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**Marek Dąbrowski, Oleksandr Rohozynsky, and Irina Sinitsina**

**Post-Adaptation Growth Recovery in Poland and Russia  
– Similarities and Differences**

*Warsaw, June 2004*

Materials published here have a working paper character. They can be subject to further publication. The views and opinions expressed here reflect the author(s) point of view and not necessarily those of the CASE.

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12 Sienkiewicza, 00-944 Warsaw, Poland

tel.: (48 22) 622 66 27, 828 61 33, fax: (48 22) 828 60 69

e-mail: [case@case.com.pl](mailto:case@case.com.pl)

<http://www.case.com.pl/>

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### **Marek Dąbrowski**

*Professor of Economics, Chairman of the Council of the CASE – Center for Social and Economic Research in Warsaw, Chairman of the Supervisory Board of the CASE-Ukraine in Kiev, Member of the Board of Trustees of the Institute for the Economy in Transition in Moscow, former First Deputy Minister of Finance (1989-1990), Member of Parliament (1991-1993) and Member of the Monetary Policy Council of the National Bank of Poland (1998-2004). In the last decade he has been involved in policy advising and policy research in Belarus, Bosnia and Herzegovina, Bulgaria, Georgia, Iraq, Kazakhstan, Kyrgyzstan, Macedonia, Moldova, Mongolia, Romania, Russia, Serbia, Ukraine and Uzbekistan and in a number of international research projects related to monetary and fiscal policies, currency crises, EU and EMU enlargement, and political economy of transition. Consultant of the World Bank and UNDP.*

### **Oleksandr Rohozynsky**

*Executive Director of CASE Ukraine. He holds masters degrees in Applied Mathematics, Economics, Policy Analysis, and Business Administration, and is working towards his Ph.D. in Policy Analysis at the RAND Graduate School, Santa Monica, CA, USA. He is economist and researcher with over 6 years of experience working in Ukraine and the US, including: leading and managing projects for Ukrainian think-tank; working with various international organizations, including World Bank, Soros International Economic Advisory Group, HIID/CASE; and providing support and advise to decision-makers in Ministry of Economy, Ministry of Finance and Prime-Minister of Ukraine.*

### **Irina Sinitsina**

*Irina Sinitsina, (Ph.D., Moscow State University, 1975) is a leading researcher at the Institute of International Economic and Political Studies, Russian Academy of Sciences (Moscow, Russia) and CASE's Senior Researcher, Member of the Board of Directors of CASE - Transcaucasus in Tbilisi, Georgia. She specializes in the analysis of social policy, including social security systems, social services, labor market, income and employment policies in Russia, Poland, Georgia, Ukraine and other FSU and Central /Eastern European countries. Since 1992, she has advised Russian ministries, governmental agencies, and the Central Bank of the Russian Federation on various social and employment policy issues. She is an author or co-author of over 40 monographs, chapters and articles published in academic magazines on the issues of social policy, social security, income and employment policies in transition economies.*

## **Abstract**

The purpose of this paper is to analyze the sources, economic and social characteristics, of growth recovery, which followed the first period of output decline in two transition countries – Poland and Russia. They represent two different groups of transition countries (new EU member states vs. CIS) in terms of adopted transition strategy and accomplished results. Generally, fast reformers succeeded and slow reformers experienced a lot of troubles. Although eventually all former communist countries entered the path of economic growth, those which moved slowly lost sometimes the whole decade. Social costs of slow reforms were also dramatic: income degradation and rising inequalities, high level of poverty and corruption, various social and institutional distortions and pathologies, violation of human rights and civil and economic liberties, attempts of authoritarian restoration, etc.

The period of ‘adaptation’ output decline was much more severe and longer in Russia than in Poland, and recovery came later. Unlike in the leading transition countries, the role of new private firms and FDI in Russia has been very limited what can be explained by administrative barriers, widespread corruption, lack of transparency, instability and contradictions in economic legislation, reflecting poor business climate. In the absence of FDI and with limited role of SME Russian economy is dominated by large domestic corporations, many of them having an ‘oligarchic’ characteristic. This additionally complicates the political economy of market reforms and weakens constituency of favor of open democratic society and liberal economic policies.

The high oil prices helped in economic recovery and fiscal adjustment in Russia in early 2000s. However, Russian economy has become increasingly oil-dependent. While major obstacles to future Russia’s growth can origin from its structural monoculture dominated by the oil and energy sector, and poor business climate, the excessive welfare state can be considered as the main development burden in the case of Poland.

In both analyzed countries poverty and inequality increased substantially during 1990s, to much bigger extent in Russia compared to Poland. While part of the income polarization was inevitably connected with departure from communist egalitarianism and part of poverty phenomenon reflected transition adaptation costs, other factors such as continuous structural distortions, incomplete liberalization, high inflation, insufficient competition, barriers to entrepreneurship, institutional weaknesses of the state captured by oligarchs, corruption, etc., played a significant role here.

## 1. Introduction

The purpose of this paper is to analyze the sources, economic and social characteristics, and perspectives of growth recovery, which followed the first period of output decline in transition economies. As the first stage of transition was inevitably associated with a deep output correction resulting mostly from distortions inherited from the command economy, which we call the ‘adaptation’ output decline, the recovery which followed will be called by us as the ‘post-adaptation’ recovery.

Our analysis covers two important transition countries (Poland and Russia) representing different transition histories, strategies and trajectories and respective periods, which can be identified as representing post adaptation recovery (1992-1999 in Poland and 1999-2003 in Russia). While the analyzed growth episode is already over in the case of Poland, it is not over in Russia yet which may give an interesting food for thought as to what kind of growth challenges Russia can meet in the near future (under assumption that both growth episodes are comparable enough).

Poland was the pioneer of post-communist political and economic transition starting this process already in 1989. In Russia it became possible two years later when the Soviet Union collapsed. In the first stage of its transition Poland represented a classical case of fast reform strategy called sometimes in more journalist-type analyzes as ‘shock-therapy’<sup>1</sup>. Russia tried to follow the same pattern but failed for domestic political reasons, representing eventually a much slower and less consequent reform path. From the early 1990s Poland and other Central European and Baltic countries (CEB hereafter) enjoyed a geopolitical chance to participate in the European integration with the EU membership finalized on May 1, 2004. Only very recently, Russia started to discuss seriously the perspective of its deeper cooperation and possibly partial integration with the EU, and the EU started to consider Russia as its future strategic partner.

For research purposes, Poland can be a good representative of the group of CEB countries considered by many comparative researches and rankings as examples of transition success (see e.g. World Bank, 2002; Dabrowski and Gortat, 2002; subsequent EBRD Transition Reports). On the other hand, Russia is the biggest CIS country and shares many structural, institutional and political problems of this group. This gives us a good comparative ground for analyzing some ‘stylized’ characteristics of economic developments of both sub-regions (i.e. CEB and CIS) and drawing conclusions related to the differences in transition strategies.

Although the main focus of this paper is placed on the post-adaptation output recovery period we start our analysis from the short characteristics of the previous period, i.e. adaptation output

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<sup>1</sup> As the notion of ‘shock therapy’ has a substantial emotional and sometimes pejorative content we will not use it in this paper preferring instead to talk about ‘fast’ or ‘slow’ (gradual) reforms.

decline because the observed differences in both countries (in terms of size, length and specific causes of this decline) determined various starting points of the growth stage. This is the topic of Section 2 of this study. In Section 3 we present a general characteristic of post-adaptation recovery period in Poland and Russia. Section 4 deals with some specific features distinguishing Poland's and Russia's growth patterns in the analyzed periods. It relates to changes in employment structure and labor market developments, the role of newly created small and medium-size enterprises, foreign direct investment, the role of energy sector (particularly in Russia), sectoral and geographical structure of trade, and fiscal policy pattern. In Section 5 we analyze progress in the sphere of structural and institutional reforms in both countries. Section 6 contains the analysis of social dimension of growth in both countries, i.e. the influence of growth pattern and structural and institutional characteristics of both economies on income level and its differentiation. Finally, Section 7 presents policy lessons for other countries.

Taking into account a very broad topic of this paper and limited time and resources to prepare it the authors had to rely, whenever it was possible, on the already existing analyzes, statistics and international comparisons and ratings of the IMF, World Bank, EBRD, OECD and several international think tanks/NGOs like the Freedom House, Transparency International, Heritage Foundation, etc. Several earlier studies of CASE and its network partners (like the Institute for the Economy of Transition in Moscow) were of great help in preparing this particular analysis. Authors are very grateful to OECD for its kind agreement to use results of the earlier CASE research on income distribution in Poland (being the part of OECD-sponsored project) for purpose of this study. We also would like to acknowledge a valuable consultation of Katarzyna Pietka who helped us to select and interpret statistical data on income distribution, inequality, poverty and social expenditures in Poland. Asad Alam and Radwan Shaban from the World Bank and Lyn Squire from the Global Development Network Secretariat gave us valuable remarks and suggestions to earlier (pre-conference) versions of this paper. Professor Bradford DeLong from the University California, Berkeley commented this paper during the Shanghai Poverty Conference. However, authors are solely responsible for the content and quality of this paper as well as for provided interpretations and conclusions.

As there is no a well-grounded and universally accepted transition growth theory we have focused on partial hypotheses developed in the already existing cross-country analyzes (see e.g. De Melo, Denizer, and Gelb, 1996; Aslund, Boone, and Johnson, 1996; Fischer, Sahay and Vegh, 1996; Havrylyshyn et al, 2000; WEO, 2000; Gros and Suhrcke, 2001; Fischer and Sahay, 2001; Campos and Coricelli, 2002; World Bank, 2002; EBRD, various issues). Methodology of most of these empirical exercises refers to the endogenous growth theory. We also use the same approach, although in a less formalized way – using the technique of narrative analysis and simple statistical comparison.

## **2. Output decline – unavoidable but painful adjustment**

A deep output decline was a common phenomenon for all the transition economies. This decline occurred regardless of the transition strategy used (Aslund, Boone and Johnson, 1996). However, the size of this decline varied depending on which transition strategy country adopted, conditions at the beginning of the transition, or external shocks (see WEO, 2000; World Bank, 2002).

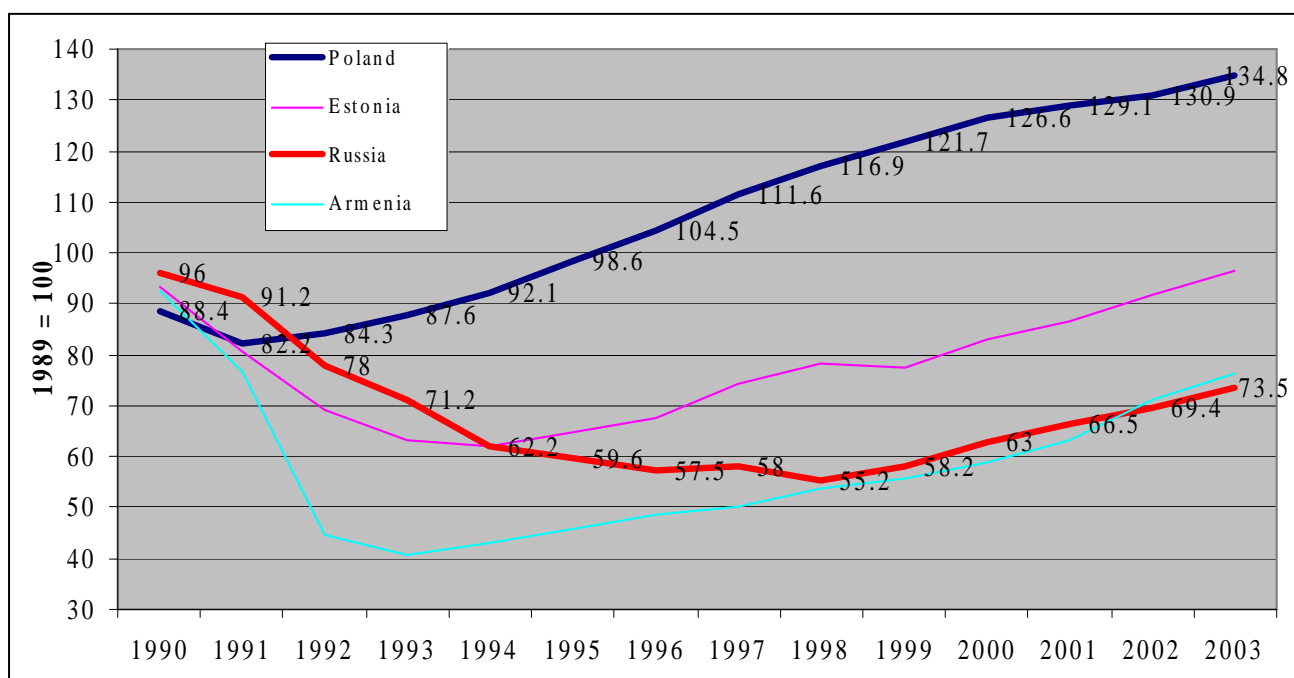
Apart from short-term costs of macroeconomic stabilization (see Balcerowicz and Gelb, 1994; Dabrowski, 1996) the size of 'adaptation' output decline was determined mostly by the scale of structural and institutional distortions inherited from the command economy. Adjustment triggered by liberalization of domestic and external markets caused a significant shift in the relative demand. On the external side, the previous export markets organized on the basis of central planning mechanism collapsed, particularly CMEA (1990-1991), and the Soviet inter-republican market (1992-1993). New import opportunities decreased demand for some domestic products while new export opportunities gave a chance to increase production of other goods. However, because the elasticity of supply response was usually limited, a shift in relative external demand had to be connected with a temporary decrease of output.

Among domestic relative-demand factors one should mention: demilitarization (see Gaidar 1997; 2003a; 2003b; Yasin, 2003), decreasing investment rate and change in the structure of investment demand, rationalization of inter-regional links (especially in Russia), elimination of forced substitution (see Winiecki, 1990, pp.781-783), more consumer freedom coming from elimination of the rationing system and from privatization of part of collective consumption (e.g., housing).

The second group of microeconomic factors was connected with a dramatic change in the cost level and structure coming from price liberalization, and elimination of multiple exchange rates, various explicit and implicit subsidies, and special price arrangements inside the CMEA and the former Soviet Union (related mostly to heavily underpriced energy resources).



**Figure 1. Real GDP growth in selected transition economies (1989 = 100)**



Note: data for 2003 are based on WEO (2003) and authors' forecast.

Source: TransMonee (2002); WEO (2003)

Finally, the third group of factors was related to microeconomic behavior and involved such issues as collapse of the mobilization role of central plan and administrative incentives connected with a totalitarian regime, expectations and incentives created by the privatization process<sup>2</sup>, expectations of massive bailouts of state enterprises by the government based on past reform experience under communism (creating credibility problems for post-communist reformers), and lack of skills to work under market conditions (see Dąbrowski, 1996; Gaidar, 2003a; 2003b).

Apart from the initial conditions determined by communist heritage and external shock the size of 'adaptation' output decline was also influenced by transition strategy. Policies did matter, particularly speed of reforms and their consistency (see World Bank, 1996; 2002; IMF, 2000; Havrylyshyn et al., 2000; De Melo et al., 2001). Wyplosz (1999) presented evidence that the countries, which proceeded with reforms in the fast manner, for example Poland, suffered smaller decline before stabilization than countries implementing gradual reforms, such as Russia.

