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Transition Economies

A Look at Russia, Ukraine and Poland

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ABSTRACT

The following paper examines transition economies of Russia, Ukraine and Poland. It takes a look at their transition period into a market economy for the period between 1989 and 1997. It looks at the initial transformation policies implemented by these countries. The effects of these policies determined the recovery of each nation. Poland was able to implement broad reforms on the macro and micro level and as a result had a small contraction period which was followed by a rapid recovery. Russia and Ukraine failed to fully implement its reforms and as a result suffered economic downturn throughout this period. The paper examines where Russia and Ukraine went wrong and what more needed to be done. It compares the two countries to Poland and looks for possible explanations for the economic slump.

INTRODUCTION

The following paper examines transition economies of Russia, Ukraine and Poland. It takes a look at their transition period into a market economy for the period between 1989 and 1997. It looks at the initial transformation policies implemented by these countries. The effects of these policies determined the recovery of each nation. Poland was able to implement broad reforms on the macro and micro level and as a result had a small contraction period which was followed by a rapid recovery. Russia and Ukraine failed to fully implement its reforms and as a result suffered economic downturn throughout this period. The paper examines where Russia and Ukraine went wrong and what more needed to be done. It compares the two countries to Poland and looks for possible explanations for the economic slump.

Mikhail Gorbachev started a series of reforms. As a result, the Soviet Union and the countries it had significant influence over abandoned the centrally planned economies and started transforming themselves into market economies. This happened to all the Soviet Republics and its neighboring Eastern and Central European countries at the same time. A common trend was seen throughout all of the transition economies. Output declined, GDP declined and inflation soared.

There were common factors that led to the overall decline in output and GDP.[1] Liberalization of domestic and external markets caused huge shifts in demand. The shifts in demand were caused by demilitarization, decrease in investment, elimination of forced substitution on the consumer side, and consumer freedom. Markets that were in place during the Soviet times, such as the Council for Mutual Economic Assistance (CMEA) and the Soviet inter-republic market, collapsed. Opening up of borders increased imports

[1] Dabrowski, Rohozynsky and Sinitsina, 2004

into these countries, this decreased the demand for domestic goods. Domestic firms were not able to substitute decreased demand in their home markets by exports, because those channels were not developed yet. Price liberalization created inflation, which increased costs for the enterprises. Decrease in state subsidies and collapse of special price arrangements all lead to many firms being unprofitable and unable to operate at past levels. Managers also did not see a need to produce at the same levels as before because there was no central plan that needed to be met. They needed to come up with new and real incentives to expand production. Many managers did not yet posses the skills required by the market economy. As a result many assumed they would be saved by the government.[2]

The phenomenon of decreased output and GDP was the same for all the countries in the transition period. What was not the same was the amount of time the countries stayed in a contracted economy. That mainly depended on the speed and effectiveness of reform policies and the country's adaptation to the new economy. Poland was able to recover within two years while Russia and Ukraine did not do so till 1999. This paper looks at the decisions of Russia, Ukraine, and Poland to see how they influenced the recovery process. It starts out with an overview of reform policies of each country and the effect on their economies. Then it takes a closer look at some policies that were significant to that country's economic development. Some theories are then given to explain why Poland was an almost immediate success while Russia and Ukraine weren't. Factors that are considered are liberalization environment of each country, the effects of the unofficial sector on the economy, and the role that foreign direct investment (FDI) played in their economies.

[2] Ibid.

RUSSIA

Overview of reforms and economy

In 1991 Yeltsin ended the communist regime in Russia, at the same time ending the communist control over government and economy. New government and economic system had to be developed to guide Russia through the transition period. In 1992 a reform package was introduced, its purpose was to replace the command economy with market. Prices, trade, and exchange rates were liberalized. Government budget was to be reduced, one of the major reductions happened at the military level with a decrease of 68 percent. There was a reduction of subsidies to state enterprises. Also, bankruptcy provisions were set up.

The release of prices caused an immediate inflation. In addition to that, the central bank was following a loose monetary policy which led to a hyperinflation, 1,353 percent in 1992. (See Appendix Table 1) Wages tried to keep up with inflation, but there were definite loses in real wages. The government decreased subsidies to state owned enterprises (SOE), this led to cash shortages in many firms. Firms then tried to purchase goods on account. When firms accrued high payables and failed to pay, suppliers in turn failed to pay wages to their employees. This created a vicious cycle and together with inability to pass up increased costs to the consumer led to output decline.[3] GDP was in decline in Russia until 1997, it declined by 14.5, 8.7, 12.6, 4.0 and 2.8 percent in 1992, 1993, 1994, 1995 and 1996 respectively. (See Appendix Table 2)

Russia experienced a big economic contraction which lasted between 1990 and 1997. One of the main reasons for that was the slow and inconsistent macroeconomic stabilization and liberalization. It impeded structural and industrial changes which were

[3] Gerber and Hout, 1998

necessary to stop and reverse the declining economy. Reforms were improperly timed and were inconsistent. The government did not focus on curbing inflation and getting macroeconomic stabilization. In other countries stabilization was usually followed by more political and economic reforms, which was not the case for Russia.[4]

Entry of new firms did not play a key role in boosting the economy in Russia, as was the case in Poland, primarily because the firms were inefficient and most of the time entered the unofficial economy. The primary reasons for that were huge government regulation and unfriendly business and investment environments. Many businesses joined the unofficial sector and tried to secure their profits even further by transferring their assets offshore. This is one of the reasons for capital outflows in Russia during the transition time. Another reason is low foreign direct investment which was very low in Russia for the same reasons as new firm development. The FDI that did enter the country usually went straight to the oil and natural gas sector ignoring all other aspects of the economy.[5] Large powerful private corporations were responsible for keeping the economy afloat. However, their interests usually rested with themselves and were at times detrimental to the society at large. Russia's business did not focus much on exports. The only goods exported in vast amounts were oil and natural gas. All other industries ignored that option and as a result remained technologically underdeveloped and uncompetitive. While this had an immediate consequence of reduced output, this also affected future business growth and development.[6]

Privatization

[4] Dabrowski, Rohozynsky and Sinitsina, 2004
[5] Ibid.
[6] Ibid.

