
Desperately Seeking Economic Recovery

Why are some of the transition economies, including Russia and Ukraine, unable to embark on a path to recovery even though their macroeconomic fundamentals are in place, with budget deficits cut, inflation brought down, and exchange rates stabilized? In the following roundup we try to find answers to this question. According to Daniel Kaufmann, these economies still lack micro-level liberalization; excessive taxation, suffocating regulations, and omnipresent bribery are paralyzing business activity. In our forum for discussion, economist Stanislav Menshikov claims that the Russian economy is suffering from unnecessarily restrictive policies and suggests a well-targeted industrial policy for revitalization. David Gisselquist's therapy differs; he recommends actions on the local level and believes that the World Bank should support a long-term growth strategy in the transition economies.

Why Is Ukraine's Economy—and Russia's—Not Growing?

by Daniel Kaufmann

Ukraine's economy contracted by about 10 percent during 1996, experiencing another year of sharp decline. Even accounting for the unofficial economy—the unreported value added—a continuing contraction in overall GDP is clear. Russia and a number of (non-Baltic) newly independent states are experiencing similar trends. Stabilization was attained in some countries, including Ukraine and Russia, but they are still missing economic growth. That suggests that macro-stabilization is a necessary but not sufficient condition for growth.

Unhappy Enterprises

Almost three years ago Ukraine initiated a major economic reform program. It has made significant progress in conquering inflation, introducing a new and relatively stable currency (the hryvna), and liberalizing trade and prices on a macro level (top-down). But liberalization at the micro level (bottom-up) has not taken place, and accordingly, the cost of operating enterprises legally is still extremely high. In 1996 enterprise surveys were conducted in Ukraine and—with a smaller sample—in Russia. The vast majority of the participating firms denied that they had benefited from the reforms (while declaring them irreversible).

Newly established private enterprises especially continue to see excessive taxation, unstable legislation, and trade and regulatory constraints as serious impediments. The practice of greasing the palms of officials—tax, health, or fire inspectors, for example—to obtain a license or avoid or reduce a tax is widespread, and payments are sizeable. These payments have not declined since the reform started in 1994. (The magnitude of these payments is of the same order as in Russia.)

A panel sample of about fifty firms in Kiev and Lviv—compiled last year through the Ukraine Rapid Enterprise Survey by the Soros International Economic Advisory Group—also reported a rising tax burden and increasing administrative, policy, and regulatory controls. Throughout 1996, the government continuously strengthened its regulation of production, pricing, bank credit, and foreign trade. Foreign business felt the heat of such constraints as discretionary application of licensing rules, spreading corruption, a fragile banking system, and legal and regulatory instability. A recent report detailing Ukraine-based U.S. bilateral agencies' experiences listed other barriers as well:

- Commercial, tax, and land codes are lacking. As a consequence, few business con-

tracts are regarded as final or binding.

- Tax laws, customs regulations, and specialized licensing procedures are cumbersome and ambiguous. This leads to arbitrary implementation of regulations and corruption.

- Bankruptcy law permits companies to accumulate debts and then simply close down, but prevents restructuring.

- Resident or nonresident companies can withdraw only a limited amount of cash from bank accounts (most enterprises are allowed to keep only a single account). Bank accounts are arbitrarily frozen.

- Corporate profit taxes vary extensively. Tax exemptions are significant and discriminatory. Local tax offices exercise considerable discretion, resulting in abuses and corruption.

- The payroll tax which includes social security contributions, the Chernobyl fund, and withholding taxes, is prohibitively high. Personal income taxes are also high.

- Company registrations are not transparent, and are time-consuming.

- Foreign currency purchases and private foreign currency loans are under administrative control, and are subject to discretionary and bureaucratic licensing procedures.

- The Antimonopoly Committee is authorized to intervene in broad and unwarranted areas of the economy.

Barriers also impede progress in the agricultural sector. About 14 percent of arable land is held as private subsidiary plots, but it is not tradable. (This private land produces about half of agricultural output; the 86 percent in collective and state hands produces the other half.) No clear policy has yet been formulated for land privatization and ownership.

It is no surprise that foreign direct investment (FDI) to Ukraine has averaged less than \$5 per capita per year. (Comparable data for Hungary show annual per capita FDI of \$1,200.) Large, promising foreign investments that were at advanced stages of preparation have recently become mired in bureaucratic red tape. And some large foreign investors are leaving the country.

Business Underground

In many transition economies politicians and bureaucrats try to control the enterprise sector through administrative measures and regulations. This gives rise to side payments, directly raising the cost of doing business within the official economy. But as taxes or other administrative barriers are raised, the illicit rents extracted from an enterprise (to evade taxes and official impediments) increase as well. Given the degree of oversight bureaucrats and politicians have over the enterprise sector in many newly independent states, an endorsement is required to operate unofficially. That "nod" comes at

a private price, probably less than the extra cost of operating in the official economy. Thus the overall cost of doing business (whether officially or unofficially) increases when a tax or regulation is imposed. But operating officially becomes relatively more costly than operating unofficially.