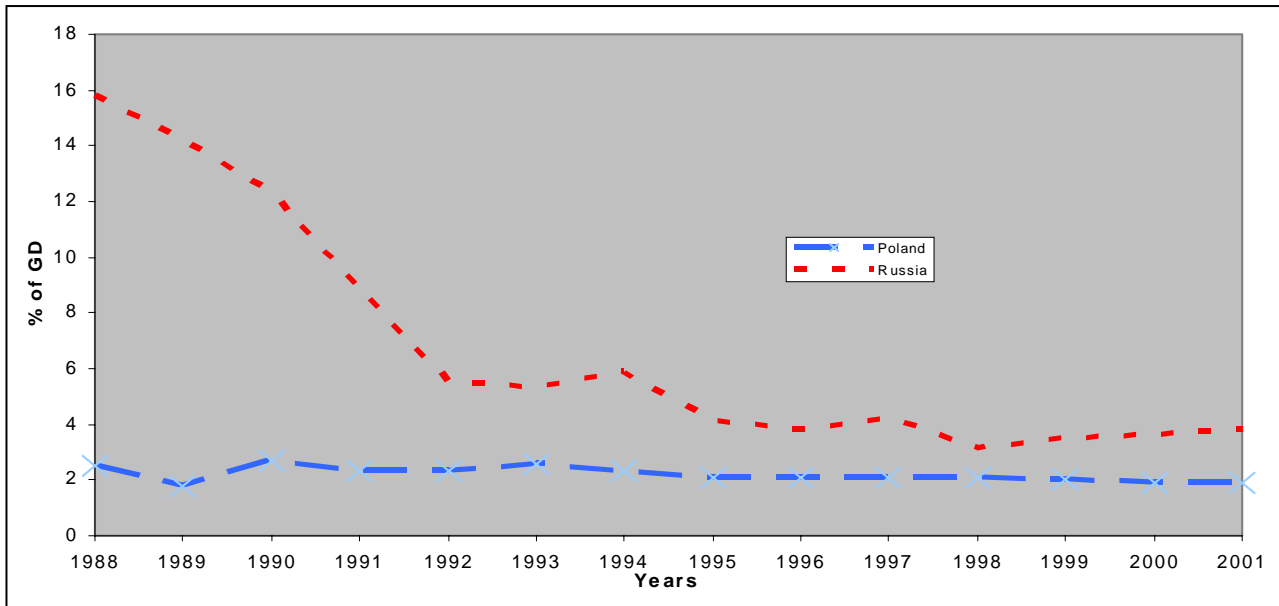
**Figure 1** shows differences between the two analyzed countries in terms of deepness and length of adaptation output decline<sup>3</sup>. Poland started its transition earlier, moved faster, and downward correction of its GDP was relatively limited - 17.8% for the period of two years (1990-

<sup>2</sup> These included the insider-outsider game of who will take over the enterprise as a private owner, outflow of the best personnel and management to the new private sector, so-called 'end game' (Blanchard and Dąbrowski, 1993) or 'privatization death' (Mertlik, 1993).

<sup>3</sup> However, one must remember about methodological risks involved in comparative analysis of early transition period. Some problems with the pre-transition GDP statistics (for example, low utility and quality of final output, limited consumption choice, distorted prices and exchange rates, over-reporting of output under communist regime) were much more severe in the former Soviet Union than in some Central European countries.

1991) only. Starting from 1992 (precisely from Q4 1991), Poland's economy took off. In Russia, output decline amounted to almost 45% of a pre-transition level and lasted for 8 years. Positive GDP dynamics accompanied by certain macroeconomic stabilization started only in 1997 but in 1998 Russian economy was again thrown back by the financial crisis. Finally, a sustainable recovery started in Q3 1999.

**Figure 2. Military expenditures in Poland and Russia, 1988-2001**



Source: World Development Indicators 2003

**Table 1. Russia: output of military industry, 1991-2001, constant prices, 1991=100.**

Item	1991	1995	1996	1997	1998	1999	2000	2001
Military output	100	25.1	18.8	13.9	16.6	23.1	29.1	29.5
Civilian output	100	39.9	28.9	28.5	28.3	36.3	44.5	50.1
Total output	100	31.4	23.1	20.1	21.7	29.1	36.2	38.4
Employment	100	54.4	46.9	41	36	33.3	34.1	33.5

Source: SIPRI (2003)

How the above differences can be explained? Certainly, initial conditions did matter strongly. Russia had longer and more severe experience with communism and command economy than Poland and the scale of inherited distortions was much bigger. **Figure 2** illustrates just one component of these distortions: the share of military-related expenditures in GDP. While in Poland their relative level in 1988 did not differ from many other countries (2.5% of GDP), in Russia it accounted to 15.8% of GDP and went gradually down to a still high share of 5.5% of GDP in 1992. **Table 1** gives an additional insight into how deep was a reduction of output of this key sector of the Russian economy in early 1990s (by ca. 75% of purely military production).

However, initial conditions cannot explain the whole size of GDP correction in Russia and its enormous length. **Figure 1** contains also data for two other former Soviet republics – Estonia and Armenia. One can assume that the size of inherited distortions was not smaller in these two countries than in the case of Russia, keeping in mind that both were fully dependent on underpriced oil and gas from Russia. Hence, after collapse of the USSR they had to adjust to much higher world oil and gas prices while Russia could gain from eliminating price distortions.

Estonia recorded five-year GDP decline (three years after obtaining independence and starting market reforms) of cumulative scale of 38.1%. In Armenia cumulative GDP decline was the highest among the four analyzed countries (by almost 60% as a result of the war with Azerbaijan) but lasted only four years and was followed by a strong and long lasting (already ten years) recovery.

The conclusion which can be drawn from the above brief and a bit simplified analysis is that Russia's negative growth trend through most of 1990s was determined by the slow pace and non-optimal sequencing of economic reforms (in addition to highly unfavorable initial conditions). Slow pace and inconsistency of macroeconomic stabilization and liberalization hampered structural and institutional changes, which were necessary to stop output decline and start its recovery. Populist policies only slowed down adaptation process and made it longer and more severe (see **Figure 1**).

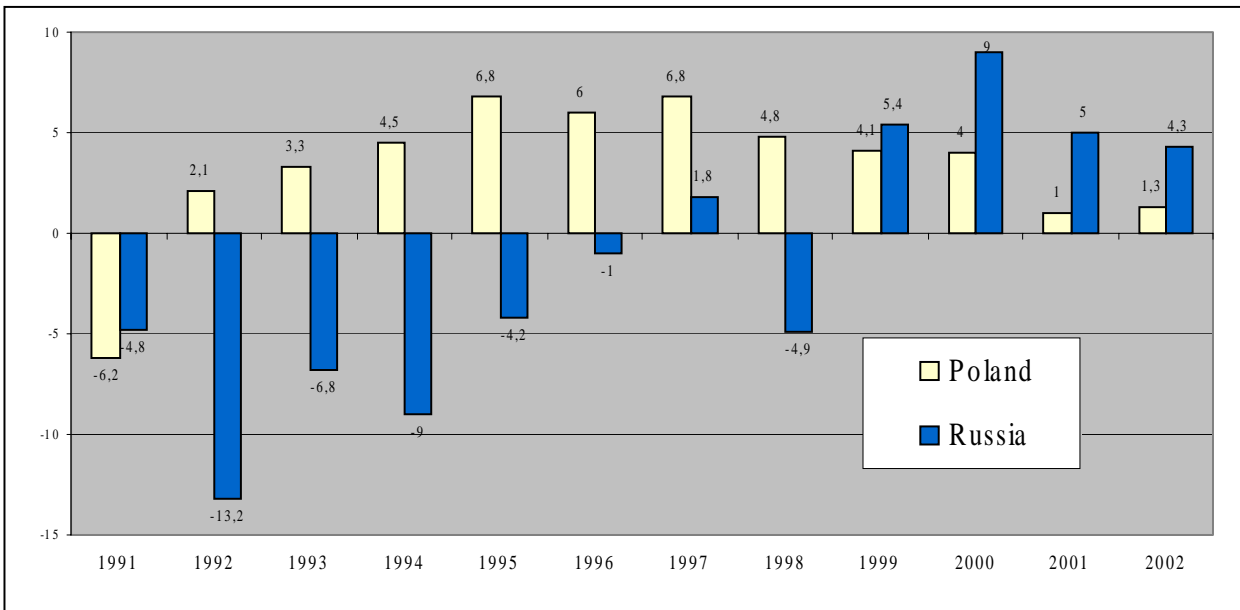
Comparisons with other countries show that progress in macroeconomic stabilization (especially lowering inflation) became a key factor of subsequent output recovery (see e.g. Fischer, Sahay, and Vegh, 1996; Havrylyshyn et al., 2000; Fischer and Sahay, 2001). Countries that tamed inflation quickly experienced a speedier and stronger recovery in output (see e.g. IMF, 2000). Moreover, in many CEE countries the early success of economic stabilization helped to strengthen the constituency in favor of further reforms, both political and economic ones. In Russia, though, the economic growth was delayed and the country has found itself in a slow-reform equilibrium for several years.

### **3. Post-Adaptation Recovery: General Characteristics**

As we mentioned in Section 2 Poland's output decline was relatively short (two years only) and recovery started already at the end of 1991. **Figure 3** shows that post-adaptation recovery in Russia began first time in 1997, i.e. five years later than in Poland and became sharply interrupted a year later by the August 1998 financial crisis. Only in the second half of 1999 Russia's growth trend took off for good, i.e. almost eight years later than it had happened in Poland. At that time, the period of fast economic growth in Poland already approached its end. This 'time mismatch' makes our analysis more difficult because it does not make a big sense to compare the same calendar years for both countries. During most of the 1990s fast growth in Poland was accompanied by the continuous output decline in Russia while strong Russia's recovery in the early 2000s overlapped with the phase of serious growth slowdown in Poland. Due to its

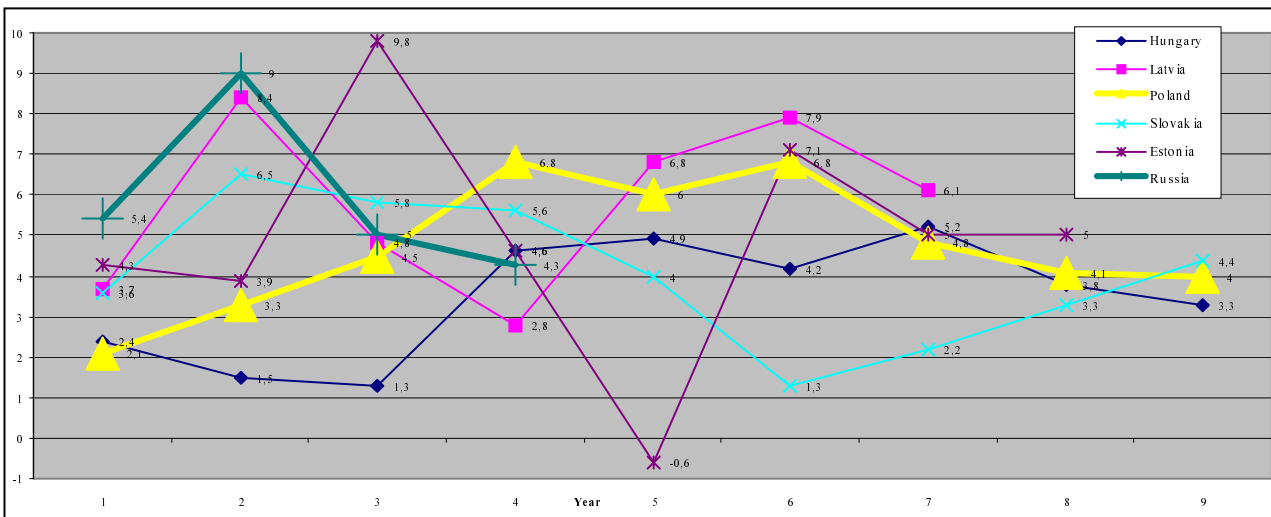
particularly long and severe period of output decline, Russia (and some other CIS economies such as Ukraine, Moldova or Kazakhstan) lagged one ‘phase’ behind Poland, other Central European, Baltic and even some CIS countries such as Armenia or Kyrgyzstan. Hence, we decided to extract a ‘recovery’ phase from each country growth statistics, eliminating in this way the above mentioned ‘time mismatch’.

**Figure 3. Annual growth rate of real GDP in Poland and Russia, in percent**



Sources: WEO (2003), p. 181, Table 7; CASE database

**Figure 4. Annual rate of real GDP growth in subsequent year of recovery period**



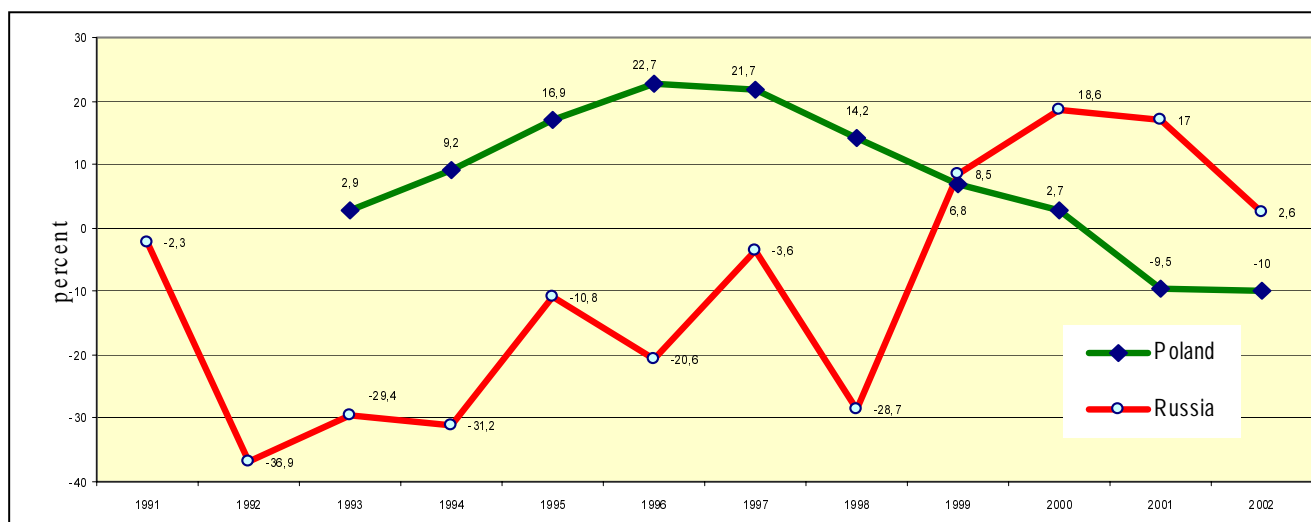
Sources: WEO (2003), p. 181, Table 7; CASE database

**Figure 4** provides an opportunity for the analysis of recovery profiles of a larger group of transition economies: apart from Poland and Russia we added Estonia, Hungary, Latvia and

Slovakia<sup>4</sup> and calibrated the chart in the way which allows comparing growth trends beginning from the moment when the ‘adaptation’ output decline became overcome. It means that year 1 in **Figure 4** means the first year of output recovery, i.e. 1992 for Poland, 1994 for Hungary and Slovakia, 1995 for Estonia, 1996 for Latvia, and 1999 for Russia.