Russia went through a rapid privatization phase where by 1994 most enterprises were in private hands. A voucher program was introduced in 1992. It gave ownership vouchers to company employees and mangers. As a result of this, company ownership was highly diluted. In addition to that, managers controlled high shares of the firms they managed. Both of these factors prevented close oversight of corporations by its owners which gave a lot of power to the managers of corporations.[7] This developed a large but very weak private sector where interests of managers were not always matched with the interests of the public.

The rate of privatization was too quick for Russia and was way ahead of proper legislative and regulatory reforms. There was no system in place to guide the managers of the new private businesses with proper governance and competition practices. As a result, managers often sold of the assets of the business to secure quick capital gains instead of focusing on long term operations and growth. Because Russian industry was comprised of mainly large enterprises, privatizing them created large and powerful firms guided by profit seeking managers. This also created a powerful lobby which thwarted further economic reform. Unprofitable enterprises and those evading taxes led to loss of fiscal revenues for the government. It also created huge income inequality.[8]

Privatized firms lacked sufficient market economy skills. They lacked a competitive edge. Managers' decisions reflected the influences of past times and they were not able to adapt quickly to the changing conditions. Managers refused to lay off

[7] Ibid.
[8] The World Bank, 2002

redundant workers and instead tried to focus on bargaining with suppliers and securing payments from customers.[9]

Policies and arrangements that are in place but need to be reformed or eliminated

According to Buckberg, "achieving a successful transition requires the creation of an institutional and regulatory environment that fosters investment and promotes new private sector activity."[10] During the transition period Russia failed to achieve that. On the contrary, investment was declining. Total investment decline was about 50, 12, 23 and 13 percent for 1992, 1993, 1994, and 1995 respectively.[11] Private sector activity was rising primarily in the unofficial sector driven there by the unfavorable environment. FDI was also low. Russia had to create a legal and regulatory environment that would foster growth and encourage business to operate officially.[12]

The tax system must to undergo reforms. Different types of taxes when accumulated lead to almost no after-tax profit. Distorted and unclear rules give a lot of power to tax inspectors in interpreting them. This leads to widespread corruption and uneven application. At times tax requirements are not even documented at the local level. Errors are usually penalized with the same severity as fraudulent evasion. Tax evasion usually occurs through transfer pricing with international subsidiaries keeping all the profits by overstating expenses, moving profits to offshore accounts, and by understating exports and overstating imports. High payroll and income taxes decrease the demand for labor.[13]

[9] Gerber and Hout, 1998
[10] Buckberg, 1997
[11] Gerber and Hout, 1998
[12] Buckberg, 1997
[13] Ibid.

Taxes would have to be reduced for firms operating officially and complying with the law. The extremely high costs of fully complying with tax laws drove managers to underreport business activities. This type of behavior promotes nonmonetary transactions and the hiding of income and assets usually in offshore accounts. Offshore accounts then become a cause for decreasing investment in the economy, and also decreasing funds for business operations.

Officials and bureaucracy also produce unfavorable business conditions. Excessive documentation, long approval time, and high fees force businesses into the underground economy. The government needs to make the requirements to start and operate a business more transparent and the process faster. And individual wanting to start a new business would have to go through a number of officials first finding out what needs to be done and then doing it step by step, signature by signature. The whole process could take months. This is another situation that facilitates corruption. "The cost of corruption and bureaucratic delays may price some potential new business out of the market, or drive them underground."[14]

The legal environment needs major improvement. The public access to law is limited. Some areas of the law are incomplete. Judiciary is not independent, judges and prosecutors are corrupt. The court does not have enforcement mechanisms such as ability to seize assets and liquidate them, and to have jurisdiction to seize offshore accounts. Also, areas of property rights protection and contract law need to be developed. The legal environment also fails to protect the public from crime. Judges are often threatened and experience violence against them. Private businesses have to pay organized crime

[14] Ibid.

for protection. 76 percent of small businesses in Moscow in 1995 said they had to pay for protection.[15]

UKRAINE

Overview of reforms and economy

Ukraine became an independent state in 1991. Independence brought a new form of government and economic system. The Soviet time rule arrangements and overall structure of the economic sector called for major reforms in order for Ukraine to survive in the new environment.[16]

While part of the Soviet Union (SU) Ukraine had major factories such as steel production, oil processing, coal mining and other chemical industries. Ukraine received raw materials and energy from other republics to produce mostly intermediate goods, only 20% were finished goods. After the collapse of SU, Ukraine was left with the large manufacturing plants but no sure source of raw materials and energy. With the collapse of the SU, the major transportation and economic links collapsed as well. This was primarily due to the introduction of new national currencies in the independent republics which led to problems determining proper exchange rates and problems with inter-bank relations. These factors hindered international trade. Furthermore, there was an overall change in foreign trade conditions. With the end of the Cold War there was a decline in the demand for military goods. Opening up of borders had an effect of increased competition with products from international firms. It also became hard to find buyers

