

Joseph Schumpeter Lecture
Government in transition

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Abstract

The speed of economic reforms is not the only important determinant of the success of the transition to a market economy: the transition of government from a communist state to an institution supporting a market economy is as critical. Survey evidence shows that Russia lags significantly behind Poland in the transition of its government, which may account for its inferior economic performance despite adopting similar economic reforms. I argue that the lack of turnover of old communist politicians, and the creation of inappropriate electoral and fiscal incentives for these politicians, may account for the poor performance of the Russian government, and suggest some strategies for improving the situation. © 1997 Elsevier Science B.V.

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1. Introduction

In one of his most celebrated, though not most clairvoyant, books, *Capitalism, Socialism, and Democracy*, Joseph Schumpeter (1942) reluctantly predicted the inevitable collapse of capitalism around the world, and a transition to socialism. Schumpeter's pessimism about the world he saw is understandable: in the late 1930's, as he was writing his book, Europe and America had not quite emerged from a major depression, and Hitler's armies were marching across Europe. Still, the inaccuracy of Schumpeter's forecasts is remarkable. Half a century later, the

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transition the world is experiencing is the reverse of the one he expected: from socialism to capitalism. Market economies around the world are limiting the scope of their governments by privatizing everything from industry to social security. Even more remarkably, the Soviet block countries, including all the East European economies and countries of the Former Soviet Union (FSU), have initiated a transition to capitalism. As an admirer of capitalism and of entrepreneurial spirit, Schumpeter would have surely rejoiced over his error.

The transition to capitalism has sparked an intense controversy among economists concerning its optimal speed. Jeff Sachs (1993, 1995) and other advocates of so-called “shock therapy”, argued that a transition economy must undertake the three essential steps of rapid liberalization — price liberalization, stabilization, and privatization — as quickly as possible to restart economic growth under normal market conditions. Opponents of this view focused on the potential costs of shock therapy, such as the rapid decline of state firms, job loss, and dislocation of labor (Murrell, 1991; Goldman, 1994). They preferred the transition economies to go slowly, and to continue inflation, subsidies, and government ownership for a longer period of time.

Five years later, the advocates of shock therapy won, at least in the context of East European transition¹. There surely was a depression almost everywhere in Eastern Europe and the FSU, caused to a large extent by demilitarization of the national economies, the collapse of state firms, and the breakdown of trade ties both between and within countries². However, the depression was if anything milder in the countries pursuing radical liberalization (Aslund et al., 1996; World Bank, 1996). Moreover, the countries in Eastern Europe — such as Poland and the Czech Republic — that have been the prototypical radical liberalizers, were growing rapidly by the mid-1990s. The countries that deferred reforms or proceeded slowly — such as Romania and Bulgaria — were growing less rapidly. Inside the FSU, the relatively more radical liberalizers, such as the Baltic States, Russia and Kyrgyzstan maintained higher living standards and experienced a milder depression than the go-slow countries, such as Belorussia and Ukraine. This particular debate about transition, then, has been resolved by experience.

Some nagging questions nonetheless remain, many of them raised by Russia. Between 1992 and 1995, Russia went through all the major treatments of shock therapy. Prices were liberalized on January 2, 1992. Most of the economy was

¹ There remains the controversial question of China, which has grown tremendously over the last 15 years despite in some ways slow reforms. The relevance of the Chinese experience for Eastern Europe is doubtful, for several reasons. First, China at the beginning of reforms was (and actually still remains) a poor agricultural economy that did not bear nearly the same burdens of a large state industrial sector (Sachs and Woo, 1994). Second, China remains a communist dictatorship that does not face the complexities (nor reaps the benefits) of democracy.

² For discussions of this recession, see Murphy et al. (1992), Kornai (1994), Blanchard (1996), Blanchard and Kremer (1997), and the World Bank (1996).

privatized between 1992 and 1994 so that the private sector produced over half of Russia's output by 1995. Finally, inflation was dramatically reduced in 1995. Yet despite the fact that Russia undertook all these measures, its official GDP continued to shrink in 1995 and 1996, and even if the unofficial sector is counted, the economy grew at best lethargically. Some advocates of shock therapy (e.g., Aslund et al., 1996; World Bank, 1996) confronted this uncomfortable evidence by reclassifying Russia into a go-slow reformer whose experience confirms rather than contradicts the virtues of shock therapy³. In contrast, the opponents of shock therapy, such as the several American Nobel Laureates in Economics in collaboration with several Soviet economists (Abalkin et al., 1996), have argued that the Russian experience proves what an error shock therapy has been. The definitional squabbles aside, Russia's experience — especially as compared to Poland's — raises several genuine puzzles.

Why was Russia not growing in the mid-1990s, whereas Poland was expanding by over 5 percent a year? Why, at least in the short run, have the effects of liberalization on private sector growth been stronger in Poland? More generally, what are the mechanisms through which radical liberalization — in the form of price liberalization, stabilization, and privatization — leads to economic growth? Are these mechanisms less effective in Russia, or are there other factors that determine growth? If there are other factors, what are they and what can be done to make them work in Russia?

The comparison of Russia and Poland is germane for several reasons in addition to their common economic policies. To begin, unlike China, both were industrial economies at the time reforms began. Both economies faced substantial disruption from the collapse of COMECON and other trade following the demise of the Soviet Union. Indeed, both economies were in shambles at the time reforms began, overwhelmed by inflation, goods shortages, and declining production. The two countries have several political similarities as well. Both experienced a near-collapse of the state prior to transition. In Poland, martial law led to the total demise of the communist party and its military regime. In Russia, the Gorbachev government faced a similar crisis, which led to the dissolution of the Soviet Union and the creation of independent Russia. After communism collapsed, both countries moved to fragmented, rapidly changing party systems and "semi-presidential" regimes, in which a conflict between president and legislature was built in from the start. Both were led in their transition by charismatic, populist presidents committed first and foremost to the destruction of communism. Yet, despite these

³ The World Bank worked particularly hard on this reclassification. For example, the background paper by De Melo et al. (1996), which explains the World Bank Development Report classification, ranks Russia behind Poland in privatization in 1994. This is so despite the fact that Russia's mass privatization program was finished by July of 1994, whereas Poland's did not even begin until 1995. Other rankings were also made creatively.

similarities as of 1990, the two countries appeared in 1996 to have very different results of their reforms ⁴.