In spite of countries’ specifics some general observations could be drawn from **Figure 4**. First, ‘taking off’ trend was quite rapid in most analyzed countries, accomplishing high growth rates already in the second or third year of the recovery phase<sup>5</sup>. It seems to confirm the hypothesis that the first stage of take off based mostly on reallocation of existing resources and capacities (exploiting the so-called simple reserves) and not on new investments which, on the contrary, were strongly depressed during the phase of ‘adaptation’ output decline. The investment volume started to increase rapidly only after economy already took off. For example, in Poland real gross fixed investment grew at an average annual rate exceeding 20% in 1996 and 1997 (see **Figure 5**). In Russia, average annual growth rate of gross domestic investment during 1991-2001 was negative and amounted to -14.6%. The situation has changed only in 1999, and positive investment growth rates have been achieved in 2000-01 (+18.6% and +17.0% accordingly).

**Figure 5. Gross fixed investments, annual percent change (constant prices)**



Sources: IMF Country Reports, IMF staff estimates, national statistics

<sup>4</sup> Adding more countries (for example, Slovenia, Lithuania, Albania, Armenia, Azerbaijan, Kyrgyzstan, Ukraine) would not change radically the picture and our conclusions below but make our graphical analysis less transparent.

<sup>5</sup> Hungary is the exception here. Beginnings of its recovery phase overlapped with serious tensions on its sovereign debt market and the necessity to conduct a drastic fiscal adjustment in 1995.

Thus, the first stage of recovery in transition economy seemed to be based on a catching-up effect using mostly the existing resources released by the 'adaptation' output decline and facilitated by the systemic changes accomplished to date. It cannot be excluded that countries with recorded deeper output decline (like Russia) had more simple reserves and, therefore, more rooms for a catching up growth. However, it is clear that sustainability of economic growth depends critically on further reform steps (see below).

The second conclusion, which can be drawn from **Figure 4** relates to a generally decreasing growth trend after the first take-off stage has been over. It additionally supports the catching-up interpretation of the first stage of post-adaptation recovery. In some cases (the example of Slovakia after 1998) the new reform effort has been needed to give a growth trend a new impulse.

The phenomenon of declining growth trend could be well observed in the case of Poland. After peaking up in 1994-1997<sup>6</sup> the growth rate started to go down systematically and reached a very low level (close to 1%) in the period of Q4 2000 – Q1 2003. Apart from exogenous factors such as the influence of Russian financial crisis (which brought the shock in Q4 1998 and the first half of 1999) and general slowdown of the world and European economy after 2000, a number of domestic factors played an important role. Among the latter one can mention: the slow pace of privatization and restructuring of several important sectors (coal, steel and other heavy industries, energy sector, railways, telecommunication, etc.), increasing labor market rigidities, high level of fiscal redistribution (in the range of 45-50% of GDP), excessive social commitments and resulting high taxes, reversal of deregulation trend of the early 1990s, and adjustment costs connected with the adoption of EU *acquis communautaire*.

In addition, due to serious macroeconomic imbalances accompanying years of very high growth rates (chronic two-digit inflation and rapidly increasing current account deficit) a serious tightening of both monetary and fiscal policies became necessary. While fiscal tightening occurred to be short-living (only in 1998-1999, followed by a substantial fiscal relaxation in the subsequent years) monetary tightening of 1999-2000 managed to bring inflation to a very low one-digit level (end-year inflation rate of 3.6% in 2001 and 0.8% in 2002 comparing to 9.8% in 1999) and substantially reduce current account deficit - from 8.1% of GDP in 1998 to 3.1% of GDP in 2001 (World Bank, 2003, p. 197, Table A18). However, the real sector had to bear costs of the stabilization/disinflation policy, and suboptimal policy mix (relatively loose fiscal vs. tight monetary policy) increased negative output/ employment consequences. Hopefully, Polish economy will benefit in future from the recent stabilization policy and a new round of microeconomic restructuring, which took place in the beginning of the 2000s but it will be already another growth phase, which will require a separate analysis.

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<sup>6</sup> At that time some Polish politicians and foreign observers started to talk about 'Polish miracle'. The same could be occasionally heard in Russia in 2001-2003. However, authors of this paper are very careful with using this kind of emotional (and *ex post* usually evidently overly optimistic) characteristics. They reflect public demand for success story and politicians' wishful thinking rather than any well-grounded empirical observation (and particularly any well-grounded forecast of future growth trend and its sustainability).

According to our simplified trend comparison presented in **Figure 4**, in 2003 Russia would be in the similar phase of its growth recovery as Poland in 1996, i.e., at its highest growth momentum. Does also Russia face the perspective of gradually decreasing growth rate in the coming years? Possibly yes if the new growth impulses will not be added to those observed in the beginning of 2000s. At this point we can risk a hypothesis that high growth rates in Russia starting from 2000 may be explained by: (1) depth of the previous output decline and use of simple reserves (e.g., utilization of idle capacities); (2) positive effects of economic reforms conducted in 1990s (particularly privatization), and (3) high oil prices on international markets (see Dąbrowski, 2003). We will come back to this question at the end of this paper after conducting a comparative structural and institutional analyzes of both economies.

## **4. Structural features of growth patterns in Poland and Russia**

In spite of potential similarities in growth trends in Poland in 1990s and Russia in early 2000s one should take a deeper look at the structural characteristics of both economies. Only such an analysis can bring us closer to the answer to the question whether we analyze the same phenomenon in both countries or different phenomena with some superficial similarities? In this section we try to address five concrete issues: employment structure and labor market developments, the role of small and medium size enterprises (SME) and foreign direct investments (FDI), the role of oil and energy production/ consumption, structure of foreign trade, and fiscal policy pattern.

### **4.1. Employment structure and labor market developments**

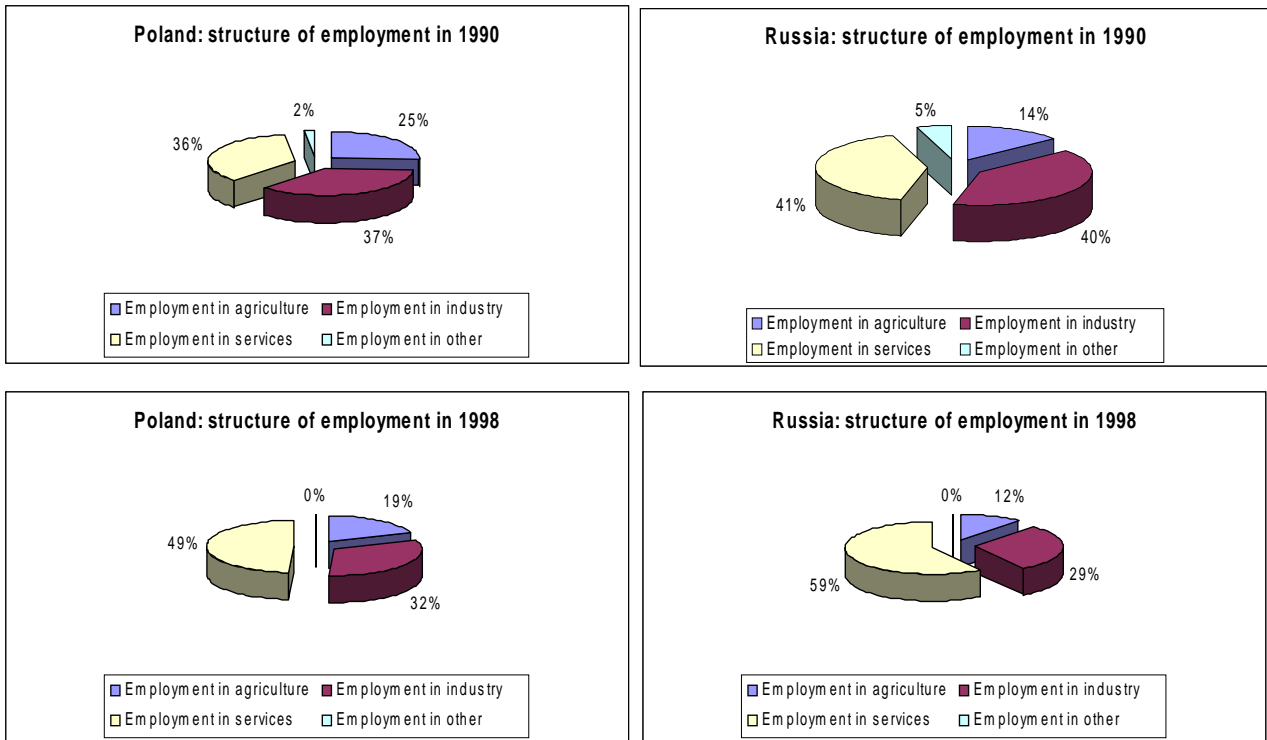
**Figure 6** provides us with a general picture of changes in employment structure of two countries in consideration recorded between 1990 and 1998<sup>7</sup>. Generally, it looks like both countries represent the similar structural changes: moving a substantial part of labor force from industry to a broadly defined service sector (more dramatic in Russia compared to Poland) and, in parallel, decreasing share of employment in agriculture (more substantial in Poland than in Russia), again in favor of service sector. Both tendencies and relative differences in both countries could hardly come as a surprise. Former communist countries were heavily over-industrialized (especially former USSR and Russia in particular) while market services were underdeveloped. Poland, which managed to avoid communist collectivization of its agriculture, suffered (and continues to suffer) over-employment in this sector typical for less developed countries. On the other hand, Russia had

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<sup>7</sup> We do not have a fully comparable data for any later year. However, according to national statistics the proportions observed in 1998 did not undergo any serious changes during the next five years.

also a certain margin of redundant labor (although much smaller than in case of Poland) in its ineffective state- and collectively-owned farms (*sovkhozes* and *kolkhozes*).

**Figure 6. Employment structure by sectors in Poland and Russia, 1990-1998, in % of total employment**

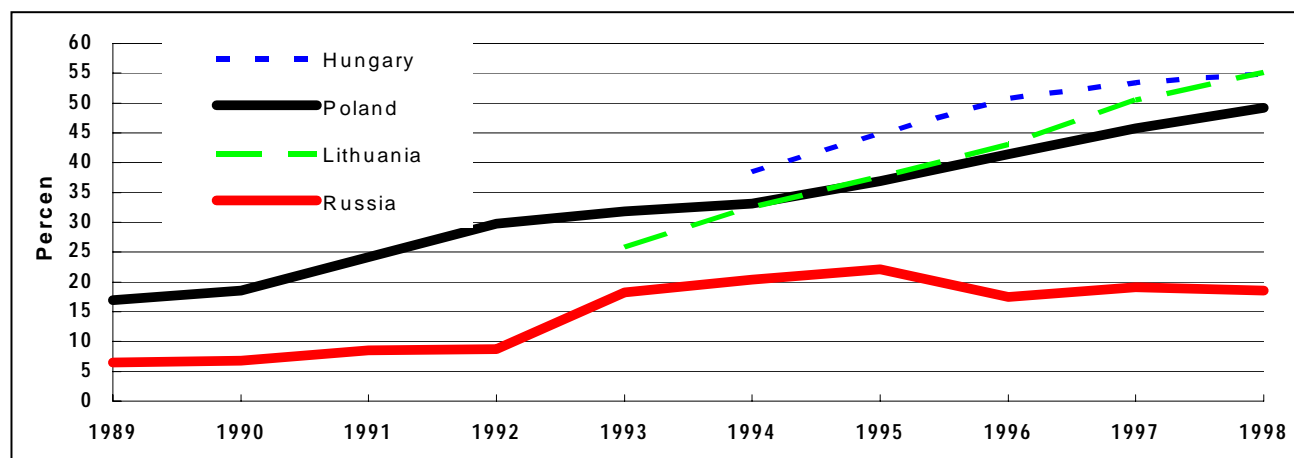


Source: World Development Indicators 2003

However, similarities seem to end at this point. If we want to investigate other characteristics of employment and labor market we will find striking differences between both countries. This relates, for example, to share of employment in small enterprises, which are defined as those employing 50 or fewer workers (see **Figure 7**). The initial differences – in 1989 the analyzed share accounted for 16.92% in Poland and only for 6.43% in Russia – did not disappear through the decade of the 1990s. On the contrary, they increased in spite of positive dynamics in both countries. In Poland the share of small enterprises increased systematically up to almost half of total employment in 1998 (49.16%), while in Russia it stabilized below 20% (18.59% in 1998). In addition, one should take into account that Poland did not represent the highest record in this respect in 1998. In two countries shown in **Figure 7** – Hungary and Lithuania – this share was even higher: 55.10% and 54.93% respectively. It is worth to admit that Lithuania started in the early 1990s from the level similar to Russia.



**Figure 7. Share of Employment in Small Enterprises, 1989-98**

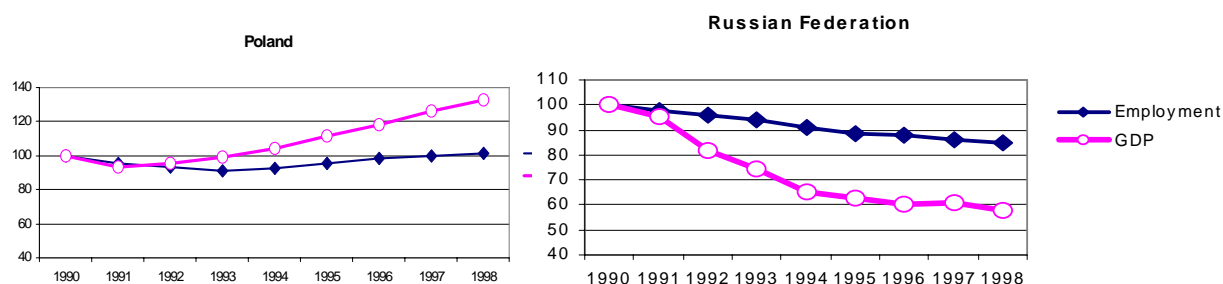


Note: Small enterprises are defined as those employing 50 or fewer workers

Source: World Bank (2002), p. 41, Table 4.2

**Figure 8** illustrates a comparison of employment and GDP dynamics in the first nine years of transition. While in Poland strong output recovery was accompanied by a very modest growth in employment – by 1.1% in 1994, 0.3% in 1995, 3.5% in 1996 (the only year with a stronger increase of employment), 1.3% in 1997 and 1.4% in 1998 – Russia’s severe output decline was connected with substantial but less dramatic fall of employment – by 3.4% in 1994, 6.4% in 1995, 3.4% in 1996, 3.1% in 1997, and 2.7% in 1998. It means that Poland recorded a continuous increase in labor productivity, while Russia – its continuous decline.