[15] Ibid
[16] International Labor Office, 1998

for the intermediate goods that Ukraine used to produce. There was a decrease in real income of citizens. All these fast changes were detrimental to the business sector.[17]

The manufacturing factories in Ukraine were very large. They controlled the production of goods and services and had large market shares in the economy. This made the economy very monopolistic and inflexible. The people running these factories were very well connected to the government and suppliers. The factories provided employment to a big percentage of population. Because of these conditions, the government was interested in keeping the big industry in operation, which often resulted in a lot of financial support. The firms assumed a kind of 'too big to fail' role in the economy. This limited competition. It created huge barriers of entry for the small firms, on one side there were the mangers of factories who had close ties to suppliers and government, on the other side the government itself did not want the added competition of new firms. In addition to this, the citizens themselves were weary of private enterprise because of long years of Soviet conditioning.

However, Ukraine did possess a few good things in terms of valuable resources. Ukranians are a large and well educated labor force. Ukraine has fertile land; 60 percent of the worlds black soil is located in Ukraine. And high reserves of coal, iron ore, and other raw materials.[18]

Macroeconomic Trends 1990-1997

Analysis of GDP shows a declining trend starting in 1989. (See Appendix Table 2 for more details.) Main cause for initial economic slowdown was disappearance of trade

[17] Ibid.
[18] Ibid.

networks. Because major industries were monopolistic, the increases in prices of raw materials and energy were transformed to the consumer.

In 1992 the government released its hold over prices. Energy prices instantaneously skyrocketed. The industries asked the government for subsidies. This led to an inflationary monetary policy and huge budget deficit. The result was a devastating hyperinflation, reaching 1,210 and 4,735 percent in 1992 and 1993 respectively. (See Appendix Table 1) The government tried to set up some controls, such as controlling prices of key inputs, regulating wages in the public sector, and reducing social programs. These policies did little to curb inflation. In addition, the government had no control over the expanding private sector. Overall business activity was at a slow down. Sales and investment plummeted giving difficulties for the firms to raise operating funds. The firms were not able to collect from its customers and as a result couldn't pay its suppliers. This had a chain effect throughout the whole economy.

In 1994 Leonid Kuchma became President of Ukraine. One of his main goals was economic stabilization. Through a series of reforms he took action to accelerate privatization, took steps in unification of the foreign exchange rate, suspended price regulation, reduced subsidies to unprofitable firms, liberalized foreign trade, and set up strict monetary and fiscal policies. The immediate effect was a decrease in inflation, which in 1994 dropped from 4,735 to 842 percent, increase in foreign trade and a decrease in the budget deficit. However, GDP growth did not recover. GDP decreased by 22.9, 12.2, 10.0 and 3.4 percent in 1994, 1995, 1996, and 1997. (See Appendix Table 2) The main reasons for that came out from the decreased government spending in the form of lower investment. This reflected on the private sector which also tightened credit

controls. In addition foreign direct investment in Ukraine was very low. All of these factors led to little or no investment into new technology. Without new technology a transition economy cannot adjust to new times and this in turn slowed down the overall growth of the economy.

Agriculture

Ukraine has one of the richest soils in the world; however its agricultural output has been suffering. Slow privatization and government intervention have been the main obstacles for growth. Privatization has been slow because there has been no clear policy regarding land privatization and land ownership. Government intervention was also much higher than in the enterprise sector. Government controlled marketing, state procurement, inter-localities sales, exports, and pricing. Local agencies named Commissions on Movements of Agricultural Commodities used to exercise enormous control over regulation, licenses, and permits. They oversee the movement of grains and are the people that can either give you permission to sell your output or not. Such large powers at the local level present a lot of corruption. Landowners with connections get preferential treatment. The current structure also has no incentives for efficient growth.[19]

FDI problems

The lack of foreign direct investment can be attributed to the fact that foreign companies do not want to invest in Ukraine. The main reasons are legal and regulatory instability, unfair application of licensing rules, fragile banking system, and widespread corruption.[20]

[19] Kaufmann, 1997
[20] Ibid.

Kaufman lists some of the specific reasons why foreign firms do not want to enter Ukraine. Ukraine has no commercial tax and land codes, this makes it hard to finalize a contract. Bankruptcy law has no provision for restructuring; in this case, firms are able to incur debts and then declare bankruptcy fleeing with the money. Corporate, payroll and income taxes are high. Registration time for a new business and fees charged for licenses and permits are high, this leads to high startup costs and to increase in the unofficial economy. There is a restriction that permits businesses to have only one bank account, this regulates the amount of funds available for withdrawal and makes freezing of funds easier. Local administration is usually very powerful and corrupt. The administrators often do things that benefit themselves and not the economy or the people at large. Ambiguous laws and high taxes often lead to side arrangements with the government, this fosters unfair competition and increase in corruption. This is also seen in the biding process for contracts, where the party with better connections is more likely to receive the contract. Finally, the overall environment of high levels of crime and corruption makes investments in Ukraine very risky. This translates to FDI being on average $4 per capita per year during the transition period.[21]

