialism. Grandiose business plans (with 'new machines from Germany') are to be avoided in favour of small sequenced or staged startups. Only after the lessons are learned and adjustments made from one stage does the project build to the next stage. This would greatly reduce the risk involved in the venture and would minimise the startup capital requirements.

Entrepreunership Education

Thus entrepreneurship education in a transitional economy needs to be seen as a very broad social effort advancing on many fronts: primary and secondary schools, adult education institutions, universities, and colleges as well as in the vast domain of public education through the electronic and print media.

Entrepreneur and Small Business Support

Business Training Centres

A number of transitional economies have already developed networks of business training Centres (BTCs). The primary example is the Morozov Project in Russia. The BTCs have a variety of functions such as business training, consulting, and serving as an information resource or library for business people. They might be organised as semi-public non-profit companies or as private companies. They might be financed my local governments, by consulting fees and user charges, or even by international donors. They might be stand-alone organisations or part of a larger network or franchise system. Usually the difficult transition is from government-funded to self-financed training which involves developing the local demand for business training services.

Government Support programmes

BTCs are not unique to transitional economies. For instance, in the United States the Small Business Administration (SBA) was a Federal agency that supported many Small Business Development Centres often associated with universities. For the agricultural sector (thinking of farms as small businesses), the Agricultural Extension Service, usually associated with an agricultural college, provided information and consulting advice on best practices to farmers all across the country.

The Federal and some state governments in the United States have extended the extension idea to small manufacturing companies as a way to foster increased competitiveness. Similar industrial extension programmes can be found in the OECD countries (e.g., Italy and Ireland). If central or regional government support for small manufacturing businesses is necessary in OECD countries, then one would imagine that it was called even more so in the post-socialist countries.

Ireland is a country that should be much studied and visited for its industrial support programmes. Ireland provides state support of industrial innovation through an inclusive support package of services, grants, and tax relief. Services include a wide range from product testing to consultancy. Matching grants are available for each stage of the innovation process from idea generation to commercialisation. Eligible activities include project feasibility studies, R&D, regional industrial development, joint ventures, energy conservation, management improvement, community enterprises, training, co-operative development, and marketing and sales development. In addition, support is available for companies employing temporary advisors or 'mentors,' those wishing to fill newly created jobs, and export assistance. Finally, there is employment support for the long-term unemployed to return to work or start up their own businesses. All of these can be found in a user-oriented reference directory with contact information with each listing.

Incubators

Business incubators provide some of the standard infrastructure (space, communications, and support services) for new startups so that the entrepreneurs can focus on what is unique to their businesses. Some incubators also provide consulting services and advice. The internal incubator (as, for instance, developed by the company in Slovenia) is an incubator inside of a large company that needs to downsize by spinning off some workers in small businesses. These could be new businesses or part of the old company to be spun off as a separate operation. The internal incubator should be a particularly important tool in the restructuring of the large uneconomic enterprises in the post-socialist economies.

Franchising

A business franchise is a pre-packaged slice of relatively successful entrepreneurship which saves the franchisee the trouble of 'reinventing the wheel.' While the concept should be very useful in the transitional economies that are currently lacking in strong entrepreneurial traditions, there are several reasons why the uptake may be slow. Firstly, many of the western franchises can only with great difficulty be transplanted into the transitional economies. The supply networks may be absent, the tastes may be quite different, and the niches may not be the same. Some foreign franchises may only work for a while due to the pent-up demand for foreign products. Eventually domestic master franchisers will be developed, and only then can the potential of franchising be realised.

Conclusions

Sometimes just to know that a competitor has made a breakthrough is enough to spur a company to make the same innovation on its own. Even scientists in one country can make a breakthrough knowing only that scientists in another country have already done so. In other words, just knowing that a journey is actually possible sweeps away half the excuses for not making the journey oneself.

We now know that a successful transition is possible. Poland, Slovenia, Hungary, and Estonia can be counted as successes and the Czech Republic and Slovakia are close behind if not across the finish line themselves. Each country has its own history, its own strengths and weaknesses, but each learned to use its strengths and overcome its weaknesses to make the journey.

We now know that it is no quick leap across a chasm and we know that half-hearted bridge-building attempts will leave only half-bridges going nowhere. With ten years of transitional experience, there is much to be learned from the successes and failures. Indeed, within the broad expanse of Russia, there have been many local success stories, and likewise in neighbouring countries. Rather than hatch some new optimal master plan in Moscow, it is a time to promote decentralised experimentation, benchmarking between experiments, and learning from the successes. We can point to lessons, strategies, and examples that can be the basis for learning. Transformation can be neither imposed nor given as a gift from the outside; transformation is a do-it-yourself project. The task is not an easy one, but the rewards are great, and one fears even to contemplate the consequences of failure.