**Figure 8. Employment and GDP dynamics in Poland and Russia, 1990 = 100**

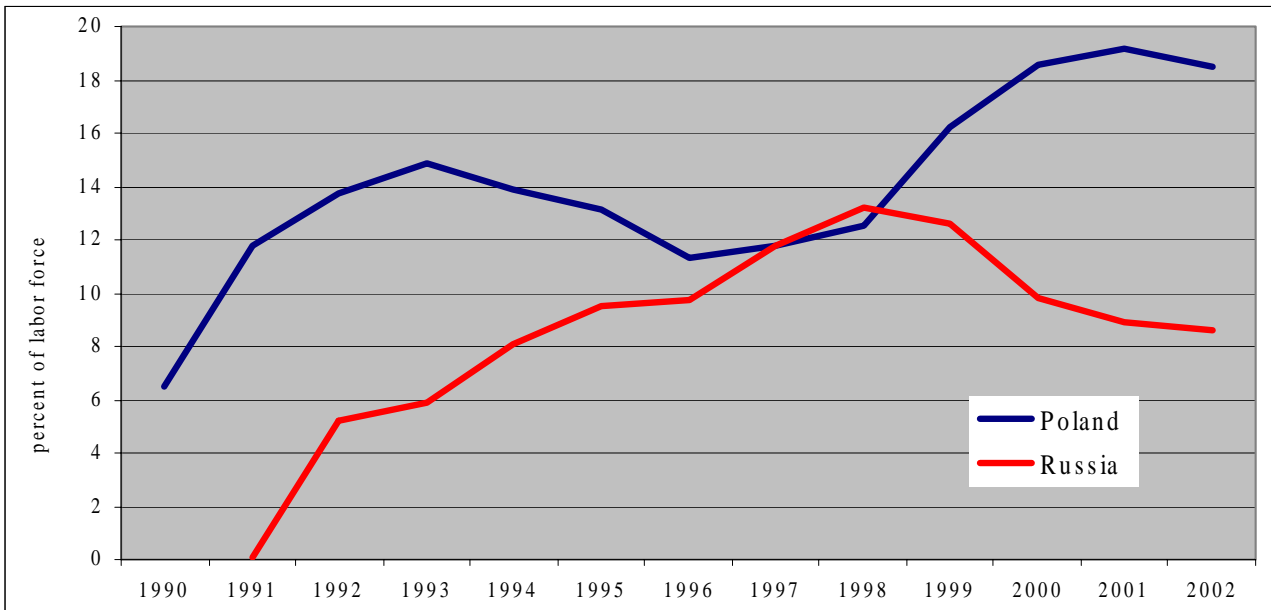


Source: World Bank (2002), p. 44, Figure 4.6

After 1998 employment trends in both countries have changed. Employment in Russia started to increase on the top of economic recovery but at a slower pace than GDP (apart from 1999 when it increased by 8.0%; in the next two years employment growth rate amounted to 1.4% and 1.3%, respectively). In Poland slower growth rates were accompanied by employment decline: by 1.5% in

1999, 3.3% in 2000, and 4.3% in 2001. Thus, both countries recorded labor productivity growth but Poland represented a less labor-intensive pattern of economic development in spite of rapidly increasing unemployment and entering the labor market by the second post-war demographic boom.

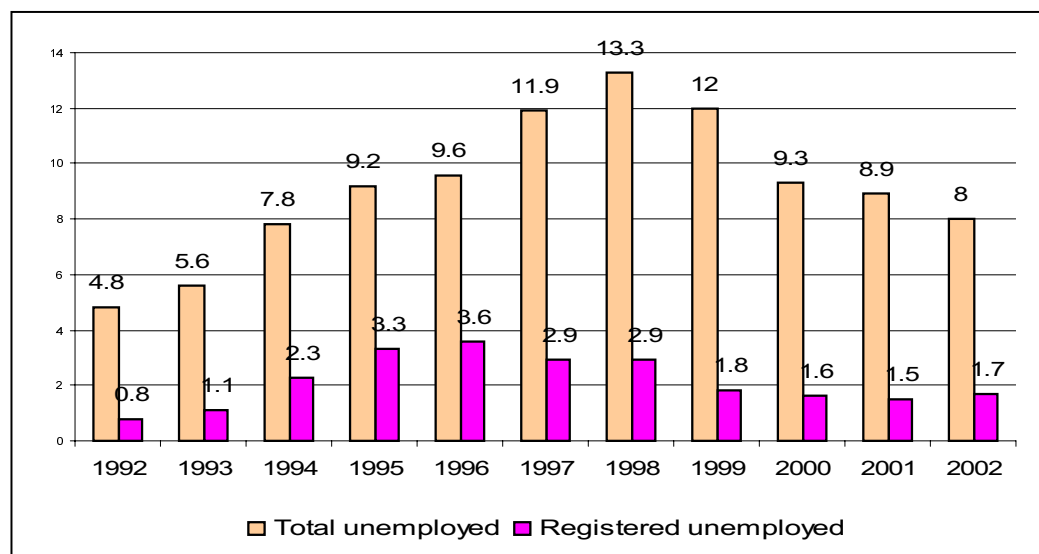
**Figure 9. Unemployment in Poland and Russia (according to ILO definition), 1990-2001**



Sources: Estevao (2003), World Development Indicators Database; Goskomstat (2003).

Employment dynamics has been mirrored in the unemployment statistics presented in **Figure 9**. Unemployment rate in Russia was systematically lower than in Poland, apart from two years – 1997 and 1998. Particularly striking is its relatively low unemployment rate in the period of dramatic output decline before 1997. Together with the mentioned low share of employment in small enterprises and lagging employment dynamics (comparing to GDP dynamics) it provides a ground to formulate a hypothesis that restructuring process of old big enterprises was delayed and these enterprises hoarded the excessive labor for a quite long time. This hypothesis can be additionally supported by a comparison of actual (surveyed according to the ILO methodology) and officially registered unemployment in Russia presented in **Figure 10** (in Poland these differences are much smaller) and by research addressing the phenomenon of unofficial ('gray' or 'black') economic activity.

**Figure 10. Total (ILO definition) and registered unemployment in Russia, % of labor force**



Source: State Statistical Committee (*Goskomstat*)

According to estimates of Johnson, Kaufmann and Shleifer (1997), unofficial economy represented 42% of GDP in Russia, 49% in Ukraine, and over 60% in Azerbaijan and Georgia in 1995, while Poland recorded one of the lowest shares (well below 20%). Although there are no fresh cross-country surveys investigating this issue anecdotal evidence speaks in favor of some ‘convergence’ of the relative size of unregistered economy in both countries. The Polish picture deteriorated compared to mid-1990s (as result of labor market rigidities, high taxes, and increasing over-regulation), while the Russian one slightly improved. Nevertheless, the gap is still substantial – probably twofold.

Generally, Russia and Poland represent two different patterns of labor market adjustment. In Russia, a decline in employment was significantly smaller than the massive collapse of output and labor demand. The adjustment took the form of lower real wages as well as the emergence of wage arrears and hidden unemployment<sup>8</sup>. Labor moved to low-productivity services. Together with labor hoarding by enterprises, these sectors served as shock absorbers in view of the lack of a well-functioning social policy (see below). The second pattern, broadly prevalent in the CEE and represented by Poland, saw employment decline with output. Job destruction was concentrated in existing enterprises, while job creation was to be found almost exclusively in new enterprises (World Bank, 2002, p. 30).

Much higher officially registered unemployment in Poland reflects severe labor market rigidities in Poland and much higher labor costs, additionally increased by high social welfare costs. Russian

<sup>8</sup> Hidden unemployment has been estimated in Russia at 8-25% of an economically active population (e.g. on long, unpaid leave or reduced working hours), shadow economy has employed about 25 million people, including 7 million not having any other job, while 18 million have combined work in formal and informal sectors.

labor market is more flexible *de facto* (not necessarily *de iure*) what is demonstrated, among other factors, by a higher actual nominal wage flexibility (see also Svejnar, 2004).

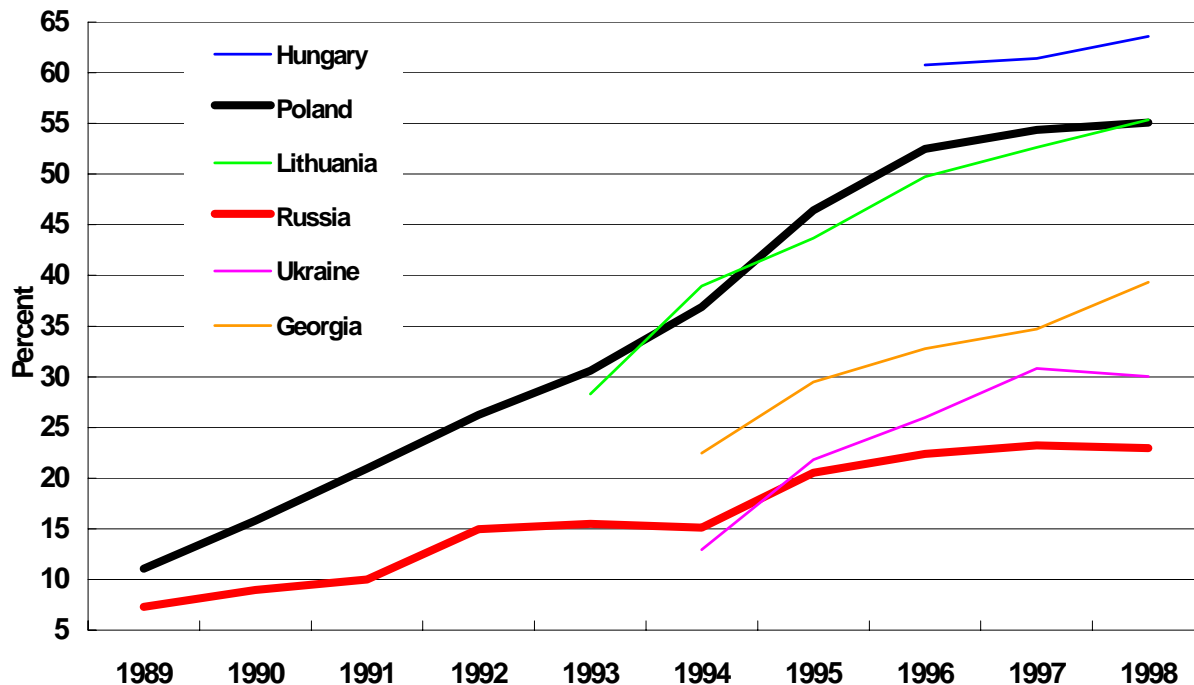
#### **4.2. The Role of SME and FDI**

The experience of CEB countries, including Poland, pointed to the key role of newly established private enterprises (mostly representing a SME category) in fostering an economic restructuring, absorbing labor resources, and bringing economic recovery. In fact, it was the main vehicle of adaptation and removing inherited structural distortions (see Dabrowski, Gomulka, and Rostowski, 2001; IMF, 2000; World Bank, 2002).

The stylized picture of a two-sector economy well illustrates the first decade of transition in CEB region. One part of the economy, mainly SOEs in heavy and military industries, big industrialized construction, and collective agriculture was declining sharply while the second part, mainly the new private firms in trade, services and manufacturing industry, was growing dynamically. The decline of the first part freed resources, such as labor, energy and other inputs, building and real estate, and enabled the rapid development of the second part. The speed of development of the 'new economy' depended very much on the real economic freedom (i.e., the comprehensiveness and transparency of liberalization process), the presence of hard budget constraints, a stable macroeconomic environment (important for the investment climate), and progress in privatization and restructuring of SOEs.

In Section 4.1 we have already shown a limited role of the newly created private firms in fostering economic recovery in Russia, due to over-regulation and poor business climate (see Section 5). The poor employment statistics is additionally confirmed by equally unsatisfactory contribution of small firms to total value added (see **Figure 11**). The gap between Poland and Russia is even bigger and Russia became outpaced not only by CEB countries but also by Georgia and Ukraine (and some other CIS countries).

Figure 11: Share of Value Added in Small Enterprises, 1989-98



Note: Small enterprises are defined as those employing 50 or fewer workers

Source: World Bank (2002), p. 41, Figure 4.3

Although years 2000-2002 brought some progress in tax reform and deregulation (see IET, 2003) it will take some time before Russian business climate will substantially improve. So far, according to existing evidence the share of small enterprises stabilized at the level close to 20% of employment and value added. This indicator should be somewhat corrected upward, taking into account the big share of unofficial economy but it will not change significantly the dramatic differences between Russia and Poland and other CEB countries.

The similar differences relate to FDI. As distinct from Poland and other CEB countries, Russia represents a not very impressive record in this sphere (see **Table 2**) mostly due to poor business climate. In 2002 Russia's per capita cumulative FDI inflow was 7 times lower than in Poland, 10 times lower than in Croatia, 11 times lower than in Slovakia, 15 times lower comparing to Estonia and Hungary, and 20 times lower comparing to the Czech Republic. Most of FDI came to oil sector and other natural resource sectors. Moreover, through the whole of transition period Russia suffered a substantial capital outflow (see e.g. Loungani and Mauro, 2000; Buiter and Szegvari, 2002). The prosecution against biggest Russian oil company YUKOS in 2003-2004 may only encourage further capital outflow.

**Table 2. FDI in transition countries, 2002 (cumulative, USD M)**

<b>Country/ Region</b>	<b>Total, \$M</b>	<b>Per capita (\$)</b>
Czech Republic	37,000	3,603
Slovakia	10,000	1,859
Hungary	27,000	2,659
<b>Poland</b>	<b>46,000</b>	<b>1,191</b>
Slovenia	5,500	2,754
<b>Central Europe</b>	<b>125,500</b>	<b>1,890</b>
Bulgaria	4,400	564
Romania	8,600	383
Croatia	7,700	1,738
<b>South-East Europe</b>	<b>24,900</b>	<b>476</b>
Estonia	3,600	2,647
Latvia	3,000	1,282
Lithuania	3,600	1,040
<b>Baltic countries</b>	<b>10,200</b>	<b>1,425</b>
<b>Russia</b>	<b>25,000</b>	<b>174</b>
Ukraine	5,000	104
Belarus	1,400	140
Moldova	700	193
<b>European CIS</b>	<b>32,100</b>	<b>156</b>

Source: WIIW-WIFO Database.

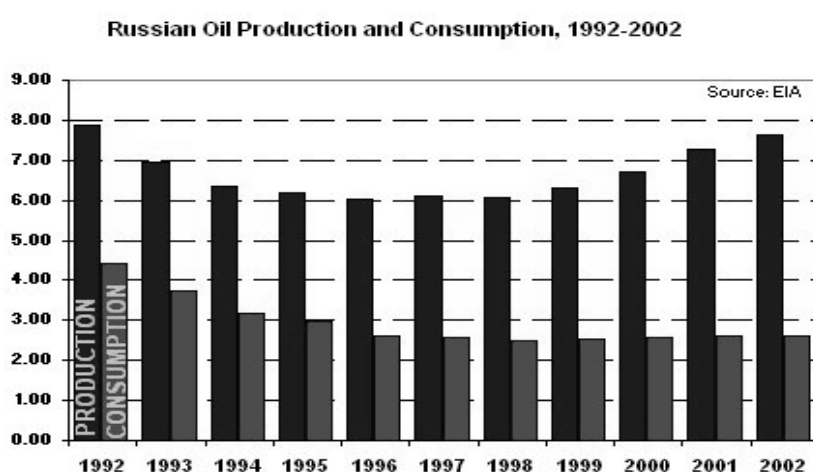
Thus, what is the main vehicle of economic growth in Russia in the absence of sufficient contribution of domestic SMEs and FDI? According to Aslund and Boone (2002) this role is played by large Russian private corporations and conglomerates. Many of them built their strength in foreign trade and financial market first and then moved to exploitation of natural resources using benefits of the loan-for-share program and other non-transparent privatization schemes in mid-1990s. Manufacturing industry, agriculture and service sector became the last stage of their expansion.

### **4.3. The role of energy sector**

A large portion of the remarkable Russian growth in early 2000s can be attributed to the increase in oil production and very high international oil prices. From 1998 to 2002, average daily oil production in Russia increased from 6 to 7.7 bbl/day (EIA, 2003; see also **Figure 12**). The energy accounted to around 20% of Russian GDP in 2002, and the energy sector generated up to 40% of fiscal revenues at the same year. Production and export of oil were the main contributors to this growth.