In this lecture, I argue that an essential part of transition to capitalism is the transition of government. To understand the Russian experience by comparison to the experiences of other fast reformers such as Poland, one needs to examine the nature of political control of economic life that remains after the reforms, as well as the support that government offers private business. I argue that despite similar economic reforms, government in Russia continues to retain substantial political control over economic life, and moreover often uses this control to pursue predatory policies toward business. The political transition in Russia has not gone nearly as far as it has in Poland, and this slowness of political transition retards economic growth.

In the next section, I develop the argument that the speed of economic reform is not the whole story, and that transition of government is a distinct and crucial determinant of economic performance. I then ask three questions. First, does the performance of governments in Russia and Poland actually differ? I show that the answer is yes. Second, why does the performance of governments in different countries, particularly Poland and Russia, differ so much? I examine and evaluate six theories of determinants of government performance. I conclude that the retention of old politicians in Russia, and the creation of inappropriate incentives for them, accounts for their predatory conduct. Finally, I examine potential policies of reforming the government in Russia.

2. Government in transition

The economics of transition typically focuses on the economic factors that shape the process ⁵. How strong is the entrepreneurial response to liberalization? How rapidly do state and privatized firms restructure? How quickly is labor reallocated between activities? Yet this approach does not pay nearly enough attention to the basic element of transition: the transition of government from the communist police state to an institution supporting a market economy. This transition of government is as essential for the economic transformation as it is for democratization of the societies escaping communism.

To discuss the transition of government, we need to assess the costs of political

⁴ There are some potentially important differences between Russia and Poland as well. Geographically, Poland is closer to Western Europe, which made it easier to use Polish labor to assemble goods for the European markets. Politically, Poland had more of a democratic as well as institutional tradition. In particular, Poland had two extremely strong non-state institutions in 1990: the Solidarity union and the Catholic Church. I return to these differences in Section 4.

⁵ An excellent discussion of theory and evidence on transition is Blanchard (1996). McMillan (1996) presents a comprehensive survey of the relevant literature.

control of economic life, of which socialism is only the extreme example⁶. The politicians controlling economic life are almost always interested in using business to achieve personal political and economic objectives⁷. The principal political objectives are to maintain voting support and prevent dissent. To this end, politicians provide jobs for political supporters through state firms, deliver services to their allies at subsidized prices, often at the expense of political opponents, and more generally direct national resources not to the economically efficient use but to the use of friends and allies. Because the cost of such use of resources is borne by the society at large and not the politicians personally, political control of economic life is generally grotesquely inefficient, as the vast empirical literature on the inefficiency of state firms illustrates. The personal economic goals of politicians do not generally further efficiency either, since they use their regulatory powers to create rents for their allies, who presumably share with them, as well as to collect bribes. Corruption is directly related to the government's role in the economy.

Under socialism, the effects of political control are especially pernicious. The politicians are the communist party, which uses its control of economic life to maintain power. Through planning, the party controls all aspects of economic life, from prices and wages, to major investment decisions, to minute aspects of resource allocation. Such control aimed at preserving communism leads to the commitment of massive human and physical resources to the military, the heavy industry that supports it, the infrastructure for the heavy industry, and the internal police — all at the expense of consumer goods and services. Politicization of the economy has created throughout Eastern Europe militarized economies with pitifully low standards of living.

When the communist power collapsed, so did the communist government machines that supported it and controlled economic life. Yet the remnants of a large government often remained, ready to continue political control. A principal goal of the political transition, and of the few reformers who undertook it, was to replace these remnants with institutions supportive of capitalism. Such transition of government entailed two separate steps. First, the economies needed to be depoliticized: control by market forces had to replace control by the government. That meant ridding the government of the levers and resources it could still rely on to control firms. But second, the transition also required the government to take on new functions, such as provision of laws and regulations that support a market economy. The state had to be weakened overall, yet strengthened in a few areas. Some muscles needed to atrophy, others to develop.

⁶ Kornai (1994) summarizes his classic work on the inefficiency of political control. For more formal discussions, see Shleifer and Vishny (1992, 1993, 1994), and Boycko et al. (1995, 1996).

⁷ Some systematic empirical evidence in support of this proposition in the context of the choice of private vs. public provision of municipal services in the United States is provided by Lopez-de-Silanes et al. (1997).

All the various treatments of shock therapy contribute to depoliticization. Price liberalization eliminates price controls, which are the principal weapons of the central planners, used to stimulate and discourage the production of particular goods, or to create shortages that allow planners to maintain their power over resource allocation. Stabilization imposes a harder budget constraint on the government, and hence prevents politicians from using subsidies to encourage firms — and often whole regions — to pursue political ends. Finally, privatization deprives the government of direct control over firms, which enables it to force firms to pursue political goals. Privatization and stabilization actually reinforce each other: privatization deprives the state of its direct power to influence firms, while stabilization deprives it of the means of buying such influence (Shleifer and Vishny, 1994).

The available evidence on stabilization and privatization supports the essential role of depoliticization. Pinto et al. (1993) showed how even state firms in Poland began to restructure after stabilization in response to hardening of their budget constraints. A large body of evidence from around the world points to efficiency improvements after privatization (e.g., Megginson et al., 1994; La Porta and Lopez-de-Silanes, 1997). For Russia in particular, recent survey evidence by Earle and Estrin (1995) and Earle and Rose (1996) shows dramatically faster restructuring by privatized firms than by state firms, measured not just by layoffs but also by new product introductions and capital investment. Earle and Rose (1996) also find much smaller political influence on privatized firms than on state firms, as well as a clear influence of large investors on the privatized firms. Such replacement of government control with shareholder control is an essential element of depoliticization (Boycko et al., 1995, 1996).

But the three radical reforms are only part of depoliticization, and of public sector reform more generally. Even with the three measures taken, the government retains much regulatory power which it can use either to support a market economy or to prey on it. The government still grants export and import licenses, regulates entry of new firms, enforces or fails to enforce law and order and so on. Shock therapy does not guarantee depoliticization, since politicians can still exercise control in many ways. Nor does shock therapy guarantee a transformation of government institutions, which is a separate endeavor altogether.