NOTES

• The findings, interpretations, and conclusions expressed in this paper are entirely those of the authors and should not be attributed in any manner to the World Bank, to its affiliated organisations, or to the members of its Board of Directors or the countries they represent.

[1] To be sure, there are measurement problems, but there are arguments both that the numbers underestimate and overestimate true GDP (see Gaddy and Ickes [1998]). The corroborating evidence–the huge decline in lifespans and the large numbers of individuals in poverty revealed by survey methodologies–corroborates the more pessimistic views of what has happened.

[2] Milanovic [1998].

[3] See, for instance, Murrell [1996].

[4] See Shleifer and Vishny [1998] and the discussion below of the 'grabbing hand' theory.

[5] There is some debate about the critical threshold, with Bruno and Easterly [1995] citing numbers around 40 per cent, and others, such as Barro [1997], citing numbers around 10 per cent. Fischer [1993] shows that while low inflation and small deficits are not necessary for high growth even over long periods, high inflation is not consistent with sustained growth. The problem is that in Russia, and in many of the other economies in transition, cutting inflation was pushed well beyond these numbers.

[6] By value. There is no agreement about the reason for the growth of barter, but several of the favoured explanations focus on policies that aimed for macro-stabilisation, such as tax policies which use the financial system for tax collection and cash flow constraints unmatched by expenditure constraints, which lead to arrears.

[7] See Akerlof, Dickens, and Perry [1996].

[8] This point was brought home forcefully by the East Asia crisis. See, e.g., Stiglitz [1999c]. For a theoretical discussion of the issues, see, e.g., Greenwald and Stiglitz [1993].

[9] These adverse consequences, resulting in the destruction of informational, organisational, social, and reputational capital, may have had particularly severe consequences, given the limitations of this capital at the beginning of the transition and the natural dissolution of some forms of this capital in the process of transition. See Blanchard and Kremer [1997].

[10] Contrast the strategy with that of China, where little privatisation occurred, yet the share of non-state enterprises in gross industrial output has risen from 22 per cent in 1978 to 74 per cent in 1997, and all but a small percentage of this rise is accounted for by new enterprises.

[11] For a discussion of the issues of corporate governance, see below–and for the question why privatisation did not really succeed in removing government from enterprise activity–see Stiglitz [1999a, b].

[12] Contrast the strategies of privatisation in Poland and Hungary with that pursued by Russia.

[13] The presumption in this calculation is that the marginal propensity to consume *within Russia* of the oligarchs is relatively small.

[14] Note that the strategy sometimes argued for by the radical reformers runs counter to this: They argue that if only the government would make business conditions sufficiently attractive, there would be a reversal of the prodigious capital flight and a flow of funds back into the country. Implicitly, they are arguing for a legitimisation of the illegitimate privatisations–which would hardly provide the sense of equity and social fairness necessary to rebuild the social contract.

[15] This view is sometimes called the 'political Coase Theorem': privatise quickly and then the necessary new institutions will automatically arise out of pressure from the new property owners and the market. For example, the Russian privatisation programme 'de-emphasised corporate governance precisely because the intent was to reduce the damage from government failure rather than from market failure.' [Shleifer and Vishny 1998, 11] 'The architects of the Russian privatisation were aware of the dangers of poor enforcement of property rights. Yet because of the emphasis on politics, the reformers predicted that institutions would follow private property rather than the other way around.' [Shleifer and Vishny 1998, 11] 'Institutions supporting corporate governance, such as the banking sector and capital markets,

are also developing rapidly [sic] in part because of the profit opportunities made available by the privatised firms.' [Shleifer and Vishny 1998, 254, note 4]

[16] See Vahcic and Petrin 1989.

[17] See Stiglitz 1998.

[18] See Johnson and Loveman 1995.

[19] See Stiglitz 1999a.

[20] See Ellerman 1998 for a discussion of similar tunnelling problems with voucher investment funds.

[21] See Marshall 1897 for an early statement of the problem, but mainly see Berle and Means 1932 and the huge literature following it. See Roe 1994, Kaufman et al. 1995, Stiglitz and Edlin 1995, Stiglitz 1982, 1985, 1987, 1994, and Dyck 1999 for recent treatments.

[22] See Black et al. 1996 followed by Black, Kraakman, and Tarassova 1999.

[23] The FOM is being developed by Ms. Lynn Engstrand of PSDPS/World Bank.

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