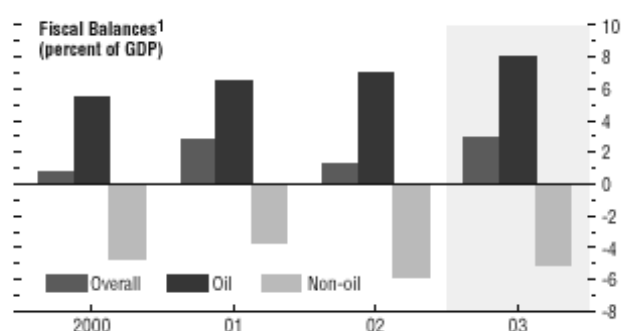
The rapid increase in oil prices, which started from the second half of 1999, apart from helping to return to economic growth, restored both balance of payments and fiscal balance, and decreased social costs of a reform package implemented in the beginning of 2000s. On the other hand, it reduced incentives to reform ineffective public services such as national defense, police or other law-enforcement agencies. It also allowed financing the Chechen War II without visible negative consequences for the federal budget. Deterioration of non-oil fiscal balances in the beginning of the 2000s (reflecting a trade-off between a real fiscal adjustment and consuming ‘windfall’ oil revenue) is well illustrated in **Figure 13**.

**Figure 12. Russian oil production and consumption, 1992-2002**



Source: EIA (2003)

**Figure 13. Oil and Non-oil Fiscal Balances in Russia**



Note: <sup>1</sup> Federal budget operations (commitments).

Source: WEO (2003), p. 42.

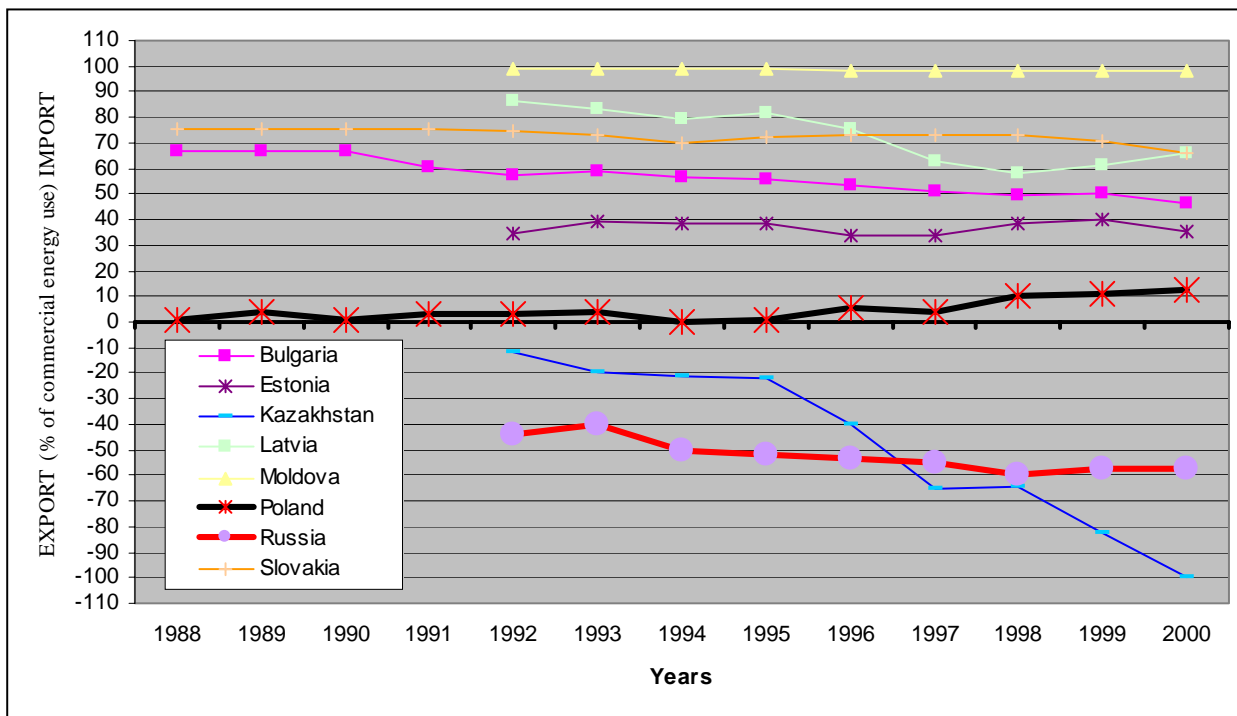
Russia is one of the major world exporters of energy resources (primarily natural gas and oil). **Figure 14** shows that while most of Eastern European and CIS countries are net importers of energy (in some cases up to a 100% of consumed energy), Russia exports the equivalent of more than 50% of energy it consumes. If Russian transition followed the Polish (CEB region) path and

adopted the energy-saving technologies it could potentially double the volume of exported energy resources. It could bring more export and fiscal revenues and speed up restructuring of manufacturing industry, agriculture, transport and other energy consuming sectors.

The economy of the Soviet Union was characterized by the use of very energy-intensive technologies. As we can see from **Figure 15**, after collapse of the Soviet Union, Russia had one of the lowest GDP per energy unit in the region. Only Azerbaijan and Kazakhstan, similarly endowed with oil and gas resources, produced less per energy unit than Russia in 1992.

Poland had one of the most energy-intensive economies among the countries of Eastern Europe and heavily relied on energy imports from Russia (in addition to its own coal sector and coal-based electric power generation). However, cutting off the sources of cheap energy (when prices of oil and natural gas imported from Russia were increased to the world level), trade liberalization and hard budget constraints pushed Polish economy to the adoption of energy-efficient technologies. By the end of Millennium, Poland's GDP per unit of energy increased almost twice but still lags behind such countries as Slovenia, Hungary and Latvia.

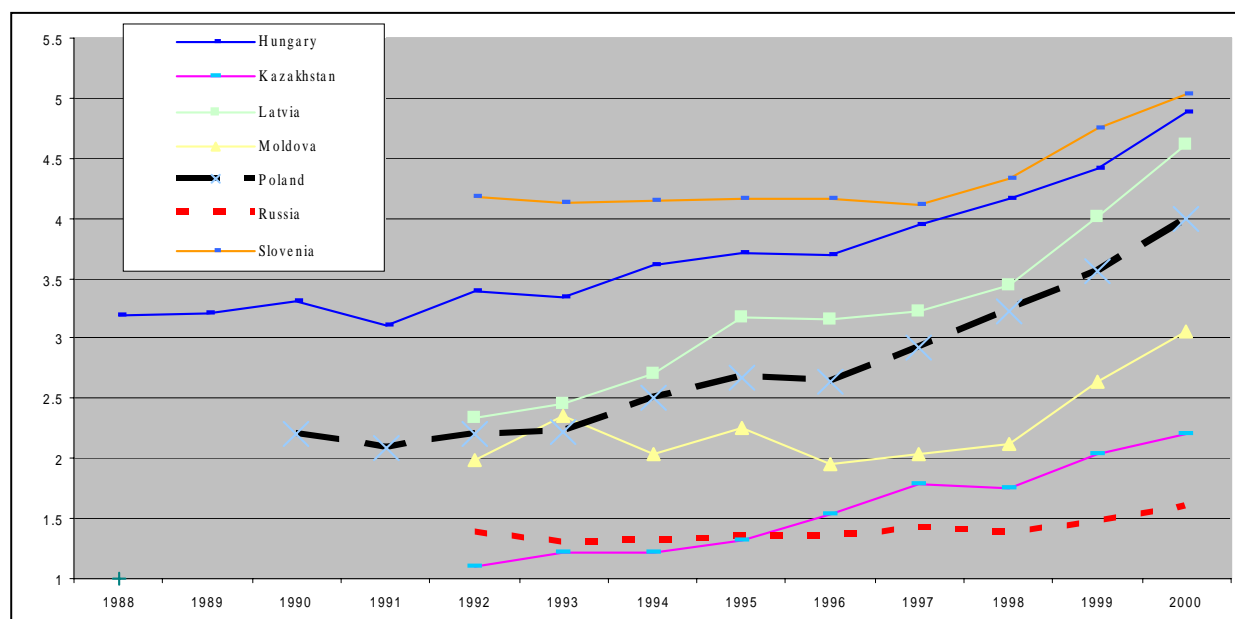
**Figure 14. Net energy import (sign +) and export (sign -) in selected transition countries**



Source: World Development Indicators 2003



**Figure 15. GDP per unit of energy use (PPP \$ per kg of oil equivalent)**



Source: World Development Indicators 2003

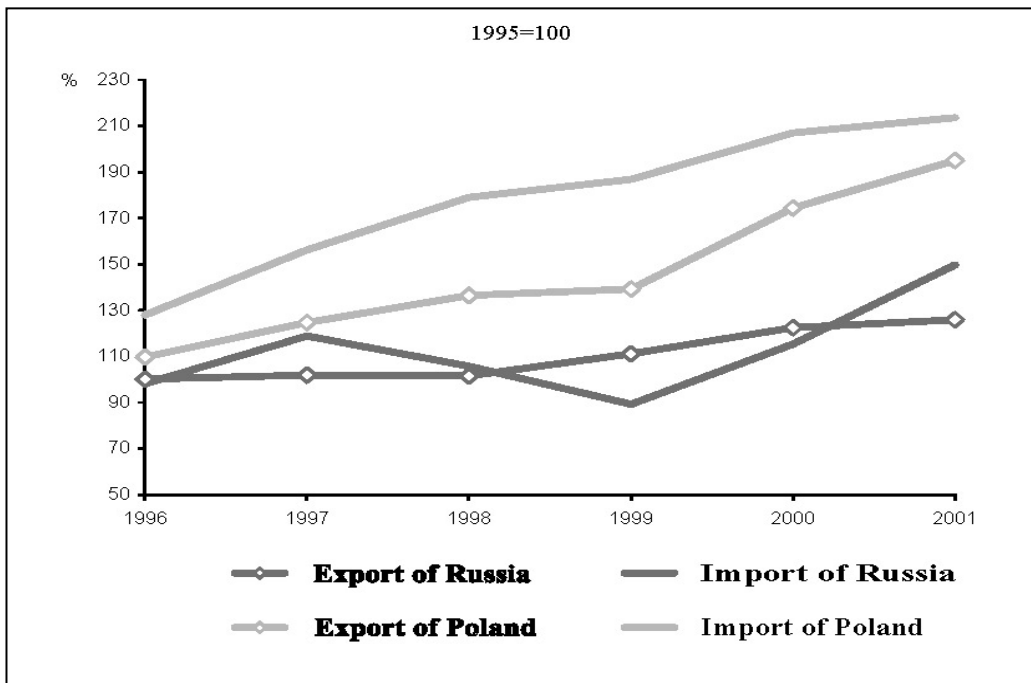
At the same time, domestic energy prices in Russia remained significantly lower than in the rest of the world. It led to conservation of the energy inefficient technologies. As a result, production per unit of energy remained almost unchanged during the period 1992 – 2000. This is in contrast even with other CIS countries such as Kazakhstan or Moldova where certain progress in energy efficiency has been recorded.

In fact, more than four-fold devaluation of the ruble in 1998-1999 (as result of the August 1998 financial crisis) and only limited adjustment of the ruble energy prices inside Russia led to a reversal of a limited progress achieved in this sphere before 1998. It increased domestic price distortions and artificially improved external competitiveness of the Russian manufacturing industry, in addition to real depreciation of the ruble (see Development Center, 2001; IET, 2003). It has seriously complicated Russia's negotiations on the WTO accession, particularly with the EU (see EU, 2003).

#### 4.4. Export and import dynamics and structure, the role of European integration

Compared to Russia, Poland's economy is more open to foreign trade (what is partly the consequence of its smaller size) and, therefore, economic growth of Poland seems to be a more export-driven. **Figure 16** shows that in the second half of the 1990s and early 2000s export dynamics of Poland systematically outpaced those of Russia, with one exception of year 1999 when Poland's export had to absorb adverse shock caused by the Russian financial crisis and Russia's export was boosted by ruble devaluation. What is particularly interesting, Poland's export took off again in years 2000-2001 despite growth slowdown.

**Figure 16. Export and import dynamics in Poland and Russia**



Source: Russia-Poland (2003), p. 77

What concerns import dynamics it was more uneven in Russia with negative trends in crisis years (1998-1999) and sharp recovery when this country entered the phase of economic growth (from 2000).

The key role of oil and natural gas production in the Russian economy determines its export structure, which is dominated by energy resources (see **Figure 17b**). Poland, on the other hand, had been increasing its export primarily due to manufacturing industry products (see **Figure 17a**), including the growing share of intra-industry trade with the EU countries. This is also reflected in the geographical structure of trade (see **Table 3**). The share of EU market in Poland's export is stable (ca. 70%) and is twice higher compared to Russia where it has decreased over the decade of the 1990s and contains mainly oil and natural gas. On the import side, there is more similarities

between the two countries although manufactured goods of the EU origin play much bigger and increasing role in the case of Poland (see **Figures 18a** and **b**).

**Table 3. Exports to the EU as share of total exports (in per cent)**

Country	1992	1993	1994	1995	1996	1997	1998	1999	2000
Bulgaria	46	46	40	38	29	36	50	51	51
Czech Rep.	..	47	46	43	58	60	64	68	69
Estonia	87	48	48	55	51	49	57	65	84
Hungary	62	56	64	65	65	73	73	76	69
Latvia	40	35	39	44	44	49	57	63	65
Lithuania	89	39	30	36	33	33	38	50	48
<b>Poland</b>	<b>62</b>	<b>69</b>	<b>70</b>	<b>70</b>	<b>66</b>	<b>64</b>	<b>71</b>	<b>71</b>	<b>70</b>
Romania	35	41	48	55	53	56	67	67	64
Slovakia	..	27	35	37	41	55	56	59	59
Slovenia	..	63	66	68	65	64	65	65	64
<b>CEB AVG</b>	<b>59<sup>a</sup></b>	<b>53</b>	<b>55</b>	<b>55</b>	<b>57</b>	<b>60</b>	<b>65</b>	<b>68</b>	<b>67</b>
Belarus	32	32	13	12	8	7	7	9	9
Moldova	3	3	6	12	10	10	12	21	20
<b>Russia</b>	<b>48</b>	<b>44</b>	<b>33</b>	<b>32</b>	<b>31</b>	<b>32</b>	<b>31</b>	<b>32</b>	<b>35</b>
Ukraine	10	14	7	13	11	12	17	18	16
Georgia	5	35	1	5	9	8	35	28	21
Armenia	1	11	28	29	21	28	34	46	36
Azerbaijan	15	7	13	15	9	11	22	46	60
Kazakhstan	30	42	16	22	19	26	31	23	23
<b>CIS AVG</b>	<b>40</b>	<b>39</b>	<b>27</b>	<b>27</b>	<b>26</b>	<b>26</b>	<b>27</b>	<b>28</b>	<b>31</b>

Note: <sup>a</sup> – includes Czechoslovakia

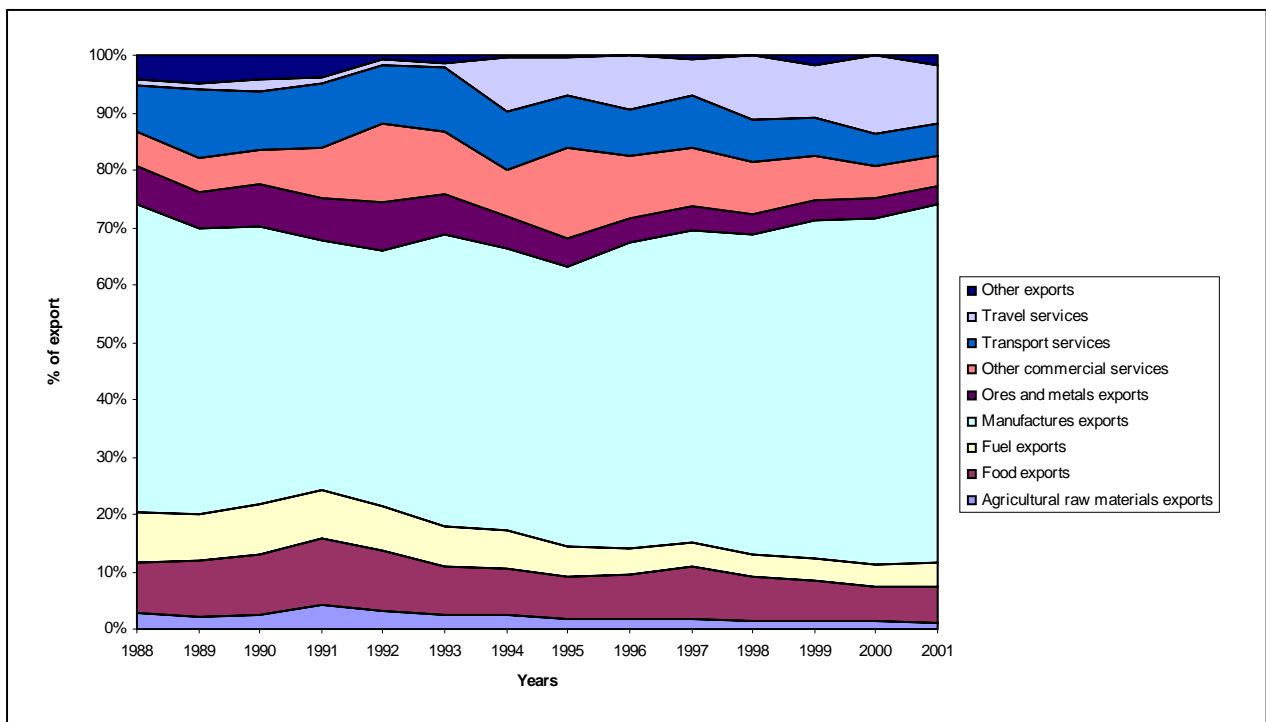
Source: Aslund and Warner (2003)

Generally, trade structure of the analyzed countries, both structural and geographical, has been determined by three groups of factors: (i) geographical location and endowment in natural resources; (ii) domestic economic policies and progress in economic restructuring; (iii) policies of their main trade partners.