This endeavor, however, is an equally essential element of the transition of government. It includes first and foremost the creation of laws and legal institutions that protect private property, enforce contracts between private parties, but also limit the ability of officials to prey on private property⁸. It also includes the creation of regulatory institutions that deal with competition, securities markets, banking, trade, patents and so on. These institutions need to support a market

⁸ For a general discussion of the importance of legal reform in the transition to capitalism, see North (1990) and Sachs and Warner (1995). For the Russian case, see Hay et al. (1996).

economy, rather than use their powers to enrich the regulators and their political allies. Such transformation of government may be as radical as the shock therapy itself.

In the next section I show that the experiences of Russia and Poland are best understood by comparing the performance of their governments. Shock therapy has greatly contributed to depoliticization in both countries by weakening the control of the central government over the economy. Yet shock therapy is far from the whole story. Despite shock therapy, politicians in Russia, particularly at the local level, retain enormous control over economic life, which they use to pursue political ends and to enrich themselves. This makes them rather different from politicians in Poland. Russia is also behind in creating the institutions of a new market economy. In short, the performance of the two countries is best understood in terms of different stages of transition of their governments.

3. Local government performance in Moscow and Warsaw ⁹

The previous section has argued that the failure of depoliticization and the continued predatory role of the state may explain slow growth even after shock therapy. One way to evaluate this argument is by comparing Russia and Poland. Although Poland started reforms two years earlier than Russia and stabilized five years earlier, by the end of 1995 both countries had completed radical reforms. Nonetheless, in 1995 Poland grew by 7 percent, and Russia probably not at all. Small business — the engine of growth of all transition economies — is growing faster in Poland than in Russia. According to the European Bank for Reconstruction and Development (1996), in 1995 Poland had two million small businesses, compared to only one million officially registered small businesses in Russia, with its four times larger population. Even if one triples this number for Russia to account for the grey economy, small business development in Poland remains more impressive ¹⁰. Can this difference in private sector growth in the two countries be explained by the conduct of their governments?

At least the anecdotal evidence appears to be consistent with the view that government performance differs significantly between the two countries. I have had many conversations with Russian entrepreneurs, particularly founders of small businesses, in which they complained about the difficulties of starting and operating a business in Russia. They always point to multiple permits, inspections, registrations, all requiring interactions with multiple officials many of whom need

⁹ This section draws heavily on Frye and Shleifer (1997).

¹⁰ The grey economy is itself evidence of predatory tax and regulatory policies of the state. According to Kaufmann and Kaliberda (1996), the grey economy accounts for between a third and 40 percent of the Russian GDP.

to be bribed before the necessary documents are issued. Then of course there are complaints about the racket and its take. To compare this to the situation in Poland, in February 1996 I asked a wealthy Polish businessman how difficult it is to open a shop in Poland. He answered immediately: “Oh, it is very, very difficult. There are now so many shops and so much competition that it is impossible to make money”. But, I insisted, remembering my Russian conversations, “What about permits, registrations, inspections, bribes, and other obstacles from the government?” “These are not a problem”, answered the businessman, “but the competition is awful; I would never recommend opening a shop in Poland”.

Since, as George Stigler has reminded us, the plural of anecdote is data, it made sense to ask shop owners in the two countries more systematically about their interactions with the state. Accordingly, in March and April of 1996, Frye and Shleifer (1997) surveyed 55 shop managers in Moscow and 50 in Warsaw about their relationship with the local government — the level of government that affects their lives most directly. We focused on relatively small shops, mostly in the food business, and employing between 5 and 50 people. Moscow shops were a bit larger (23 vs. 15 employees on average), a bit newer (3 vs. 4.5 years in operation), and their managers were a bit older (45 vs. 42 years old, on average), but in general the shops were chosen to be similar. Each shop manager answered a brief questionnaire about his legal and regulatory environment.

Table 1 reports answers to questions about law and order, or courts and protection. In both countries, courts are rarely used. Only 19 percent of shop managers in Moscow and 14 percent in Warsaw report having used them in the last 2 years ($t = 0.66$). This may simply reflect the high cost of using courts in both countries. However, when asked whether they needed to use courts but did not, 45 percent of Moscow managers answer yes, whereas in Warsaw, only 10 percent do ($t = 4.32$). Either the Moscow shop managers have less faith in their courts, or they face more frequent disputes that require court intervention than their counterparts in Warsaw.

When asked whether they “could use courts to defend their rights if the

Table 1

Legal environment: the fraction of affirmative responses to questions in Moscow and Warsaw and the t -tests of differences in responses

	Warsaw (n)	Moscow (n)	t -statistic
Used courts in the last 2 years	0.14 (50)	0.19 (53)	0.66
Needed to use courts, but did not	0.10 (50)	0.45 (53)	4.32
Can use courts against government	0.41 (46)	0.50 (52)	0.86
Can use courts against business partner	0.45 (38)	0.65 (52)	1.97
Contacted by racket in the last 6 months	0.08 (50)	0.39 (54)	3.91
Does one need roof/umbrella to operate?	0.06 (50)	0.76 (54)	10.10

government grossly violated their property rights”, 50 percent of Moscow respondents, and 41 percent of Warsaw respondents, answer yes ($t = 0.86$). Evidently, business people in both countries retain significant skepticism about the independence and effectiveness of courts in disputes with the government. On the other hand, when “the government” is replaced by “a business partner” in this question, 65 percent of Moscow respondents, and only 38 percent of Warsaw respondents, answer yes ($t = 1.97$). In this question, Moscow shop managers appear to be more prepared to resort to courts. Finally, we find that 57 percent of Moscow shops have hired legal counsel, compared to only 36 percent of Warsaw shops ($t = 2.2$). This may reflect greater interest in litigation, but more likely, lawyers are needed in Russia to deal with bureaucrats.

We also ask about private rather than public protection. In Russia, it is common for shop owners to pay private security agencies that protect them from crime and help resolve disputes. This institution is known as “a roof” in Russia, and is apparently is referred to as “an umbrella” in Poland — perhaps to reflect the greater fragility of the requisite private protection in Poland. We ask the respondents whether it is true that one cannot operate a store in your city without a roof (an umbrella). In Moscow, 76 percent answer yes, whereas in Poland only 6 percent do ($t = 10.10$). A related question is whether a shop manager has been contacted by the racket in the last 6 months. In Moscow, 39 percent of the respondents answer yes, whereas in Warsaw only 8 percent do. In short, these data make clear that private enforcement of rules (as opposed to law) and order plays a greater role in Russia than in Poland. Since the respondents in both cities are equally skeptical about courts, the likely reason for the higher incidence of protection rackets in Russia is the greater failure of simple police protection there.