The absence of micro liberalization has two effects on the economy:

- It slows overall output recovery because higher operating costs deter some firms from starting businesses; others may get started but then stagnate or go bankrupt.

Table 1. Evolution of the unofficial economy in countries of Eastern Europe and the former Soviet Union and possible determinants, 1989-94

Country, by degree of change in unofficial economy	Change in unofficial economy's share 1989-94 (percentage points) ^a	Unofficial economy's share 1994 (percentage of total)	Private sector development and liberalization index (0-100)	Average annual inflation rate (percentage)	Bureaucratic discretion index (0-100)
<i>Extremely high increase (war)</i>					
Georgia	52	64	22	309	36
Azerbaijan	46	58	17	208	32
Average	49	61	20	259	34
<i>Very high increase</i>					
Ukraine	34	46	13	393	46
Russia	28	40	32	230	43
Moldova	28	40	27	299	35
Average	30	42	24	307	41
<i>Medium increase</i>					
Kazakstan	22	34	22	414	35
Latvia	22	34	40	106	46
Lithuania	17	29	44	165	54
Estonia	13	25	49	123	44
Czech Republic	12	18	60	15	65
Average	17	28	43	165	49
<i>Low increase</i>					
Belarus	7	19	18	362	40
Bulgaria	6	29	49	79	49
Hungary	1	29	69	23	74
Poland	0	15	69	116	71
Average	3	23	51	145	58
<i>Decline (repressed politics)</i>					
Uzbekistan	-2	10	19	177	28
Romania	-5	17	39	104	26
Average	-4	13	29	141	27
Overall average	17	32	37	195	45

a. Calculations based on main conservative scenario of aggregate electricity consumption (Kaufmann and Kaliberda 1996).

Note: The private sector development (PSD) and liberalization index ranges from zero (anti-PSD and liberalization) to 100 (maximum pro-PSD and liberalization). Annual inflation rates are based on geometric averages. The bureaucratic discretion index has been standardized to range from 0 to 100 (maximum discretion) based on annual Freedom House indices of civil and political liberalization.

Source: *From Plan to Market*, M. De Melo, C. Denizer, and A. Gelb (1996), Freedom House.

• It encourages businesses to operate in the unofficial economy, where the added operating cost is relatively less than in the official economy. (The trend was different elsewhere: following liberalization, the share of the unofficial economy declined in Poland, in some other Central and East European countries, and in the Baltics; [see table 1].)

Prior to the transition, the share of the unofficial economy in overall GDP in the Soviet Union was estimated to be 10-15 percent. In Ukraine the unofficial segment of the economy had grown to more than 40 percent of overall GDP by 1994, and by mid-1996 it was estimated to be about one-half of overall GDP. The increase was due partly to the significant decline of the official economy during the period and partly to the tripling in the absolute size of the unofficial economy.

Although some new businesses are altogether unregistered, having entered directly into the unofficial economy, others

register the visible part of their operations. They receive some state support (social protection), and hide the rest of their business. The ratio of reported to unreported activities depends largely on the costs and benefits of operating in each economy.

Most firms surveyed in Ukraine admitted paying bribes to lower their official tax burden and to secure various licenses; [see table 2]. Senior management in the new private enterprises must spend a lot of time with public officials "securing" licenses and permits and "negotiating" taxes and penalties. In 1995 they spent about 30 percent of their working hours with officials, and almost 40 percent in 1996. (Managers in Russia—as our small sample indicates—need to spend about 30 percent of their working hours with officials, compared with 15 percent in Lithuania and 8 percent in El Salvador, for instance. During a recent visit to Moscow IMF Managing Director Michel Camdessus, while praising the strong

commitment of Russia's reformers to stabilization, warned them to face the realities of the enterprise sector. He was surprised to see so many entrepreneurs waiting in the ministers' offices. "You cannot build a market economy on this basis," (he cautioned.)

Enterprises in Ukraine are hit hard by taxes and regulations. Thus, in order to survive, they are willing to pay significant sums in bribes and consequently misreport large shares of their value added. This is why many firms are forced to submerge their operations at least partly. At the national level, the unofficial economy reduces the country's tax base and official foreign exchange holdings (thus fostering capital flight) and in so doing lessens the state's ability to manage the economy. But the costs are also significant on the enterprise level; besides the high extralegal payments required, operating in the underground economy undermines entrepreneurial

Table 2. "Unofficial" payments by enterprises for official permits, licences, and other "favors" in Ukraine and Russia, 1994 and 1996

Type of licence or "favor"	Ukraine				Russia	
	Average "unofficial" fee required for "favor" ^a		Percentage of enterprises admitting need to pay "unofficially"		Average fee required for "favor" ^a	Percentage of enterprises admitting need to pay "unofficially"
	1996	1994	1996	1994	1996	1994
Enterprise registration	\$176	\$186	66	64	\$288	44
Each visit by fire or health inspector	\$42	\$40	81	72	\$67	23
Each regular visit by tax inspector	\$87	\$91	51	56	\$250	21
Each phone line installation	\$894	\$550	78	95	\$1,071	100
Lease in state space (sq. meter per month)	\$7	..	66	88	\$26	39
Each export license or registration	\$123	\$217	61	96	\$643	43
Each import license or registration	\$278	\$108	71	93	\$133	50
Each border crossing (lump sum)	\$211	\$194	100	90
Domestic currency preferential loan (percentage of value)	4	..	81	..	8	38
Hard currency preferential loan (percentage of value)	4	..	85	..	23	53

a. Average among those who admit making unofficial payments. Preliminary data based on March 1996 survey of 150 state or private enterprises in five large Ukrainian cities, and 50 enterprises in three large Russian cities. Caution should be exercised in interpretation of the data, which are not representative of the whole country (particularly in Russia, where the sample is small). The mid-1994 survey results for Ukraine are based on a similar survey instrument.