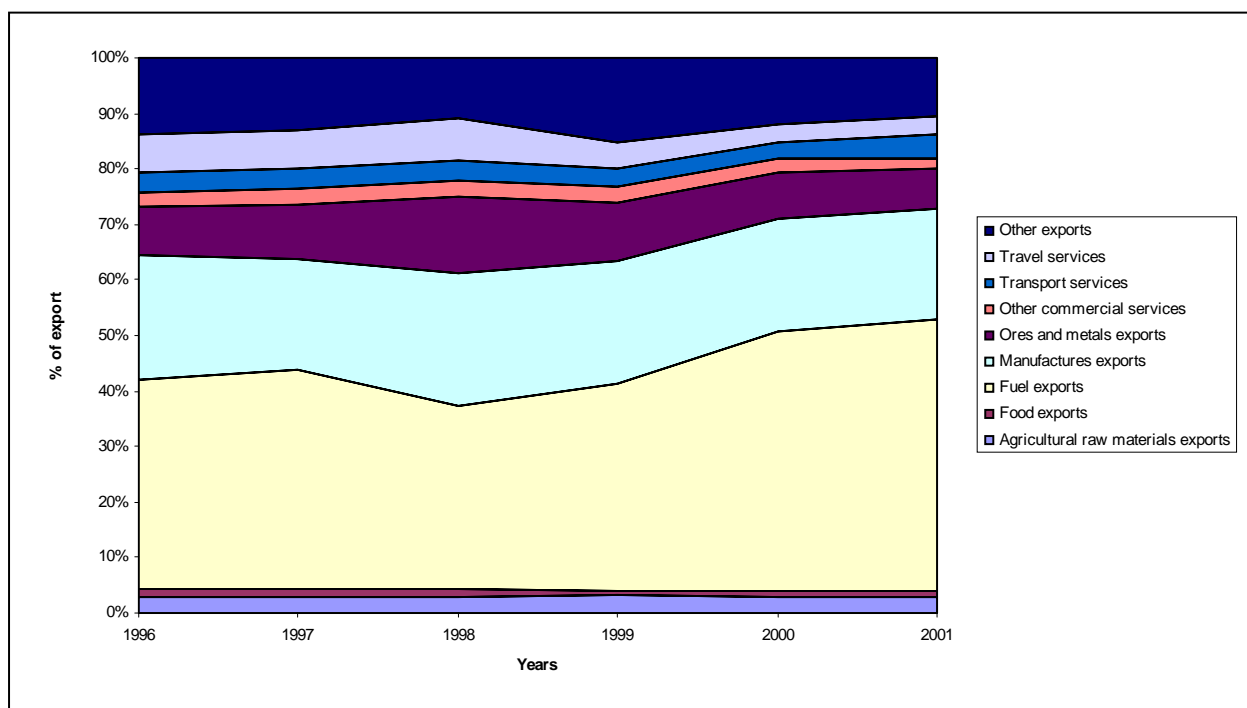
Let us look briefly at how these factors work in practice. Close neighborhood of Western Europe and poor natural resource base pushed Poland towards developing intensive trade relations with the EU, with dominance of manufacturing industry exports and imports. It speeded up, in turn, the restructuring of Polish industry and increased its competitiveness on the EU market. So we can observe a kind of 'virtuous' cycle. In the case of Russia, abundance of cheap energy resources led to its natural competitive advantage in this sphere. On the domestic front, underpriced energy inputs slowed down (apart from slow pace of structural and institutional reforms – see Section 5) the process of restructuring of non-oil and non-gas sectors of the Russian economy, making them internationally uncompetitive or exposed to anti-dumping restrictions (the case of ferrous and non-ferrous metallurgy).

However, one caveat needs the additional comment. Russia is not geographically so distant from the Western Europe to justify a half of Poland's share of EU-oriented export in the total export. Here the negative role of EU trade policy should be strongly highlighted. While from the very beginning of transition process Poland and other CEB countries (and recently also Balkan countries) were supported by the EU with the preferential access to its market and a clear perspective of the European integration, nothing of this kind was ever offered to Russia and other CIS countries (apart from very limited Partnership and Cooperation Agreements).

**Figure 17a. Sectoral composition of Polish export**

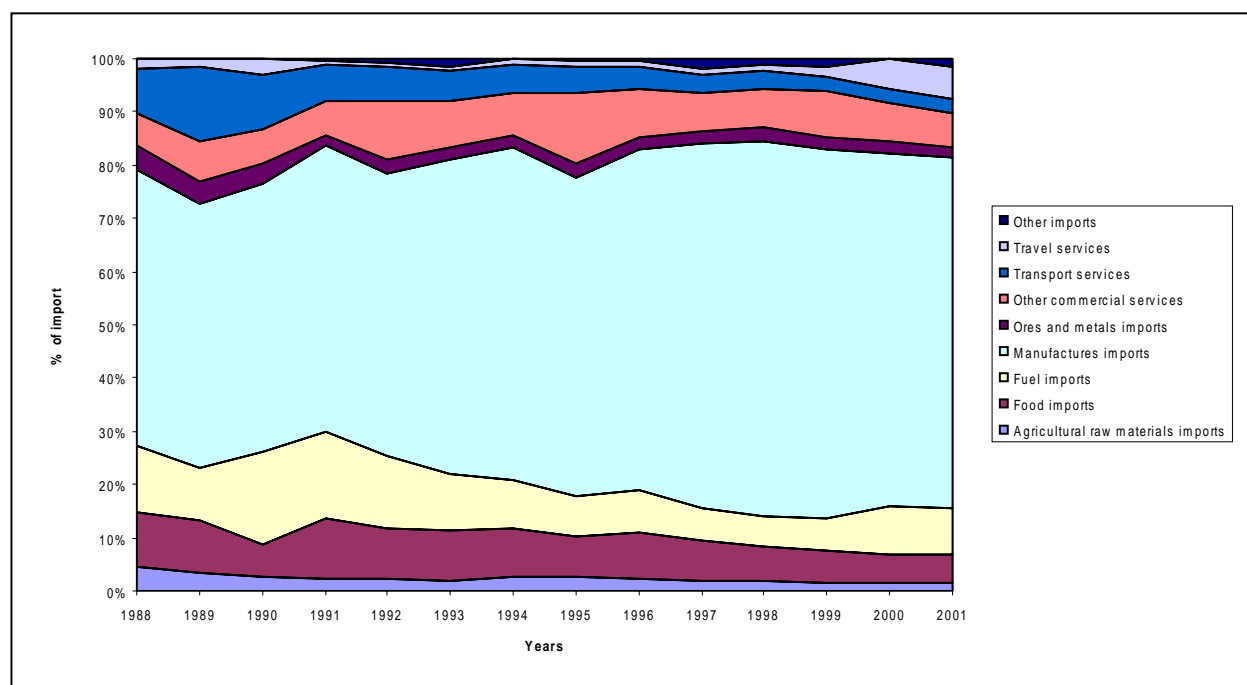


**Figure 17b. Sectoral composition of Russian export**

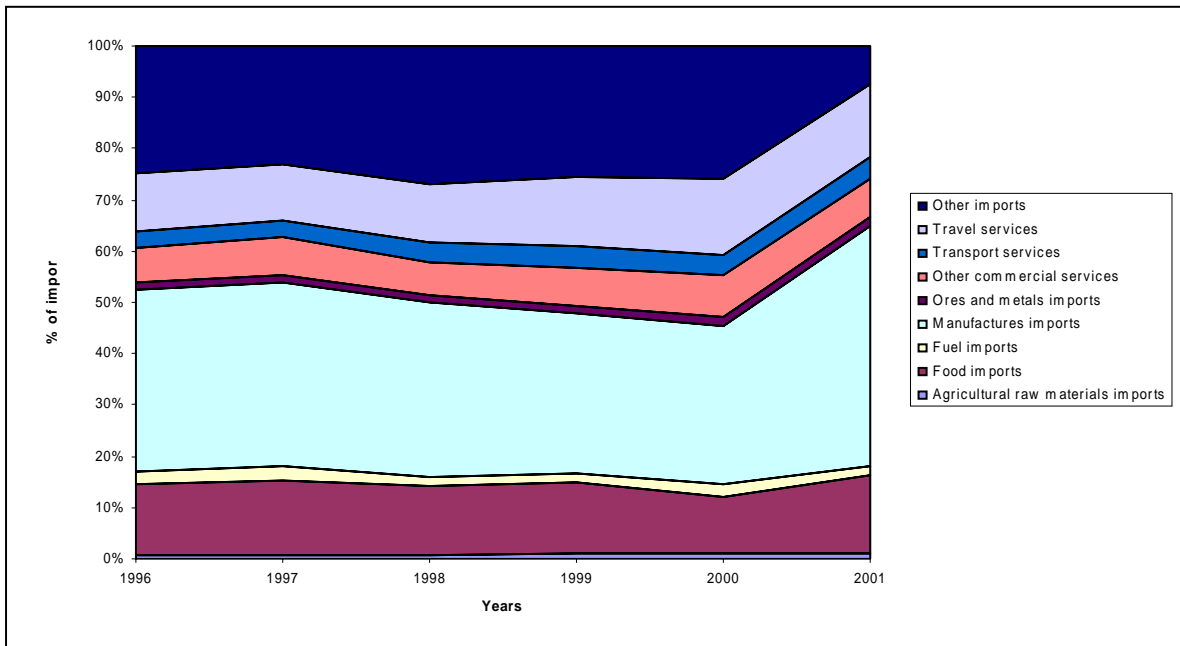


Source: World Bank (2003b)

**Figure 18a. Sectoral composition of Polish import**



**Figure 18b. Sectoral composition of Russian import**



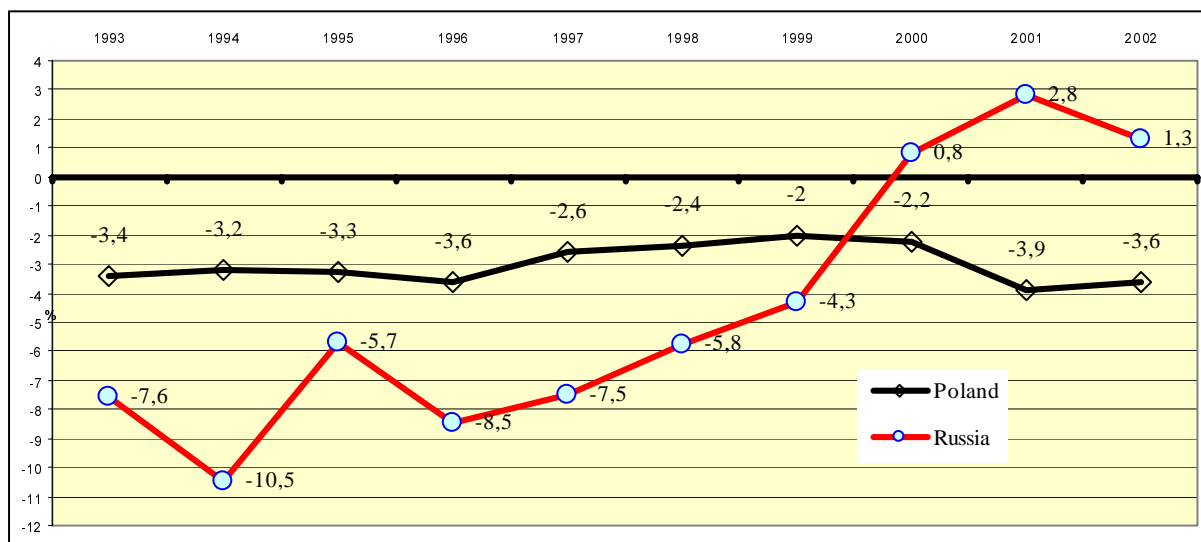
Source: World Bank (2003b)

The European market was always protective against products from Russia and CIS (Aslund and Warner, 2003). Oil was the only good that was welcomed by the EU; however, its export has been limited by the underdeveloped transportation infrastructure.

#### 4.5. Fiscal policy pattern

Poland and Russia experienced serious fiscal tensions throughout most of their transition process like many other post-communist countries, with few exceptions such as Estonia or Slovenia. However, the scale of these tensions and time profile differed significantly. Russia experienced severe fiscal imbalances from the late Soviet period until 1998, which led to subsequent currency crashes – in August 1992, September 1993, October 1994 ('Black Tuesday' of October 11), and finally to the full-scale financial crisis in August 1998. After 1998 Russia's fiscal situation radically improved (see **Figure 19**) – first as a result of ruble devaluation and later as a consequence of high oil prices. It helped to repay a significant part of outstanding public debt (see **Table 4**). However, as we discussed in Section 4.3 and showed in **Figure 13**, high oil revenues mask gradual deterioration of non-oil fiscal balances what can become a serious problem when world oil prices go down.

**Figure 19. General government balance, percent of GDP**



Source: World Development Indicators Database

Poland's fiscal position represented less dramatic fluctuations during the period of the 1990s, though it was never close to balance, i.e. zero deficit. In the early 2000s it started to gradually deteriorate, leading to rapidly increasing deficit and debt-to-GDP ratio in 2003 and probably even more in 2004 (i.e. beyond the time horizon of **Figure 19** and **Table 4**). It can seriously undermine macroeconomic stability and prospects of the new economic recovery phase observed from mid-2003.