The next set of questions deals with the regulatory environment, and the closely related problem of corruption. Table 2 presents the results. When asked how long it took to register their business, Moscow respondents average 2.7 months, compared to 0.7 month in Warsaw ($t = 5.02$). When asked how many inspections they had last year, Moscow residents average 18.56, and Warsaw managers 9.99 ($t = 3.46$). Moscow shop managers are also more likely to be fined by inspectors

Table 2

Regulatory environment: responses to questions about government regulation and corruption and t -tests of difference between Warsaw and Moscow

	Warsaw (n)	Moscow (n)	t -statistic
Time to register business (months)	0.72 (47)	2.71 (51)	5.02
Inspections last year	9.0 (49)	18.56 (55)	3.46
Percentage of shops fined by inspectors last year	46 (49)	83 (52)	2.72
Number of different agencies conducting inspections	2.65 (49)	3.58 (55)	1.84
How legally vulnerable do you feel on scale 1–10	3.6 (50)	5.1 (55)	3.91
How often does one need to bribe officials on scale 1–5	2.21 (47)	2.9 (53)	2.52

than their counterparts in Warsaw: 83 percent of them report having paid fines compared to 46 percent in Warsaw ($t = 2.72$). Fines may be a good measure of regulatory burden, as well as a proxy for corruption.

One measure of the severity of the regulatory burden is the concern of the shop managers are about being in violation of some regulations. To get at this issue, we ask shop managers how “legally vulnerable” they feel, on a scale from 1 to 10. The mean answer in Warsaw is 3.6 compared to 5.1 in Moscow ($t = 3.9$), consistent with the greater regulatory and tax burden in Russia. Another measure of regulatory burden is corruption, since a standard way to get around difficult regulations, requirements, delays and fines is to pay a bribe. We ask our respondents somewhat discretely: how often does one need to bribe officials to do business in your city, on a scale from 1 to 5 (1 is almost never, 2 is rarely, 3 is sometimes, 4 is often, and 5 is almost always). The mean response in Warsaw is 2.2, compared to 2.9 in Moscow ($t = 2.52$). We also explore the structure of corruption by asking how many different agencies visited the shop. On average, 3.58 different agencies conducted inspections of Moscow shops, compared to 2.65 in Warsaw ($t = 1.84$). If the amount of bribes rises with the number of independent bribe takers, this evidence points further to the greater burden of regulation in Moscow than in Warsaw.

In sum, the Frye–Shleifer evidence indicates that shop owners in neither country are particularly keen on using courts, though the Russian respondents have a greater need for them. On the other hand, private protection is used much more extensively in Russia than in Poland. Regulations in Russia appear to be a good deal more oppressive to business than they do in Poland. This is reflected in the frequency of inspections, in the greater legal vulnerability that Russian respondents feel, as well as in the greater burden of corruption in Moscow. We have not obtained much information about taxes, although the respondents in both countries view taxes as their most important problem, and respondents in Russia report heavy reliance on bribes to avoid taxes. It appears that the tax burden, like the regulatory burden, is more severe in Russia, at least if we take the enormous underground economy there (which does not exist in Poland) as evidence. Indeed, if taxes and regulations drive businesses in Russia underground, it is not surprising that they need to rely on criminals rather than police for protection.

One final question corroborates the anecdote that began this section. When asked to rate the problem of product market competition on the scale from 1 to 10, Moscow shop managers’ average answer is 4.8, compared to 6.2 in Warsaw ($t = 2.3$). Evidently, the Polish shop keepers have their rents extracted by competitors, while the Russian ones by the bureaucrats.

These results suggest that the transition of government into one that supports markets from the one that preys on them has gone further in Poland than in Russia. Regulators of small business exert more power over business in Moscow than in Warsaw, and use this power to enrich themselves. Nor has the Russian government yet successfully taken on the basic market-supporting functions, including

police protection. Russia is much more of a laggard in the transition of its government than it is in shock therapy.

4. Possible causes

In the previous section, I presented evidence indicating that the Russian government remains a good deal less supportive of private business than the government in Poland. I have focused on the local government, but similar observations can be made about the central government as well. In this section, I examine some of the possible causes of this differences in government performance. Discussions with colleagues have convinced me that a very large number of possible causes can account for this difference in public sector performance. Here I examine only six, and try to identify the most convincing.

4.1. Shock therapy as a cause of government failure in Russia

Some people have argued that the radical reform itself — in the form of privatization and stabilization — is responsible for the ineffectiveness of the Russian state. For example, the limitations on public spending in Russia may have caused its government to abandon its basic functions, such as police protection. Also, privatization has allegedly turned state assets over to the mafia, and thus has caused crime.

The evidence does not support these arguments. First, as I already mentioned, Poland and the Czech Republic were the champions of shock therapy, yet neither experienced the same collapse of the state as Russia did. Ukraine has been a prototypical go-slow (if at all) reformer, yet the data indicate that its government is at least as predatory as Russia's (Kaufmann and Kaliberda, 1996). The disorganized, predatory state was fully operational in Russia in 1991 and 1992, even though privatization did not happen until 1993–1994 and stabilization until 1995. I would not go as far as agreeing with Sachs's (1995) claim that radical reform by itself revives the bankrupt state. My point is rather that radical economic liberalization and government reform are two necessary but distinct elements of transition.

4.2. Trust, social capital, and the civil society

An alternative set of explanations of government failure in Russia deals with trust, social capital, and civil society. In recent years, various authors — including Gambetta (1988), Coleman (1990), Putnam (1993), Gellner (1994), and Fukuyama (1995) — used these concepts to explain why some societies function better than others. Putnam (1993) invokes the concept of social capital to explain why governments in Northern Italian regions function better than governments in

Southern Italy. Putnam shows that, empirically, some measures of trust between people in a region — such as participation in non-governmental associations — are strongly correlated with the quality of government performance in that region.

It is important to distinguish two views of how social capital contributes to better government. On the first view, taken by Coleman, Fukuyama and Putnam, trust promotes cooperation between people, and cooperation leads to better performance of all institutions in the society, including the government. On the second view, which is similar to Gellner's theory of civil society but has also been stressed to me by Janos Kornai and Jeffrey Sachs, the essential manifestation of social capital is the presence in a country of non-state institutions that watch, criticize and restrain the government. Active participation by citizens in such institutions enables them to limit the predatory tendencies of public officials. On this view, countervailing power rather than cooperation between people per se improves the performance of the government.