Source: The survey.

confidence, preventing longer term investment.

According to estimates based on our survey, in both Ukraine and Russia registered firms that are responsible for about 80-85 percent of unreported economic activities are prepared to return to the legal sphere over time; only an entrenched, hard-core 15-20 percent want to stay, no matter what. Thus the unofficial economy is still relatively shallow, and with appropriate economic and institutional reforms its size could be cut.

State Restructuring

What could be those "appropriate economic and institutional reforms"?

- A major deregulation program should be launched. Such a program could level the playing field for new enterprises, eliminating most enterprise licenses and permits while keeping those that are absolutely necessary (health, environment, and safety), according to simple and transparent rules. Abuses of discretionary government powers should be eliminated (including forced delays at customs, arbitrary cancellations of import permits, and levying of steep penalties). Export registration requirements and indicative export pricing should be eliminated, along with inter-oblast trading restrictions and oblast-specific export barriers (for grain, coal, or any other commodity). Restrictions on domestic agricultural trade should be lifted, and the discretionary enforcement of state contracts terminated. The remaining price controls for artificial monopolies should be abolished, and the price inspectorate offices closed. At the sectoral level, deregulation of the energy and power sectors should be carried out, exposing gas and other subsectors to competition. More generally, the large industrial structures need to be demonopolized. This is urgent in Russia.

Privatization should be accelerated. To date, less than one-third of medium-size and large enterprises have been privatized,

with about 70 percent of their shares sold. Many of the privatized assets have been transferred to earlier managers, who are in full control of the enterprises. This trend, coupled with the absence of deregulation, has worked against enterprise restructuring. Land privatization is also urgent.

- Tax rates should be reduced and the tax regime simplified. The excessively high payroll tax needs to be cut. Tax payments should be credibly enforced, and special privileges and exemptions need to be eliminated. An improved tax administration should oversee a new tax regime that is simple, moderate, and transparent.

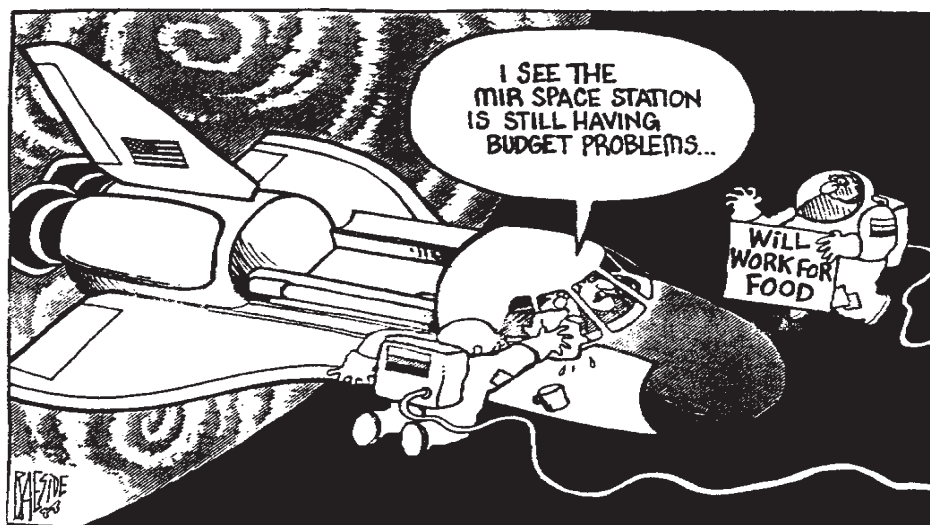
- The financial sector should be streamlined.

- The public sector needs to be restructured. The legions of bureaucrats, currently setting and monitoring prices, authorizing licenses and permits, and otherwise regulating enterprise activity would be more productive collecting corporate taxes, teaching, or starting their own businesses. Similarly, accelerated privatization in the agricultural and enterprise sectors would substantially relieve the overstretched civil servants, enabling them to focus their activity where public sector involvement is really needed, such as reforming local governments (particularly in Russia) and the relations between local and central governments.

A window of opportunity is now open to take bolder measures not only in Ukraine (despite the delay in reforms in recent months) but also in Russia. With the support of the international community, these governments, working in cooperation with the reformers, may be able to carry out a bold reform program. If the historic opportunity is seized, both countries could look forward to vigorous and sustained growth, exceeding 4 to 5 percent a year. The key is to create a pro-business and pro-investment climate by implementing deregulation and government reform.

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