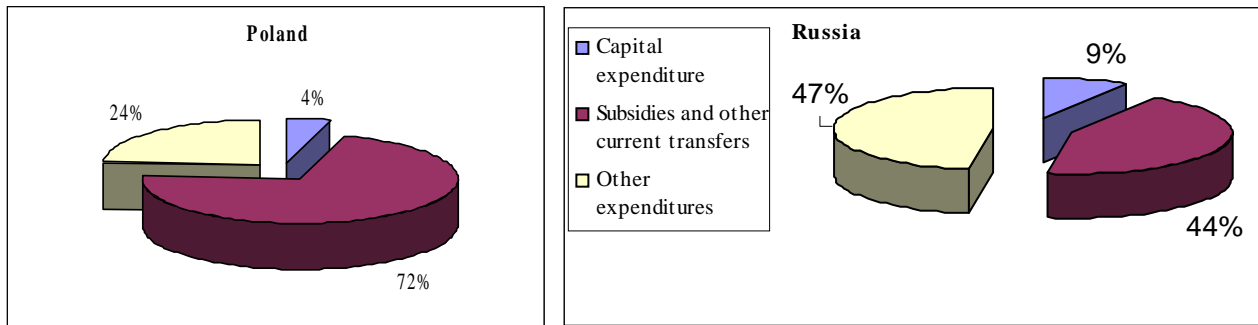
**Table 4. Central government debt, total (% of GDP)**

Country	1994	1995	1996	1997	1998	1999	2000	2001
Czech Republic	16.4	14.1	11.8	11.4	11.4	12.8	15.1	16.9
Estonia			6.2	5.2	4.3	4.6	3.1	2.7
Hungary	86.6	85.2	71.9	63.3	61.5	60.5	54.9	
Poland	68	54.3	47.9	46.9	42.9	43.4	39.6	40.4
Russia					138.1	101.9	62.2	48.8

Source: World Development Indicators database

Poland has also found itself in the kind of 'high spending – high taxes' trap with the general government expenditure to GDP ratio being quite stable in the range of 44-48% (the characteristic shared by other Central European and post-Yugoslav countries). The main fiscal burden comes from excessive social programs, which is illustrated in **Figure 20** by a very high share of transfers and subsidies in the total general government expenditures. Social expenditures crowd out public investments. They also lead to high indirect labor costs (payroll taxes), which are at least partly responsible for high unemployment rate (see Section 4.1).

**Figure 20. Structure of general government expenditure in Poland and Russia, 2001**



Source: World Development Indicators 2003

Russia represents a lower level of fiscal redistribution (ca. 10 percentage points of GDP) and a lower share of social transfers in the total budget expenditures (also approximately 10-11 percentage points of GDP - see **Table 5**). The latter eases fiscal pressure and redistribution burden (compared to Poland) but, on the other hand, gives less room for cushioning poverty and income inequalities (see Section 6). The same can be said about lower health and education expenditures in Russia.

**Table 5. Social expenditures of consolidated government by function (% of GDP)**

Expenditure item	Country	1995	1996	1997	1998	1999	2000	2001	2002
Education	Poland	5.2	5.5	5.7	5.6	5.7	5.9		
	Poland**						5.7	6.0	n.a.
	Russia				3.6	3.1	3	3.1	3.8
Health	Poland	4.6	4.9	4.5	4.3	4.3	4.2		
	Poland**						4.1	4.1	n.a.
	Russia*				2.5	2.2	2.2	2	2.4
Social security and welfare	Poland	20.7	20.8	20.8	19.6	19.4	18.7		
	Poland**						18.0	19.3	n.a.
	Russia				9.3	8.4	7.2	8.8	n.a.

Note: \* Including physical training and sports; \*\* Changes in the methodology of national accounts since 2000; GDP calculated for 2000 is slightly higher than GDP according to the previous methodology.

Sources: own calculations based on GUS (1998; 2000a; 2001a); Goskomstat (2001; 2002; 2003) and CASE database.

An additional room of fiscal maneuver in Russia provided by high oil prices was partly used for ambitious reform of direct taxation, being the good example for other countries. It involves flat personal income tax with the single rate of 13%, the similar low rate of CIT and the single social tax with a regressive scale.



## 5. Composite indices of structural and institutional reforms

This chapter includes the analysis of various composite indicators computed by the international organizations and think tanks such as EBRD, Freedom House, Transparency International, Heritage Foundation and Fraser Institute. These indicators and ratings refer to various important areas of structural and institutional reforms, civil and economic freedoms, business and investment climate, etc. Authors of this paper are generally aware of methodological problems and dilemmas involved in any attempt to quantify qualitative, sometimes narrative, characteristics and the necessity to treat the obtained results with a certain dose of caution. Nevertheless, this is the only available technical opportunity to conduct cross-country comparisons related to more sophisticated components of economic and institutional system.

### 5.1. EBRD assessment of privatization and structural reforms

Since the first half of the 1990s the EBRD is conducting regularly (in its annual 'Transition Reports') the assessment of various aspects of structural and institutional reforms in transition countries. The continuity, generally unchanging methodology and deep factual knowledge of reform developments in transition economies are the strong side of the EBRD rankings. Its weakness is connected with a relatively narrow scale of granted scores (1-4 or 1-3) what does not provide sufficient differentiation of individual countries' ratings and all institutional nuances, particularly in the recent years when most of them completed the basic agenda of market reform.

**Table 6** shows that the share of private sector in GDP in mid-2001 was quite similar in Poland (75%) and Russia (70%). Also scores for large (3+) and small (4+ and 4) privatization were almost the same. It is the sphere of governance and corporate restructuring where we see bigger differences: Poland has 3+ score and Russia 2+ only. The latter reflects specifics of privatization processes in both countries and Russia's problems with legal reforms.

**Table 6. Privatization results in selected CEE and CIS countries**

Country	Private sector share in GDP, %, mid-2001	Privatization		Governance & enterprise restructuring
		large	small	
Armenia	70	3+	4-	2+
Poland	75	3+	4+	3+
Russia	70	3+	4	2+
Hungary	80	4	4+	3+
Czech Republic	80	4	4+	3+
Estonia	80	4	4+	3+

Source: EBRD (2002)

Corporatization and privatization in Russia were more rapid than in the majority of CEB and CIS countries, including Poland. The current share of private sector in GDP was achieved already in the mid-1990s (starting from virtually zero in late 1980s) when many other countries (including Poland) still lagged behind. This became possible due to launching a mass voucher privatization program in 1992, which brought about a rapid formal ownership transformation of the Russian economy. However, the voucher program also had its negative by-effects such as diluted ownership and insider dominance (see Blaszczyk and Radygin, 2002). Privatization in Poland, on the other hand, went more slowly but with a dominance of strategic foreign investors (what helped to promote FDI inflow), some role of insiders (management/ employees buyout schemes), substantial role of initial public offering and stock exchange, and a marginal role of vouchers. Together with the private sector inherited from the communist era (ca. 25% of GDP in 1989, including agriculture) and rapid development of new private firms (see Section 4.2) it gave eventually the summary picture similar to that of Russia but with a better quality characteristic.

However, in the two analyzed countries privatization process is not finished yet, contrary to what can be said about Estonia or Hungary. In both Poland and Russia, the state has retained a substantial amount of share holdings, which are very difficult to sell. And it is well known from the experience of many other countries in the world that government agencies cannot ensure an effective management of shares permanently or temporarily held by the state.

EBRD indices also cover other important related areas and here the differences between Poland and Russia are bigger (in favor of Poland – see **Table 7**). They relate, in the first instance, to financial sector, infrastructure reform and trade policy. It seems that in these particular spheres the positive influence of the EU integration process and EU *acquis communautaire* is visible in case of Poland (and the absence of this factor in case of Russia).

**Table 7. EBRD indices on structural and institutional reforms, 2002**

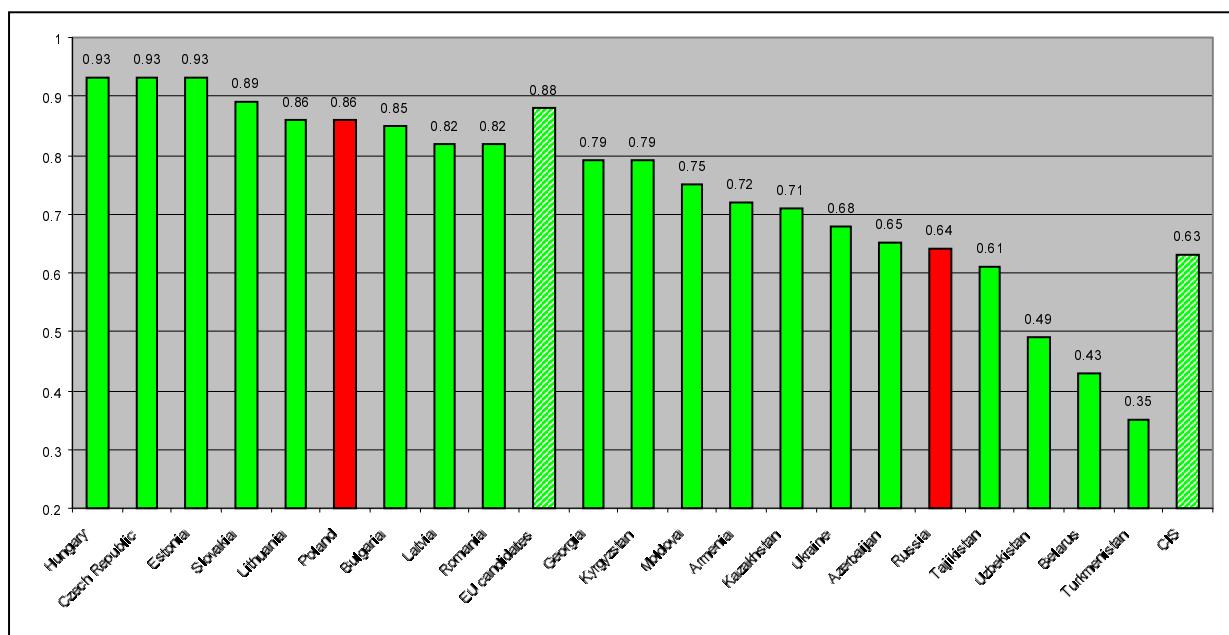
Area of reform	Poland	Russia
Banking reform & interest rate liberalization	3+	2
Securities market & non-bank financial institutions	4-	2+
Infrastructure reform	4-	2+
Price liberalization	3+	3
Trade & foreign exchange system	4+	3
Competition policy	3	2+

Source: EBRD (2002)

## 5.2. Modified EBRD index

Aslund and Warner (2003) computed the structural reform index based on EBRD privatization and liberalization indices as well as using other inputs (for example, those of the World Bank). The results are presented in **Figure 21**.

**Figure 21. Structural Reform Index (normal economy=1)**



Note: The composite structural reform index consists of 73 percent liberalization and 27 percent privatization.

Source: Aslund and Warner (2003) based on EBRD structural indices

The two analyzed countries do not occupy leader positions in their regional groups (Poland in the EU candidates group and Russia in the CIS group). There are five countries recording better scores than Poland: Hungary, Czech Republic, Estonia, Slovakia and Lithuania. However, Poland's position is visibly better than Russia's one.

### 5.3. Freedom House indices

Since 1972, the Freedom House has published an annual assessment of the state of freedom worldwide on the basis of political rights and civil liberties rating on a one-to-seven scale. These countries, which rating averages 1-2.5 are generally considered as 'Free', 3-5.5 – 'Partly Free', and 5.5-7 – 'Not Free'.

Russia, while formally remaining in the 'Partly Free' category, has steadily decreased its rating, closely approaching the 'Not Free' status (see **Table 8**). This is in sharp contrast with the stable high rating of Poland and other CEB countries accomplished already in the beginning of 1990s. More importantly, the progress in democratization and human rights standards has been strongly correlated with progress in economic reforms with causality going in both sides but being more important in relation to political reforms as factor determining the economic progress (see also Dąbrowski and Gortat, 2002). Empirical research conducted in the Russian regions also confirm that guarantees of basic human rights and civil liberties have the fundamental importance for business and investment climate (see Mau and Yanovskiy, 2002).

**Table 8. 'Freedom in the World' Ratings, 1991-2002**

Years	Poland		Russia	
	Score	Category	Score	Category
1991-92	2.2	F	3.3	PF
1992-93	2.2	F	3.4	PF
1993-94	2.2	F	3.4	PF
1994-95	2.2	F	3.4	PF
1995-96	1.2	F	3.4	PF
1996-97	1.2	F	3.4	PF
1997-98	1.2	F	3.4	PF
1998-99	1.2	F	4.4	PF
1999-00	1.2	F	4.5	PF
2000-01	1.2	F	5.5	PF
2001-02	1.2	F	5.5	PF

Source: FH (2003a)

Similarly to worldwide indicators, Freedom House since 1997, in its 'Nations in Transit' study, provides subcategory ratings and averaged scores that are signposts of progress or regress in political and economic reforms in 27 CEE and FSU countries. These scores are based on the following categories and subcategories: democratization (electoral process, civil society, independent media and governance), rule of law (constitutional, legislative, and judicial framework), and (until 2002) economic liberalization (privatization, macroeconomic and microeconomic policy).

**Table 9** indicates an ever-widening gap between Russia and Poland both in democratization and the rule-of-law categories (although Russia represented a modest improvement in RoL in 2003 and Poland recorded some deterioration of both democratization and RoL scores in 2002-2003). In the six transition categories, which the Freedom House tracks, Russia has experienced regress in

**Table 9. 'Nations in Transit' Scores, 1997-2003**

Country/ Indicator	1997	1998	1999-2000	2001	2002	2003
<b>Poland</b>						
Democratization	1.50	1.45	1.44	1.44	1.50	1.63
Of which: electoral process	1.50	1.25	1.25	1.25	1.25	1.50
- civil society	1.25	1.25	1.25	1.25	1.25	1.25
- independent media	1.50	1.50	1.50	1.50	1.50	1.75
- governance	1.75	1.75	1.75	1.75	2.00	2.00
Rule of Law	na	na	1.88	1.88	1.88	2.00
Of which - - corruption	na	na	2.25	2.25	2.25	2.50
- constitutional, legislative and judicial framework	1.50	1.50	1.50	1.50	1.50	1.50
<b>Russia</b>						
Democratization	3.80	4.10	4.25	4.63	4.81	4.88
of which: electoral process	3.50	3.50	4.00	4.25	4.50	4.75
- civil society	3.75	4.00	3.75	4.00	4.00	4.25
- independent media	3.75	4.25	4.75	5.25	5.50	5.50
- governance	4.00	4.50	4.50	5.00	5.25	5.00
Rule of Law	na	na	5.25	5.38	5.38	5.13
of which - - corruption	na	na	6.25	6.25	6.00	5.75
- constitutional, legislative and judicial framework	4.00	4.25	4.25	4.50	4.75	4.50

Sources: FH (2002; 2003b)

all but one (corruption) category since 1997. Poland recorded slight deterioration in the following categories - electoral process, independent media, governance and corruption – in years 2002-03.

#### 5.4. Transparency International Corruption Perceptions Index

The TI Corruption Perceptions Index (CPI) ranks 102 countries in terms of the degree to which corruption is perceived to exist among public officials and politicians. CPI score is rated on a scale from 1 to 10 - a perfect 10.00 would be a totally corruption-free country.