La Porta et al. (1997) test both of these views of trust using data from the World Values Survey, a sociological survey of 1000 people in each of 40 countries conducted last in the early 1990s. One question that the survey asked might bear on the "cooperation" view of trust: "Generally speaking, would you say that most people can be trusted, or that you cannot be too careful in dealing with people?" The percentage of people answering yes to this question is one measure of trust in a country. La Porta et al. (1997) examine the relationship between this measure of trust and several proxies for government performance across countries, such as infant mortality and public education expenditure, but also perceived corruption, bureaucratic quality, and judicial efficiency. They find a positive correlation between trust and government performance across the world, even controlling for per capita income.

World Values Survey also asked whether respondents participate in a variety of civic activities, including: (a) social welfare services for the elderly and deprived; (b) education, art and cultural activities; (c) local community affairs; (d) activities related to conservation, environment and ecology; and (e) work with youth. The percentage of these activities in which an average respondent in a country is involved may measure the intensity of civic participation. La Porta et al. (1997) examine how this participation variable affects their proxies for government performance. While this variable does not work as well as the measure of trust, it is generally also positively correlated with government performance, controlling for per capita income.

This evidence suggests that, in principle at least, low social capital might be a valid explanation of the poor performance of Russia's government. To examine this possibility, Table 3 presents the data on the answers to the trust and participation questions in the World Values Survey. The data seem quite plausible. On trust, the Scandinavian countries are at the top, Turkey and Brazil are at the bottom. On participation, Scandinavia is again very high whereas the East European countries appear to be at the bottom. On trust, Russia and Poland are in

the middle, with 37 percent of the Russians and 34 percent of the Poles believing that people can be trusted. This puts the two countries very close together: a bit below Germany and Japan, but higher than the Czech Republic and France. The

Table 3

Social capital around the world: world values survey, 1990–1993 (Inter-university Consortium for Political and Social Research)

Country	<i>Trust</i>	<i>Participation</i>
Sweden	66.10	10.94
Norway	65.05	11.74
Finland	62.72	10.66
China	60.30	3.97
Denmark	57.66	11.35
Netherlands	53.47	20.80
Canada	53.07	11.42
United States	51.06	11.72
Ireland	47.36	8.04
United Kingdom	43.68	7.01
Iceland	43.60	11.35
Switzerland	42.6	46.64
Japan	41.7	12.79
Germany	37.85	9.39
Russia	37.45	2.94
India	35.43	n.a.
Italy	35.30	4.49
Poland	34.50	n.a.
Spain	34.24	2.70
South Korea	34.17	10.06
Belgium	33.50	10.05
Mexico	33.45	5.37
Austria	31.82	5.97
Lithuania	30.80	3.70
Bulgaria	30.39	3.13
South Africa	29.00	n.a.
Czech Republic	27.83	n.a.
Estonia	27.57	5.45
Belorussia	25.47	n.a.
Hungary	24.58	2.41
Argentina	23.30	2.58
Nigeria	23.20	n.a.
France	22.79	6.08
Chile	22.70	5.77
Portugal	21.67	4.07
Latvia	19.04	4.42
Slovak Republic	17.38	3.38
Romania	16.06	1.37
Turkey	9.98	n.a.
Brazil	6.45	5.86

Table 3 (continued)

Country	<i>Trust</i>	<i>Participation</i>
Mean	35.30	6.90
Median	33.00	5.86

n.a. = not analyzed.

Trust: The percentage of people that answered “Yes” when asked “Generally speaking, would “Yes” when asked “Generally speaking, would you say that most people can be trusted or that you say that most people can be trusted or that you cannot be too careful in dealing with people?”

Participation: Percent of civic activities listed in the text in which an average respondent participates.

participation variable is unfortunately not available for Poland, although Russia is in the middle of the East European pack, lower than the Slovak Republic but higher than Hungary and Romania.

These data do not support the view that poor social capital is responsible for government failure in Russia. If cooperation is the essential benefit of social capital, then Russia should not expect to have a government as good as that in Sweden and Denmark, but can surely count on one as good as that in France. If participation in civic organizations is the key benefit, Russia’s future is not as attractive, but still typical of Eastern Europe, where some countries with lower rankings, such as Hungary and Romania, are succeeding in the transition of their governments.

It is possible, of course, that our measures — particularly that of participation — do not adequately capture the efficacy of the civic countervailing power to the government. Poland, in particular, had two institutions at the beginning of reforms that played a critical role in the transition of its government: the Catholic Church and the Solidarity Labor Union. The Catholic Church, while not in general a friend of economic reforms, had nonetheless used its influence to demand a clean government. The Solidarity Union essentially destroyed communism and became the basis of Poland’s first non-communist and reformist political party. The orthodox church in Russia has not played a significant role in politics, and there was no anti-communist political movement comparable to Solidarity. In fact, as of this writing, Russia still does not have a reform-minded political party. My concern with putting too much emphasis on the role of these two institutions is that many countries in Eastern Europe, including Hungary, the Czech Republic, Slovakia, or Romania, managed a government transition without a counterpart of either Solidarity or the Polish Catholic Church. This makes me skeptical that these powerful countervailing institutions fully account for the differences between Russia and Poland in the transition of their governments.¹¹

¹¹ Consistent with this skepticism, Pop-Eleches (1997) has redone the Frye–Shleifer survey in Romania (Frye and Shleifer, 1997), a country with no countervailing institutions similar to Poland’s, and found that Romania’s legal and regulatory environment is much closer to Poland’s than to Russia’s.

4.3. *Cultural antagonism to capitalism*

I next consider the perennial favorite: the theory that the Russians do not believe in capitalism (e.g., Goldman, 1994). I am not sure that this theory would explain government failure in Russia, even if it were true. However, since the theory is so often repeated, one must keep repeating that there is no evidence supporting it¹². Like gossip, it spreads without substantiation.

Several years ago, Shiller et al. (1991, 1992) published the results of surveys they conducted in Russia, United States, Ukraine, Germany and Japan that tested public attitudes toward capitalism. The fact that the surveys were conducted before radical reforms had begun in Russia is especially valuable since they can genuinely assess respondents' attitudes toward markets and capitalism rather than their reaction to the events taking place in their country. The authors of the surveys discovered astonishing similarity across countries in responses to their questions: people everywhere were positively inclined toward markets and incentives, although they also had rather strong sentiments in favor of fairness and equality. There was no evidence of excessive Russian suspicion of capitalism.