Informal Sector

Aside from the monopolistic manufacturing sector, Ukrainian economy also developed a huge informal or unofficial sector. (See Appendix Table 3 for more details.) The unofficial economy was estimated to be about 12, 46 and 50 percent in 1989, 1994, and 1996 respectively.[22] The main reasons for the development of the unofficial sector were high taxes, foreign trade regulations, foreign exchange restrictions, unstable and

[21] Ibid
[22] Kaufmann and Kaliberda, 1996

unclear legislation, and problems in the progress of privatization. These regulatory type factors were joined together with a sort of people side demand for the informal sector. Ukrainian people faced very few employment possibilities, they saw a decrease in their real wages, non payment of wages, and were fired or laid of from the state enterprises. As a result, they had nowhere else to turn but to the informal sector. The informal sector then became a buffer for individuals needing work and income. It became a medium for new and emerging firms to exist in and grow. Another positive effect of the informal sector is that it made the economy and markets more flexible, something that the big enterprises could not provide.[23]

The arguments against the informal sector are that it is bad for the economic stability because of its huge size. It reduces state revenues because firms operating in the informal sector are less likely to pay the full amount of taxes, or not pay taxes at all. It is bad for fair competition because of all sorts of corruptive relationships that are formed between the parties including the government. And it produces no incentives for firms to enter the formal sector.[24]

The main driving force for the unofficial economy is the high operating costs produced by politicians and legislature. Politicians wanting more power and money try to get control and significant influence over the business activities. The way they are able to get it done is through bureaucratic and administrative pressure. To side pass the overwhelming degree of administrative paperwork and time, businesses have to bribe the officials to expedite the process. Increases in administrative controls, types of permits and licenses, and taxes usually yield an increase in the amount of the bribes. Also,

[23] International Labor Office, 1998
[24] Ibid.

managers have to spend an increasing amount of time with officials trying to work things through. This creates high operating costs for those trying to do business officially. In order to survive mangers move their businesses fully or partially into the unofficial economy. Even though the unofficial economy still involves many side payments to such parties as tax officials, it is still considered cheaper than operating in the official economy.

What needs to be done

Major macroeconomic reforms implemented during the Kuchma administration served their purpose of stabilizing the economy. However, they did little to expedidte its growth. Kaufman argues that there needs to be a series of reforms done on a micro level, to liberalize the private sector and enable it to freely function and grow. He has a theory that promotes "pro-private sector development policies" (PSD).[25] The key thing is to reduce the high costs that impede firms from operating efficiently. These high costs arise from unstable legislation, high taxes, and trade constraints. These regulatory costs are the highest for Ukraine as compared to other developing countries. In a survey it was established that Ukrainian firms face the biggest barriers in import and export restrictions, taxes, some price interventions, and slow privatization. Also managers of private firms find themselves spending lots of time with government officials gaining permits or licenses in order to be able to operate their business. This adds to their operating costs and affects both official and unofficial enterprises.

These factors function as breaks for the overall economy. There is delayed output because high operating costs serve as barriers for new firms to enter the economy and

[25] Kaufmann, 1997

also force existing firms into bankruptcy. Firms which are unable to function in the official economy end up switching to the unofficial sector.[26]

A full out reform program has to come at once in order to liberalize markets at micro level. Costs of doing business in the formal sector have to come down. Tax and regulatory reforms have to be implemented. A new wave of deregulation is also needed. It should come in the form of eliminating permits and licenses, except those that are needed for health and safety reasons. Rules have to be clear and not confusing. Abuse of power at the local level has to be eliminated to avoid further corruption. Requirements on exports and prices have to be eliminated. Agricultural restrictions have to be removed; especially those focused on pricing, exports, and inter locality trading. Registration of new firms has to become easier in order for new firms to enter and facilitate more efficient and competitive markets. Privatization has to occur at a much faster rate.[27]

As far as the tax reform goes, tax rates for corporations have to be lower. Payroll tax has to be lowered as well. New firms should be able to operate at lower tax rates while they try to establish themselves. This will give further incentives for entrepreneurs to open up businesses and for existing firms to move from the unofficial to official economy. Another incentive for firms to move from the unofficial sector to official is to forgive past tax evasion. There also has to be a lower tax rate for foreigners to attract FDI. Elimination of import duties to exporters can serve as an incentive to export more.[28]

POLAND

[26] Ibid.
[27] Ibid.
[28] Ibid.

Overview of reforms and economy

Poland started its reform process in 1989, earlier than most Eastern European countries. It implemented a wide range of reforms in a very short period of time, a concept some call as a 'shock therapy'. Its contraction period reached the lowest level in 1991 and then reversed itself producing considerable growth in GDP and investment. GDP growth was -11.6, -7, 2.6, 3.8, 5.2, 7, 6.1 and 6.9 percent for 1990, 1992, 1993, 1994, 1995, 1996 and 1997. (See Appendix Table 2) Investment averaged about 16 percent per year during that time.[29] Macroeconomic stability and institutional reforms were able to foster these results.