The attitude toward markets and capitalism should be distinguished from the attitude toward the short run economic consequences of transition, such as recession, unemployment, and significant dislocation of labor. Perhaps the clearest way to see this is to recall the unpopularity of integration in East Germany, where the people expressed deep unhappiness in all the surveys despite the massive resource transfers they received and despite vast objective increases in their consumption. Aslund et al. (1996) present the results of annual surveys conducted by the European Commission which asked people in transition economies whether they liked the direction in which their country was going. The authors show that in Poland, for example, 41 percent more people answered no than yes to this question in 1991, right after the radical reform. The sharp excess of pessimists remained until 1995, the year the economy grew by 7 percent. Since Russia's recession lasted longer, Russia reports large excess of pessimists through 1995 — the last year for which the data are reported, — but the numbers are not that different from Poland in 1991. Earle and Rose (1996) also report negative attitudes in Russia toward the government's economic policy, combined with complaints that reforms have not been fast enough.

This evidence suggests that the Russians are unhappy with the situation in their country, and not that they are culturally hostile to capitalism. One commonly mentioned reason for this unhappiness is the perception that the government is dysfunctional, corrupt, and incapable of delivering growth and stability. But this shows that government failure is the reason for the concern about the economy,

¹² For a debunking of this theory in the context of the participation of the Russian public in privatization, see Boycko et al. (1995).

not that the skepticism about capitalism is the cause of government failure. The theory of Russian hostility to markets, then, is not supported by the data.

4.4. Human capital of politicians

Politicians, like the rest of us, require certain skills to practice their craft. Some of these skills are very different in a market economy than in a communist economy. While all local politicians need to make sure that the garbage is collected and public transport works, politicians in a market economy also need to worry that local entrepreneurs are able to get licenses to operate their businesses, borrow funds from non-fraudulent banks, rent space, go to court, and so on. The public goods of market and communist economies are not the same.

It is doubtful that a communist politician can quickly pick up the requisite skills. His difficulties may be even greater if he is of mature age, and his learning capacity is diminished (Posner, 1995). Many of today's Russian politicians are communist leftovers experiencing significant hardships understanding what is expected of them, and fearful that in the new society they will be outsmarted by competitors. Few of these leftover politicians have transformed themselves into capitalist politicians. You simply cannot teach an old dog new tricks.

The problem of renewing human capital during transition is not unique to politicians: obsolete human capital might be the most significant deterrent to the restructuring of privatized state firms as well. Barberis et al. (1996) examine the restructuring of Russian shops following privatization, and find that the mere presence of new owners and managers — as opposed to the presence of new incentives — is the best predictor of restructuring. In both the economy and politics, the replacement of obsolete human capital may well be the central problem of transition.

In politics, Poland appears to have gone a good deal further in solving this problem than Russia. Studies of elections and of turnover of elites corroborate this view. For example, 75 percent of local leaders elected in Poland in 1990 had no record of government service, and 45 percent of newly elected mayors were under the age of 40. While I have not been able to find comparable percentages for Russia, they are certain to be a good deal lower even now. The reason that Poland had such substantial replacement of political leadership is the popularity of Solidarity. In 1990, 47 percent of newly elected politicians came from civic opposition movements (mainly Solidarity) and another 39 percent were independents, with only 8 percent being communists. In the Russian election to the local soviets in 1990, a much lower 33 percent of the winners came from civil opposition movements and a vastly higher 49 percent were communists. Indeed, if one looks at local governments today, in Poland the people have largely changed and been replaced by a younger crowd, with some experience in both democratic politics and the market economy, whereas in Russia, the local leaders are largely

the very same people who were there before the reforms began¹³. In this respect, Solidarity changed Poland — Russia would be a very different place politically if it had a similar revolution from below.

A recent Polish study of political elites in the two countries paints a similar picture¹⁴. The authors interviewed several hundred members of the 1993 political, economic, and cultural elites, and asked them about their current and past activities. For Russia, they discovered that, of the current political elite, 83 percent were former communist party members, and, of the current economic elite, 53 percent were former party members. For Poland, the respective numbers were 30 and 57 percent. This together with their other findings shows that the former Polish elite has been largely removed from politics and has dedicated its energies to business. In Russia, in contrast, the former political elite remains in power today.

Although I have focused on local governments as the place where the turnover of political elites is essential to make government hospitable to private business, Russia's problems with obsolete human capital affect national economic policies as well. While it is often difficult to disentangle the economic confusion of politicians from self-serving rhetoric, some Russian politicians elaborate their views in barely-read scholarly publications, presumably to preserve their insights for history. Take for instance the apparently genuine conviction of the former central bank governor Geraschenko that inflation in Russia was caused by monopoly pricing rather than the hyperactivity of his printing presses. Or consider a 1994 article by Yavlinsky (Gorbachev economist and sometime Presidential candidate) and Braguinsky advocating a full-blown Peronist growth strategy for Russia: with large government spending, protection of industry, and massive state investment in "strategic firms". To conclude, the lack of turnover of human capital in Russian politics may well be a serious reason for the poor performance of its government.

4.5. *Incentives of local politicians*

An equally important problem for government performance is incentives facing local politicians. For local politicians to support the growth of new business, they need to have either political or financial incentives to do so. These incentives come from several sources. First, if politicians need to collect campaign contributions to run their elections, they might favor new business as a source of potential campaign donations. President Yeltsin's 1996 reelection campaign, for example,

¹³ The city of Moscow — despite the shortcomings of its government relative to that in Warsaw — is an exception for Russia: in 1990 over half the members of its local soviet have changed. Interestingly, Moscow has been growing much faster than other Russian cities.

¹⁴ Szelenyi et al. (1995) *Elites in Poland, Russia, and Hungary: Change or Reproduction*. The numbers I present come from a review by Jakub Karpinski (1996).

was largely financed by private firms. Second, if politicians need to provide public goods to attract votes, and must collect taxes to pay for these public goods, they would support the growth of new business to broaden the tax base. This mechanism may operate even without elections: in China, evidently, local communist leaders count on taxes from small business to finance public goods required for their localities to function (Oi, 1992). Finally, local politicians may support private business if they effectively become shareholders in it and profit personally when it does well. This mechanism is also essential for political support of Chinese township and village enterprises (Liu, 1992; Oi, 1992). These three incentive mechanisms — campaign support, local tax base, and personal share holdings — can all in principle encourage local political support of private business.

Close ties between local government and business are not always conducive to new business formation and entry. The existing firms might use their political connections and campaign contributions to deter entry, to limit trade, or to restrict the opportunities of competitors to grow¹⁵. At the national level, these ties between government and existing firms have encouraged anti-growth policies in many countries. Still, it is naive to believe that the local politicians in any country would accommodate private business growth unless they have some incentive to do so, and the channels outlined above describe some of the clear cut incentives.

Along a variety of dimensions, the incentives of local politicians in Russia — unlike those in Poland — do not encourage them to support private business. First, the electoral motive has been rather weak in Russia¹⁶. Although Russia held local elections for a variety of positions in 1990, President Yeltsin has subsequently assumed control over local governments. In 1991 he signed a decree giving himself power to appoint governors and mayors without elections in most regions, and in 1993 he sharply curtailed the power of the local legislatures. The ostensible reason for these steps was to prevent separatist pressures. As a consequence, the officials Yeltsin appointed were selected for their loyalty and lack of political ambition rather than particular market sympathies. Indeed, the appointed governors often undermined private business because they feared the political challenge it could bring about.

This situation of centralized control is slowly changing in Russia. In 1996, many regions are scheduled to elect governors, and some local elections are scheduled to be held as well. Gubernatorial elections are not without costs. The elected governors will use their mandates to threaten political independence and thus extract resources from Moscow (see below). They might also restrict trade to protect local business, much as their Chinese counterparts do (Young, 1996). Governors are also too far from the small local business to rely on it for campaign

¹⁵ See Young (1996) for a striking account of such anti-competitive policies pursued by provincial governments in China.

¹⁶ Some details on the electoral process in Russia are contained in McFaul (1993) and Teague (1996).

finance or other forms of political support¹⁷. Local elections are more obviously beneficial since the officials who would actually benefit from local business support and at the same time do not have separatist or protectionist ambitions are precisely the local politicians.

Poland has held elections more consistently than Russia (Swianiewicz, 1992; Barbone and Hicks, 1995). Most importantly, the officials at very local levels — where small business would actually have a political say — are all elected. Because of elections, Polish politicians appear to have much stronger sympathies for private business than their Russian counterparts.

In addition to the problem of insufficient electoral oversight, the incentives arising from local government finance are also very different in Russia and in Poland¹⁸. In Poland, the principal source of funds for local governments are local taxes and fees, especially property taxes. Grants from the central government and even shared taxes are less important, and arguably structured so as to encourage local business formation. This system gives the incentive to the local politicians in Poland to broaden the tax base to increase revenue, and the principal mechanism for broadening the tax base is new business formation and employment.

In Russia, the situation is different. Over two-thirds of local government revenues comes from their share in taxes collected by the central government. Moreover, while this share is in theory fixed, in practice it is negotiated. Regional governments negotiate with Moscow, and local governments negotiate with regions. The effects of such fiscal federalism (which should be contrasted with Chinese fiscal federalism where sharing rules are evidently firmer) are perverse. Governors have little incentive to broaden their tax bases, and instead devote their efforts to negotiations with Moscow¹⁹. Moreover, as Treisman (1996a,b) has persuasively shown, the regions that get the most revenue are the ones that create trouble for Moscow: they have strikes, labor unrest, and separatist movements, and vote *against* the incumbent Moscow government. Peace and prosperity in a region do not, evidently, increase the resources of the local government. This situation is likely to get worse when governors are elected, since the President will lose his power of appointment and will retain few mechanisms of keeping the country

¹⁷ This may be too strong, since the election of governors might bring in more economic reformers. For example, Moscow's mayor was reelected in 1996 with over 90 percent of the vote. Moscow has grown rapidly over the last few years, and the closeness of the ties between its government and business is legendary. In contrast, the mayor of St. Petersburg was not re-elected in 1996, largely because of his mismanagement of the city's economy. He was defeated by an opponent promising to make St. Petersburg more like Moscow.

¹⁸ For details on local government finance in Russia, see Le Houerou (1994) and Wallich (1994). For information on Poland, see Barbone and Hicks (1995).

¹⁹ Teague (1996) quotes the former finance minister Fedorov describing Russia as the only country where you can get what you want by standing outside the ministry of finance and yelling.

together other than throwing money at the separatist regions²⁰. Under these circumstances, it is not surprising that local governments in Russia do not feel pressured to promote small business²¹.

The final potential incentive of the local officials is financial, namely to become effective shareholders in the local businesses and to prosper when they do. This model appears to be widespread in China (Oi, 1992), and many people have pointed out its relevance for the city of Moscow. Nonetheless, it appears to be much less widely adopted in Russia than I would have guessed several years ago. Rather than encourage local business and profit when it does, local officials in Russia often destroy local business through excessive up-front corruption and regulation. They confiscate the wealth before there is any. Why is this so?

The likely reason is that many of the local officials in Russia see a rather short and insecure future for themselves in politics. If the private economy grows, they are likely to lose power because they will not be acceptable to the new business elites. If elections are held, they are also likely to lose power to the younger generation that can more credibly promise growth to voters. In the absence of political security that would guarantee them access to the future profits of firms, and of corporate governance mechanisms that would enable them to just take equity and count on future dividends, many local government officials are simply grabbing what they can while they can. This approach, of course, is simply devastating for growth²².

4.6. *Initial conditions*

The final explanation of the difference in government performance in Russia and Poland is that the two countries started with different “initial conditions”. Indeed, Poland has been pursuing economic reforms for much longer than Russia, at least since the 1980s. As a consequence, the Polish private sector was well established by 1990, when radical reforms began. By 1986, one-third of the Polish labor force was employed in the private sector, including agriculture, and a quarter of national output originated in the private sector — not counting the underground economy (Rostowski, 1989). When constitutional protection of private property came in 1989, a large share of the economy was already in that form. The large size of the private sector also meant that government had some experience dealing with it. Many of the Solidarity members who entered the government in 1990 actually came from the private sector.

Furthermore, Poland had a much more substantial legal history and tradition to

²⁰ For a perceptive and relevant analysis of federalism, see Riker’s (1964) classic book.