Before the start of the transition period, Poland was considered by many to be in a very bad shape. It experienced high inflation, large external debt, and a large black market for currencies. However, it was able to turn itself around quickly and even serve as a model transition economy. Some of the reasons for that were its initial conditions. Political reforms began early in Poland. Poland already had an existing private sector, which comprised about 25 percent of the economy. There was broad initial price and trade liberalization. Obstacles to foreign trade were broken down which led to trade being developed with the West. This in turn enabled firms to restructure themselves quickly and become internationally competitive. A lot of external debt was forgiven to Poland, this lowered its outstanding debt and served as one of the attractions for future FDI. There were low entry barriers for new firms. As a result many new firms entered, labor was able to move from state owned enterprises into the new private sector. Legislature immediately developed contract enforcement. The government developed hard budget constraints for public enterprises which lowered their burden on fiscal

[29] Dabrowski, Rohozynsky and Sinitsina, 2004

policies. Entrepreneurship was encouraged. Social safety net was maintained through out the transition process to help citizens cope with uncertainty. On top of all this there was a careful macroeconomic policy which was put into place with a focus on foreign exchange policy which kept Poland's currency from being overvalued and staying competitive.[30]

Exports

Because of the above conditions Poland was able to experience prolonged growth between the periods of 1991 and 1997. Growth was primarily driven by exports. Poland was able to quickly find new trading partners and its exports to EU rose to a stable 70 percent. This contributed to a competitive manufacturing industry.[31] Manufacturing turned out to be one of the primary contributors to output. By 1997 it accounted for more than 60 percent of the aggregate value-added.[32]

New firms

Increase in the number of firms in the industry also contributed to economic growth. During the communist times large size industrial firms dominated the industry. Emergence of a large number of small firms was a correction to that distortion and a development of a consumer services oriented small business sector.[33] The new small and medium sized firms played a key role in Poland's economy. They were able to facilitate economic restructuring, absorb labor resources, and develop new business leaders who were not influenced by the old regime. Table 4 in the Appendix shows an increase in the

[30] De Broeck and Koen, 2000
[31] Dabrowski, Rohozynsky and Sinitsina, 2004
[32] De Broeck and Koen, 2000
[33] Ibid.

commercial law companies many of which were joint ventures with foreign investment. The private sector was able to double its contribution to the economy between 1989 and 1994 from 28 percent to 58 percent respectively[34] and by 1998 it accounted for 70 percent of output and employment.

Problems

Poland did face some problems during the transformation period. A prevailing problem was unemployment. Unemployment was zero while economy was centrally planned. This created a lot of redundant workers. Once the economy moved into a market system, many businesses in order to stay competitive had to lay off the unnecessary labor force. That, together with the contraction between 1989 and 1991, produced high unemployment. Even as private sector output rose, employment did not keep up at the same pace.[35]

There was some form of corruption going on, although on a much lower scale than in Ukraine and Russia. It was something that was inherited from the communist times. While power was concentrated at the top and transparency was low officials had the tendency to be corrupt. Some of that was still left in Polish society. In addition to that the people themselves were used to it to some extent. After World War II the country was under heavy influence of the Soviet Union. State controlled enterprises were seen as unfriendly. Therefore, it was the norm to accept corruption at that level because people didn't feel that it was detrimental to them or their country, rather to that alien regime. Those feelings might have still existed during transition time.[36] However, corruption in Poland was pretty low. A good indicator of that would be the size of the

[34] Borish and Noel, 1996
[35] De Broeck and Koen, 2000
[36] The World Bank, 1999

unofficial economy. In 1994 it was estimated to employ only about 5 percent of the labor force.[37] Johnson and Kaufman show a decreasing trend of the unofficial economy in Poland, 15.2 percent for 1994, which is a much lower number than other transition economies.[38] (See Table 3 in the Appendix for more details.)

A closer look at Poland's fight with the unofficial economy and corruption shows a series of well implemented reforms. It held elections at the national and local levels, electing people who were not in power during communism. It removed lobbying organizations with special interests which existed prior to the transition period. Worker councils fired managers of organizations in the beginning of transition period. All of these steps were aimed at reducing the influence of self motivated groups and government officials.[39] These actions together with reforms at the macro and micro levels helped curb corruption and unofficial economy.

Other things that were a bit problematic were unprofitable state owned enterprises along with some other private firms. It was also hard to privatize or liquidate some SOEs because they were unappealing to investors. In addition to that, it is hard to liquidate major industries in an economy that has significant unemployment figures, which were as high as 16 percent at a certain point. A problem that occurred with many private firms was that they did not invest in capital assets. Instead earnings were spent on consumer goods and not left inside the business. This was more of a problem for the future because longevity and growth depend on the capital assets producing the output. Another problem which was prevalent among transition economies was the increasing arrears.

[37] Borish and Noel, 1996
[38] Johnson and Kaufmann, 2001
[39] Ibid.

This created tightening of credit and put more emphasis on cash and barter transactions which decreased liquidity for private firms.[40]

Privatization

Privatization was slow in Poland. Many thought that newly privatized firms would not be able to adapt to the fast changing market conditions. This could have led to a wide range of bankruptcies and then to social turmoil.[41] The government also wanted to institute proper reforms before turning the business sector into the private hands. Because of extra time, the government was able to shop around for different privatization options. Some enterprises were privatized through the sale of shares on the Warsaw Stock Exchange. About 1000 medium sized firms had their assets and liabilities sold off through installment sales.[42] Many firms were privatized together with foreign investors. This also attracted FDI. Table 4 in the Appendix gives some sort of a picture into the rate of privatization in Poland between 1990 and 1998. You can see that in 1990 out of 107 started privatizations only 6 were complete. This rate increased over the years and in 1998 there were 4,684 privatizations started and 3,081 were completed. Another important factor to point out was that Poland entered the transition period with an already existing private sector. In 1989 it made up 25 percent of GDP. As a result it did not have to rush to turnover high amounts of privatized entities. The outcome, of course, was favorable because Poland always had a substantial private sector and was still able to increase its size but with much better quality than other transition economies.[43]