²¹ My discussion of fiscal federalism in Russia and of ways to improve it has been strongly influenced by Thomas Piketty’s (1995) memorandum on this subject.

²² For theoretical and historical analyses of how politicians’ horizons affect their tendencies to appropriate wealth, see Olson (1991) and De Long and Shleifer (1993).

rely on. Many of its commercial laws were adopted as soon as reforms began because they were based on Poland's own pre World War II laws. Some of the people who were involved in the pre-war legal practice, and many of their students, were alive and capable in 1990. The national tradition made the implementation of at least some institutional reforms a good deal easier.

Russia has been building capitalism for a much shorter time. Gorbachev's reforms allowed some quasi-private firms in Russia, but very few compared to Poland. Russia's history of market institutions is equally sparse. Russia's pre-revolutionary laws were an instrument of autocratic control, not a mechanism of protection against it (Owen, 1991). The regulatory agencies have been created from scratch, and their employees often view their jobs as mandates for personal enrichment rather than efficient regulation²³.

Having said this, the importance of initial conditions can be overrated. Many countries in Eastern Europe, such as Slovakia and the Czech Republic, are growing rapidly even though they had as little private business before the reforms as Russia did. Some countries of the FSU, such as Kyrgyzstan, are also growing despite having a limited history of legal traditions and public institutions. With proper political incentives, initial conditions are often overcome.

4.7. Summary

The conclusion that the Russian government is less effective in serving the market economy — as well as its people — than the Polish government is uncontroversial, but the exact cause of poor government performance is difficult to pin down. Nonetheless, I conclude that the arguments to the effect that Russia is historically and culturally incapable of good government — such as low trust and anti-market culture — lack support. The more convincing argument is that Russia has not had as radical a change in its government, in terms of both structure and personnel, as Poland or the Czech Republic. Starting from this perspective, one does not need to give up hope that Russia is capable of a political transition. What, then, are the necessary steps?

5. Strategies for public sector reform in Russia

I began this paper by establishing that the speed of economic reform is not the only essential input into the success of the transition to capitalism. The transition

²³ A typical, though sad, example along these lines is the creation of the Russian anti-monopoly agency. As soon as it was created, the agency began compiling lists of companies that it felt fell under its jurisdiction. It started with major national monopolies, and then quickly moved on to local "monopolies" such as bakeries and bathhouses. Business owners quickly understood the situation, and began to bribe anti-monopoly officials just to get off that list.

of government into one supporting the market economy is a separate, and perhaps as important, element of the transformation. The analysis of the previous section points to some reforms of Russia's political system that could accelerate the transition of the government. Before turning to these reforms, however, let me briefly pause on the suggestion that the way to address Russia's problems is to increase the size and power of its government by following the policies of increased spending, government-mandated increases in wages and pensions, and public sector investment. These strategies are advocated by such distinguished writers as Yavlinsky and Braguinsky (1994) and Abalkin et al. (1996).

It is possible to make the case that Russia spends too little on education, public safety, and even welfare²⁴. Nonetheless, the increase in the size of the government *as it exists in Russia today* is unlikely to help the public. This state would waste most of the additional resources to support the inefficient agriculture and military industrial complex, to keep the declining industries from shutting down, and to stop reallocation of labor into services and small business. Many of the resources of this larger state would be simply stolen and transferred abroad. The tax burden from this large, predatory state would also eliminate, or at best drive underground, the small private business that has become the engine of the Russian economy despite all the difficulties it faces. Russia needs a state focused on a different set of functions, rather than a bigger state doing more of what it already does so badly. And for that it needs first and foremost political reform.

The analysis of the previous sections points to three most essential public sector reforms. Perhaps the most critical one is to accelerate elections at the sub-regional or local levels. Such elections would increase accountability of the local politicians to the public and therefore, through such channels as the need for public revenue and for political contributions, make local government friendlier to business. If the incumbent politicians prove incapable to accommodate these political demands, they will lose power. Local elections would thus stimulate the turnover of human capital as well as provide politicians with better incentives. Local elections also have the benefit that cities do not want to become independent countries, or to protect their business from trade. The case for regional, or gubernatorial, elections seems to me to be weaker both because separatism is likely to ruin Russia's public finances and because the accountability of governors to small business is more limited. Polish-style grass-roots democracy has the clearest economic benefits²⁵.

Parallel to electoral reform, fiscal federalism — and more generally the tax system — in Russia needs to be reformed as well. If local governments are to be

²⁴ For example, in 1992 Russia spent 11.6 percent of consolidated government expenditure on education. This figure fell to 10.6 percent in 1995, the year of extreme fiscal austerity. The somewhat more inclusive figure for Poland in 1991 is 15.6 percent.

²⁵ Another potential benefit of local elections is that they would foster the development of political parties, which some scholars regard as essential both for effective democratic politics and for keeping together federalist states such as Russia (Riker, 1964).

responsive to the needs of their constituents, they must tax their constituents themselves and spend the money to a large extent from these proceeds. Taxation and representation would then go together. Such reforms are likely to reduce Russia's currently prohibitive tax rates, but also to stimulate incentives for the government to actually collect the taxes. It is striking to me how similar Poland and China are in this regard, and how different both of them are from Russia.

Finally, institutional reforms, hard as they are, need to continue. Legal reforms are the most important among those, but creating functional bureaucracies, one at a time, is also crucial.

Russia's mediocre growth record points to the urgency of these reforms. In fact, some have argued that Russia has made a mistake of beginning with economic reforms, and delaying these political and institutional reforms. To be sure, transition in Russia would have been easier if it had an effective (not large!) government. But this evaluation ignores a critical interaction between the economic and political reforms, namely that economic reforms create pressure for political reforms. In Russia in 1991 and 1992, the pressure for political reforms supporting markets simply did not exist, in part because private business barely existed. Today, private business accounts for over half of the GNP and has a strong economic interest in making government more accommodating. Accommodation includes regulatory and institutional reforms, such as containment of corruption, creation of law-based society, and design of a sane regulatory system. Business pressures are likely to play a critical role in the political transition of Russia, and of course they did not exist before economic reforms.

Russia now faces the moment of opportunity to make the political transition. Its growth has lagged because its government has lagged, despite the rapid speed of economic reforms. But time is on Russia's side primarily because it now is a market economy, with a strong and growing private sector asserting its needs. Russia may have lagged in political reforms, and has surely paid the price, but it is difficult for me to believe that the laggard will fail to catch up.

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