[40] Borish and Noel, 1996
[41] Paci, Sasin and Verbeek, 2004
[42] The World Bank, 2002
[43] de Melo, Denizer and Gleb, 1996

AN OVERVIEW OF THE RESULTS OF TRANSITION

Table 5 and Table 6 in the Appendix provide a good overview as to the success of each countries transition policies. Table 5 presents GDP change for Poland, Russia and Ukraine in terms of their 1989 GDP levels. 1989 serves as a benchmark year in order to judge how well the country performed in terms of GDP. By 1998 Poland has seen a definite increase in its GDP over its 1989 levels. Even though after ten years it has only seen a 17 point increase in its GDP levels, it is still impressive considering that it underwent a tremendous transformation and was able to adjust to a new economic system. The same cannot be said about Russia and Ukraine. They are well below their 1989 levels with Ukraine loosing almost two thirds of its GDP. These results can be attributed to the failures in their reform policies and inability to quickly adjust to the new economic system.

Table 6 presents a look at how Russia and Poland rank up in attracting FDI during the transition period. FDI for Poland has seen a considerable increase with a 2.9 percent of its GDP in the period between 1996 and 1999. However, Russia in the same period is almost at the same level as Poland was between 1992 and 1995. Russia's inability to attract FDI shows a failure in its political and economic policies during this period. This failure can also be attributed to its contracted economy.

Why Russia and Ukraine did not see the same rapid growth as Poland

Kaufman offers a pretty simple explanation to the above question: "Ukraine and Russia share an anti-PSD regulatory and tax environment, that is a nonliberalized economy from a microeconomic perspective. This is in sharp contrast with Poland, which has had a pro-PSD environment for years. Not surprisingly, Russia and Ukraine

have only a small fraction of the number of new enterprises that Poland has, although the latter is by far the least populated of the three countries."[44]

Liberalization index

The focus on micro level liberalization has also been looked at by the World Bank. They have developed a liberalization index. The function of that index is to measure how GDP is affected by the level of reforms done in a country. It measures the reforms that are needed to make markets the main mechanisms of allocating resources in an economy, also considering those policies that stabilize the economic environment, liberalize trade, and promote competition. Countries are ranked on a scale of 0 to 1. 0 represents an untrasformed and centrally planned economy, and 1 represents a fully implemented market economy. Table 8 in the Appendix lists the results for Russia, Ukraine, and Poland. It is of no surprise that Poland is ranked much higher on the index than Russia and Ukraine. World Bank adds that countries with "better policies are associated with higher annual growth of GDP."[45]

Capture Economy

A theory offered by Hellman, Jones and Kaufman states that under certain conditions companies can have such significant influence that they have the policy makers and the economy overall working for their advantage, or in other words they 'capture the economy'. When one firm extracts huge benefits from the government, it captures it. As a result society suffers, usually by 10 percent over a three year period.[46]

Large firms with ties to the state usually get preferential treatment in ways of secure property and contractual rights. They then enjoy higher growth rates than the rest

[44] Kaufmann, 1997
[45] The World Bank, 2002
[46] Hellman, Jones, Kaufmann, 2000

of the firms. When new firms enter an industry, in order to be competitive they turn to state capture in a strategic type way. For them, state capture is not a substitute for innovation, but is a substitute for the weakness in the legal and regulatory framework. The authors argue that by improving reforms to full liberalization, a country can reduce the extent of the capture economy by 15-30 percent.[47]

The authors classify different types of corruption into three categories administrative corruption, state capture, and influence. Administrative corruption is the amount that firms spend in illicit and non transparent payments to public officials in order to receive alternative treatment in regards to some established law. State capture is the amount that firms spend in illicit and non transparent payments to public officials in order to influence the making of new laws, rules and regulations by government. Influence is the degree which firms have in establishing new laws, rules and regulations by government.

Results for administrative corruption are as follows: Poland spends 1.6 percent of revenues, Russia 2.8, and Ukraine 4.4. Poland shows the lowest administrative corruption. This result can be linked directly to the fact that out of the three countries Poland has the lowest unofficial economy, while Ukraine the highest.

The results for captors and influential enterprises are summarized in Table 9 in the Appendix. They show that Poland has the lowest influential firms, 3, as a percentage of the total firms in the sample. It ties with Russia at 9 percent of captor firms. Ukraine once again has the highest captors and influential firms, 12 and 14 percent respectively. The overall capture economy index for Poland is 12, while Russia and Ukraine both score

[47] Ibid.

a 32. Poland is classified as a low captor economy, while both Russia and Ukraine are classified as high.

The authors note that larger firms are more likely to participate in state capture. They have the highest demand for resources and therefore have a higher probability of influence and state capture. They usually pay less bribes as a percentage of revenues because they have many more options of how to deal with the state. However, smaller firms are much more impacted by administrative corruption.

The social costs of state capture are very severe. With state capture companies are able to buy extra barriers to enter for their potential competitors. The government will tend to undersupply the public with needed services if it is able to provide it to a few firms for money. Empirical evidence shows that in low capture countries the real rate of sales growth over the three years studied was 21.4 percent. In big capture countries it was 11.1 percent, a 10 point difference. Same was the case with investment rates, 21.1 percent for low capture countries compared to 11.5 for high.[48]

This study shows why Poland would outperform both Russia and Ukraine. It had a much lower unofficial sector and lower corruption. It also developed sufficient policies and reforms where a firm would need to pay for extra protection of an unavailable public good. Plus, its private sector is composed of a large number of small firms who would probably not have the money or the power to capture or influence policy making. That is not the case in Russia and Ukraine which are dominated by large industries who do have the power and the resources to capture their economies. As a result the society suffers while the few gain.

Strategic Alliances and FDI

[48] Ibid.

Strategic alliances are an important part of a growing economy. They provide a source of added assets from the partners. They provide access to resources and capabilities and are a way of getting access to new technology without capital outlays. During the SU, there were no private property rights. This provided little incentives to invest in new technology to make processes more efficient. As a result Soviet companies and the private enterprises that succeeded them were left with outdated technology that put them at a competitive disadvantage. One of the ways to go about in obtaining new technology would be through strategic alliances. A government can encourage that by providing special tax subsidies. However, that did not happen in either Russia or Ukraine. Russian government never made a distinction between firms that had foreign partners and those that did not. The main reason for that was the unstable environment.[49]

Strategic alliances in Russia and Ukraine were influenced by the unstable government and institutional structure. So they tended to be short term focused with special emphasis on the partners who were able to provide finances or access to financial resources. No consideration was given to developing a good capital structure for long term operations. Russian managers were primarily focused on short term investments because of their inabilities to price long term ones. The uncertainty of long term returns were caused by political risks which would require higher premiums to accept the risk.[50]

Government in Poland, on the other hand, encouraged foreign investment. That can be seen through their increasing FDI and policies facilitating investment. It can also be seen through their privatization program where many state firms where privatized to

[49] Hitt, Ahlstrom, Dacin, Levitas and Svobodina, 2004
[50] Ibid

foreign companies or to joint ventures with foreign companies. This stimulated their technological development and increased competitiveness for their enterprises.

Strategic alliances with foreign companies are a source of FDI. While the above paragraphs focus on Russia's and Ukraine's reluctance to seek long term strategic alliances with other firms, this one looks at the other side to see if the foreign company is attracted to an investment in a particular country. Faria and Mauro propose the characteristics that a foreign company would look for when evaluating its investment in another country. Institutional quality is a big factor. It looks at things like the type of regulation, red tape and corruption found in a country. Corporate governance is also important, lack of which might signal an unfriendly environment to business. Human capital and natural resources are also significant factors.[51]

FDI brings in equity investment that may be very valuable to a firm. During the transition period from plan to market a firm's only source of financing may be the bank. Efficient equity markets take a long time to develop, so a bank based system is developed. Banks loan money to firms and in turn they are able to provide better monitoring of the firms than shareholders would.[52] However, it is bad for the firms to be dependant solely on debt financing. In times of high inflation and high interest rates it can be very costly. Firms then also become more affected by bank and economic crises. So in transition economies the best source of sufficient equity financing can be FDI. Another thing worth mentioning is that during the transition period in Russia and Ukraine banks did not really lend to firms. Russia and Ukraine had the worst performing banks

[51] Faria and Mauro, 2004
[52] Popov, 1999

when it came to allocating credit to firms. [53](See Appendix Table 10) Instead banks invested their portfolios into government treasuries which were made to keep up with inflation.

Russian and Ukrainian enterprises did not receive substantial FDI, they did not receive any bank credits, and profits were sent offshore. The lack of these 3 financing sources is a reasonable explanation as to why there was no growth or expansion. Russian and Ukrainian enterprises had no way to grow, there were no investment funds available for them to expand. This explains the negative investment percentages, the declining GDP, and the lack of capital improvements throughout the enterprises.

CONCLUSION

This paper presented an overview of transition economies of Russia, Ukraine, and Poland. It also tried to address the reasons why Russia and Ukraine were not as successful as Poland in quickly rehabilitating themselves from the initial contraction that followed the collapse of their command economies. The main factor that played a significant role in determining how successful the transition period would be was the extent of reforms in each country.

Russia and Ukraine were not able to produce the same package of reforms that Poland shelled out. They tried to do the right thing by liberalizing their macroeconomic variables and letting the market determine supply and demand. However while the economy at large seemed to be operating at a market level, the individual firms were not able to fully participate in that economy and contribute to it. There were many barriers that existed at the firm level which prevented the economy from growing. These barriers

[53] Huang, Marin and Xu, 2004

were the result of unfinished reforms. Wile much was done to stabilize the economy, like efforts to decrease inflation and excessive government spending, there was little done in a way to promote fair and competitive growth of the private sector. The lack of these basic reforms and governance structures were then the main cause to all the other troubles that took place. Whether it was an insufficient tax system, an insufficient legal system, a growing unofficial economy, red tape, widespread corruption, negative investment rates, or low FDI, it can all be attributed to the lack of initial reforms at the local level. These reforms were needed to promote private sector growth and participation in the economy. The absence of these policies instead promoted the exact opposite of what the two countries were trying to achieve.

Poland, on the other hand, introduced a huge wave of reforms. These reforms helped the country to get back on its feet quickly. It introduced policies that encouraged private sector development at a measured pace. It focused on getting its reforms in place and economy stabilized before it was to swell up with eager entrepreneurs. This helped it develop a healthy private sector that was contributing to the economy and society. It also encouraged and was able to attract FDI along with an extensive exporting network. This made Polish companies competitive worldwide and ensured their future development.

A couple of theories took a step in explaining the differences between Russia and Ukraine with Poland. The liberalization index developed by the World Bank quantified the degree of reform in each transition economy. It then showed that the countries with higher levels of reform were also better performing economically. This once again put the light on Russia's and Ukraine's lack of reforms as one of the causes to their economic derailment. The capture economy theory shows how corrupt officials together with

unethical mangers can cause a stagnation in legislative and regulatory development. When a company buys special legislation that only helps that company, the rest of the society suffers. The lack of FDI in Russia and Ukraine, as discussed before, caused for insufficient capital development in the private firms.

Going through a transition is very tough. As illustrated in this and many other papers, it is a very uncertain and dark road. However, credit has to be given to the countries that are struggling with it. Turning your whole economy upside down overnight while trying to maintain stability in the country is an extremely tough thing to accomplish. Therefore, it will definitely take some time before these countries will be able to develop well functioning economies.

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APPENDIX

Table 1
Inflation for Poland Russia and Ukraine, 1989-1994

	1989	1990	1991	1992	1992	1994
Poland	251	586	70.3	43	35.3	32.2
Russia	2.2	5.6	92.7	1,353	896	220
Ukraine	2	4	91.2	1,210	4,735	842

Note: Inflation is represented by average annual change in the consumer price index.
Source: de Melo, Denizer, Gelb, 1996

Table 2
Growth of Real GDP for Poland, Russia and Ukraine, 1990-1997
Percent per year

	1990	1991	1992	1993	1994	1995	1996	1997
Poland	-11.6	-7.0	2.6	3.8	5.2	7.0	6.1	6.9
Russia	-2.3	-5.0	-14.5	-8.7	-12.6	-4.0	-2.8	0.8
Ukraine	-3.6	-8.7	-9.9	-14.2	-22.9	-12.2	-10.0	-3.4

Source: Berg, Borensztein, Sahay and Zettelmeyer, 1999

Table 3
Unofficial Economy for Poland, Russia and Ukraine, 1989-1995
Percent of GDP

	1989	1990	1991	1992	1993	1994	1995
Poland	15.7	19.6	23.5	19.7	18.5	15.2	12.6
Russia	12.0	14.7	23.5	32.8	36.7	40.3	41.6
Ukraine	12.0	16.3	25.6	33.6	38.0	45.7	48.9

Source: Johnson and Kaufman, 2001

Table 4
Poland's Private Sector Development, 1989-1998

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Commercial law companies	16,905	36,267	53,771	69,907	83,283	95,017	104,922	115,739	126,465	136,497
# of the above with foreign capital	429	1,645	4,796	10,131	15,167	19,737	24,086	28,622	32,942	36,850
State enterprises	7,337	8,453	8,228	7,245	5,924	4,955	4,357	3,847	3,369	2,906
# of firms started privatization		107	1,297	2,056	2,635	3,132	3,582	3,953	4,178	4,648
# of firms completed privatization		6	228	612	989	1,380	1,930	2,503	2,837	3,081
Percentage of total output		30.9	42.1	47.1	52.0	53.3	57.9	60.1	67.2	
Percentage of employment	46.2	48.9	54.1	56.0	58.9	60.6	62.4	65.1	68.2	70.7

Source: De Broeck, Koen, 2000

Table 5
GDP Change In Poland, Russia and Ukraine 1989-1998
Index, 1989=100

	1994	1995	1998
Poland	92	98	117
Russia	51	49	55
Ukraine	44	39	37

Source: Johnson and Kaufman, 2001

Table 6
Share of FDI as a Percentage of GDP for Poland and Russia

	1992-1995		1996-1999	
	USD millions	% of GDP	USD millions	% of GDP
Poland	2,540	0.6	17,096	2.9
Russia	3,965	0.3	8,412	0.7

Source: The World Bank, 2002

Table 7
Private Sector Share Estimates as a Percentage of GDP for Poland Russia and Ukraine, 1990-1996

	1990	1991	1992	1993	1994	1995	1996
Poland	27	31.4	45.3	47	53	58	60
Russia	6	6	23.5	32.9	50	58	60
Ukraine	10	10	25.5	18.7	31	36.5	42

Source: Berg, Borensztein, Sahay and Zettelmeyer, 1999

Table 8
Liberalization Index for Poland, Russia and Ukraine, for the years 1990, 1995, 1998

	1990	1995	1998
Poland	0.6	0.8	0.9
Russia	>0.2	0.6	<0.6
Ukraine	>0.2	>0.6	0.6

Note: Numbers are approximate because taken from a chart.
Source: The World Bank, 2002

Table 9
Capture Economy for Poland, Russia and Ukraine

	Administrative Corruption % of revenue	Captors % of sample	Influential % of sample	Capture Economy Index	Classification
Poland	1.6	9	3	12	Low
Russia	2.8	9	7	32	High
Ukraine	4.4	12	14	32	High

Source: Hellman, Jones, Kaufmann, 2000

Table 10
Bank Credit to Private Sector as a Percentage of GDP for Poland, Russia and Ukraine, for the years 1994, 1996, 1997, 1999

	1994	1996	1997	1999
Poland	12	16	18	19
Russia	12	7	8	12
Ukraine	5	1	2	9

Source: Huang, Marin and Xu, 2004