**Table 10. The Corruption Perceptions Index, 1998-2002**

Country	1998		1999		2000		2001		2002	
	Score	Rank	Score	Rank	Score	Rank	Score	Rank	Score	Rank
Estonia	5.7	26	5.7	27	5.7	27	5.6	28	5.6	29
Hungary	5.0	33	5.2	31	5.2	32	5.3	31	4.9	33
Poland	4.6	39	4.2	44	4.1	43	4.1	44	4.0	45
Russia	2.4	76	2.4	82	2.1	82	2.3	79	2.7	71
Slovenia	na	Na	6.0	25	5.5	28	5.2	34	5.7	28
Ukraine	2.8	69	2.6	75	1.5	87	2.1	83	2.4	85

Source: <http://www.transparency.org>

While Poland and Russia ‘converge’ somewhat in terms of score and ranking (Russia’ position improved while Poland’s position worsened) there is still a wide gap between them and, more generally, between CIS and CEB countries in favor of the latter (see **Table 10**).

#### 5.5. The Heritage Foundation Index of Economic Freedom

Since 1995, the HF Index of Economic Freedom rates each country by studying 50 independent economic variables. Economic freedom is defined as the absence of government coercion or constraint on the production, distribution, or consumption of goods and services beyond the extent necessary for citizens to protect and maintain liberty itself.

The analyzed variables fall into 10 broad categories: trade policy, fiscal burden of government, government intervention in the economy, monetary policy, capital flows and foreign investment, banking and finance, wages and prices, property rights, regulation, and black market activity. Each factor is scored according to a grading scale running from 1 to 5: a score of 1 signifies a set of policies that are most conducive to economic freedom, while a score of 5 signifies a set of policies that are least conducive (Beach and O’Driscoll, 2003).

**Table 11. The HF Index of Economic Freedom, 1995-2003**

Year		Estonia	Hungary	Poland	Russia	Slovenia	Ukraine
1995	Score	2.40	3.00	3.30	3.40	na	3.70
	Rank	18	41	59	69	na	85
1996	Score	2.50	3.00	3.10	3.50	3.50	3.80
	Rank	28	61	71	93	93	118
1997	Score	2.50	3.00	3.10	3.55	3.30	3.75
	Rank	32	68	73	106	89	122
1998	Score	2.30	3.00	2.90	3.35	3.00	3.80
	Rank	24	71	61	95	71	123
1999	Score	2.35	2.95	2.80	3.50	2.90	3.60
	Rank	30	69	52	110	62	126
2000	Score	2.20	2.55	2.80	3.70	3.00	3.60
	Rank	22	41	53	122	74	116
2001	Score	2.05	2.55	2.75	3.70	2.90	3.85
	Rank	14	42	54	127	63	133
2002	Score	1.80	2.40	2.70	3.70	3.10	3.85
	Rank	4	32	45	131	79	137
2003	Score	1.80	2.65	2.90	3.70	2.85	3.65
	Rank	6	44	66	135	62	131

Source: O'Driscoll, Feulner, and O'Grady (2003)

As **Table 11** indicates, Russia is the only country (among the chosen set of transition economies) which demonstrated a consistent deterioration in the degree of economic freedom in the course of the past eight years and remains among the least free countries in the region. Despite several achievements in the economic sphere (e.g. taxation reform), the trend toward increased political and administrative coercion is characterized by a growing bureaucracy, cutbacks in regional autonomy, interference in regional elections, crackdowns on the independent media, the granting of increased power to the country's security agencies, and a reluctance to introduce military and judicial reforms (O'Driscoll, Feulner, and O'Grady, 2003). Across the board, Russia scores poorly in almost all of the factors, with one exception of government intervention (2.5). Moreover, similarly to the *Freedom House* indices, HF figures indicate a widening gap between Russia and CEB countries.

Poland's scores in this ranking, although much worse than in most other new EU members, did improve moderately during the last eight years (apart from 2003) and are visibly better than those of Russia.

## 5.6. The Fraser Institute's Economic Freedom of the World (EFW) Index

Somewhat similar to the HF index, the EFW index measures the degree of economic freedom across 123 countries in five major areas: size of government (expenditures, taxes, and enterprises); legal structure and security of property rights; access to sound money; freedom to exchange with foreigners; and regulation of credit, labor, and business. Counting the various sub-components, the EFW index utilizes 38 distinct pieces of data. Each component and sub-

component is placed on a scale from 0 to 10 that reflects the distribution of the underlying data. The component ratings within each area are averaged to derive ratings for each of the five areas. In turn, the summary rating is the average of the five area ratings (Gwartney and Lawson, 2003, p. 6).

**Table 12. EFW Index , 1990-2001**

Year		Estonia	Hungary	Poland	Russia	Slovenia	Ukraine
1990	Score	na	5.0	4.0	na	Na	na
	Rank	na	74	101	na	Na	na
1995	Score	5.6	6.3	5.3	4.0	4.9	3.5
	Rank	74	46	82	116	92	122
1997	Score	6.7	7.2	6.2	5.1	5.9	4.2
	Rank	54	47	61	91	73	108
1999	Score	7.4	7.1	5.7	3.9	6.2	4.6
	Rank	36	43	85	117	72	106
2000	Score	6.9	6.6	5.8	4.5	5.9	4.5
	Rank	41	52	81	118	77	118
2001	Score	7.5	7.0	6.0	5.0	6.1	4.6
	Rank	16	35	77	112	73	117

Source: <http://www.freetheworld.com/2003/EFW2003Dataset.xls>

Similarly to the HF index, the EFW index rates Russia very close to the bottom of the countries' list (see **Table 12**). One important difference, however, is the positive, albeit slight, dynamics of the EFW index scores: Russia's rating has risen from 116 to 112 (out of 123) between 1995 and 2001. Across the board, Russia (like most post-communist countries) rates relatively better in freedom of foreign trade (74, on a par with Poland) and size of government (73, higher than most CEE economies), but lags far behind in access to sound money (112) and especially in regulation of credit and business (119). Poland's scores and ranking improved systematically during the recorded period but at the same time Poland lags evidently behind Estonia (the most economically free country in Eastern Europe) and Hungary.

## 6. Social dimension of growth patterns

This part of the study will discuss the social consequences of differences in growth patterns and reform strategies between Poland and Russia. We will take a look at the following specific data: dynamics of household consumption, human development index, income differentiation and poverty. We will also try to show how structural and institutional distortions influence quality of life and equality of chances to participate in economic activity.

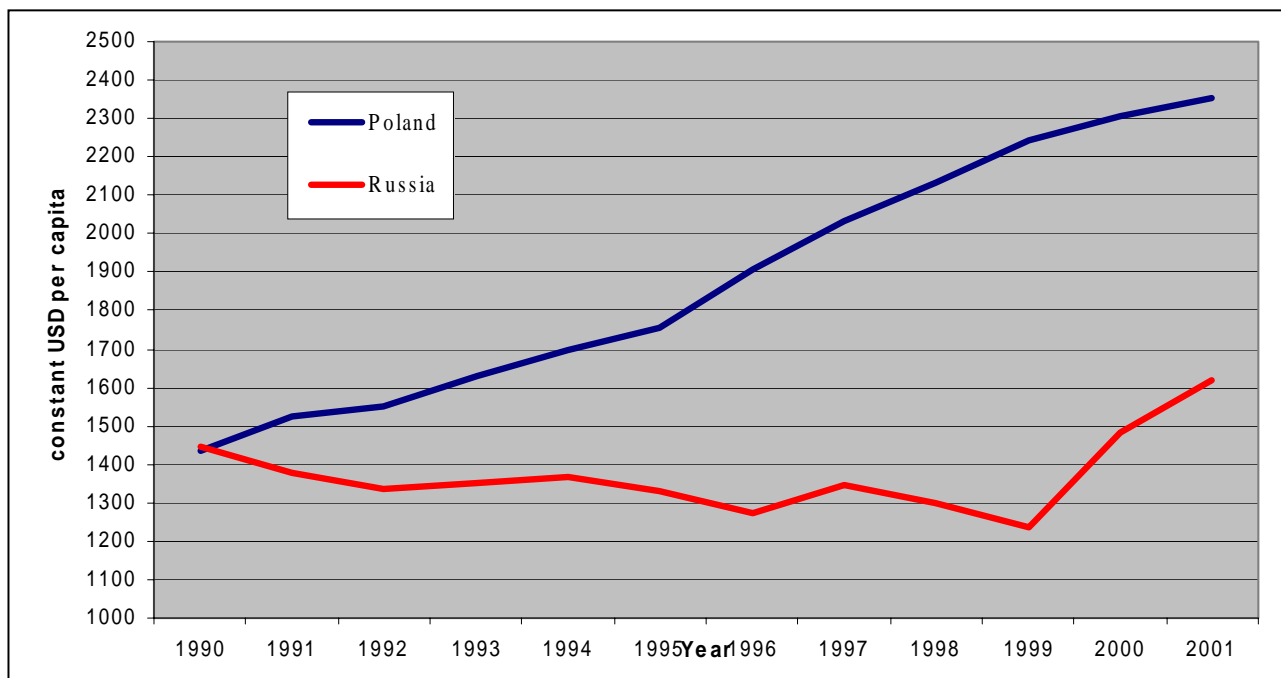
As pointed out by Kakwani (2000), the degree of poverty depends upon two factors: average income and income inequality. The increase in average income reduces poverty and the increase in inequality increases it (other things being equal). Thus, the change in poverty can be

decomposed into two components: one is the growth component relating to change in mean income, and the other is the inequality component relating to change in inequality.

### 6.1. Household consumption

As real wage and real income dynamics involve several methodological weaknesses, the dynamics of household consumption seem to be a better proxy of actual income trends and provide a less distorted picture of the early years of transition. Ability to capture at least part of the unregistered economy seems to be a strong advantage of this particular indicator. On the weak side, calculating household per capita consumption in current US dollar terms involves an effect of the real appreciation/depreciation of a domestic currency. As real appreciation of both zloty and ruble prevailed in the long run, this meant that the real consumption dynamics denominated in domestic currencies and fixed prices would present less favorable picture (but differences between both countries would be probably similar).

**Figure 22. Household consumption per capita in Poland and Russia**



Source: World Development Indicators 2003

We can see from **Figure 22** that both Poland and Russia started their transition with approximately the same level of household consumption per capita. However, transformation in Poland was accompanied by a systematic increase in per capita consumption while in Russia the level of per capita consumption started to decrease in 1989, and continued this trend for a decade (following GDP decline). The trend was reversed only when Russian GDP started to grow.



## 6.2. UNDP Human Development Index

Among many composite indices of quality of life developed throughout the past two decades (see Booyesen, 2002 for their deeper characteristics), the UNDP human development index (HDI) is by far the most widely used one. Providing a simple summary measure of three dimensions of the human development (living a long and healthy life, being educated and having a decent standard of living), it combines measures of life expectancy, school enrolment, literacy and GDP per capita to allow a broader view of a country's development than using income (or household expenditure) alone.

**Table 13. Human Development Index Trends 1985-2001**

HDI Rank in 2001	Country	1985	1990	1995	2001
29	Slovenia	..	0.843	0.851	0.881
32	Czech Republic	..	0.835	0.843	0.861
35	Poland	..	0.794	0.81	0.841
38	Hungary	0.803	0.803	0.807	0.837
39	Slovakia	..	..	..	0.836
41	Estonia	0.818	0.814	0.793	0.833
45	Lithuania	..	0.819	0.785	0.824
50	Latvia	0.803	0.803	0.761	0.811
63	Russia	0.811	0.809	0.766	0.779
75	Ukraine	..	0.797	0.748	0.766
76	Kazakhstan	..	0.781	0.738	0.765

Source: HDR (2003)

**Table 13**, which presents HDI time series for CEE and FSU transition countries, demonstrates that, as opposed to Russia, where HDI value has declined steadily in the course of 1985-1995, the majority of CEE countries, including Poland, either increased or maintained HDI scores throughout the whole transition period. However, as pre-transition GDP might involve several methodological distortions, at least this component of HDI should be interpreted with caution. On the other hand, period after 1995 has been marked with improvement of HDI in all countries presented in **Table 12**, including Russia.

## 6.3. Income inequality – general picture

The majority of post-communist countries, including Poland and Russia, started their transition with the world-lowest levels of inequality. This reflected ideologically driven pattern of income policy of the communist regime and almost total absence (Russia) or limited role (Poland) of the private sector business activity. Thus, growth in inequality was unavoidable but it varied greatly across the region (**Table 14**). It has increased rapidly and dramatically in most CIS countries where in the course of 2-3 years Gini coefficient nearly doubled compared to pre-transition level.

**Table 14. Transition countries: Gini coefficient of income per capita<sup>a</sup>**

Country	1989	1993	1995	1996	1998	1999	2000	2001
Central Europe								
Czech Republic	0.198	0.214	0.216	0.230	0.212	0.232	0.231	0.237
Hungary	0.225	0.231	0.242	0.246	0.250	0.253	0.259	0.272
Poland	0.275	0.317	0.321	0.328	0.326	0.334	0.345	0.341
Slovak Republic	–	–	–	0.237	0.262	0.249	0.264	0.263
Slovenia	–	–	0.264	0.252	0.243	0.248	0.246	–
Baltic countries								
Estonia	0.280	–	0.398	0.370	0.354	0.361	0.389	0.385
Latvia	0.260	–	–	–	0.330	0.330	0.327	–
Lithuania	0.263	–	–	0.347	0.332	0.343	0.355	0.354
South-Eastern Europe								
Bulgaria	0.233	0.335	0.384	0.357	0.345	0.326	0.332	0.333
Macedonia	–	–	0.295	0.311	0.308	0.308	0.346	0.334
Romania	0.237	0.267	0.306	0.302	0.298	0.299	0.310	0.353
Serbia and Montenegro	–	–	–	–	0.289	0.273	0.373	0.378
CIS								
Belarus	0.229	–	0.253	0.244	0.253	0.235	0.247	0.245
Georgia	0.280	–	–	–	0.503	–	–	0.458
Kyrgyz Republic	0.270	–	–	–	0.411	0.399	0.414	0.377
Moldova	0.251	–	–	–	–	–	0.437	0.435
Russia (A) <sup>b</sup>	0.265	0.398	0.381	0.375	0.374	–	–	–
Russia (B) <sup>c</sup>	–	–	0.439	0.501	0.446	–	0.432	0.422
Ukraine	0.228	–	0.470	–	–	0.320	0.363	0.364

Notes: (a) - unless indicated otherwise, estimates are based on interpolated distributions from grouped HBS data, reported to the MONEE Project; (b) – HBS data; 1989-96: Flemming and Micklewright (1999, Appendix B), 1997-98: [www.worldbank.org/research/transition/heididata/Ydata.xls](http://www.worldbank.org/research/transition/heididata/Ydata.xls); (c) - IRC estimates from RLMS, rounds 5-10.

Source: UNICEF (2003), p. 94.

Today, Russia ranks among the world's highest levels of inequality, similarly to many developing economies with inegalitarian distributions of income (see Svejnar, 2004)<sup>9</sup>.

**Table 14** might suggest that in the late 1990s and early 2000s income inequality in Russia started to decrease. It could lead to the hypothesis that post-adaptation growth recovery in Russia had a more 'equitable' character than in the case of Poland (where income differences continued to increase during 1990s). We are afraid, however, that this kind of conclusion would be too far-going and premature because there are doubts whether Gini coefficient actually decreased in Russia in the years of economic recovery. These doubts are related, in the first instance, to official methodology of weighting and aggregation of regional data in Russia (see **Box 1**).

**Box 1: Methodological doubts concerning Gini coefficient in Russia**

Inequality data in general and particularly those referring to Russia should be treated with a great caution. Even official Goskomstat (State Committee of the Russian Federation on Statistics) data are backward incompatible: both Statistical Yearbooks and other serial

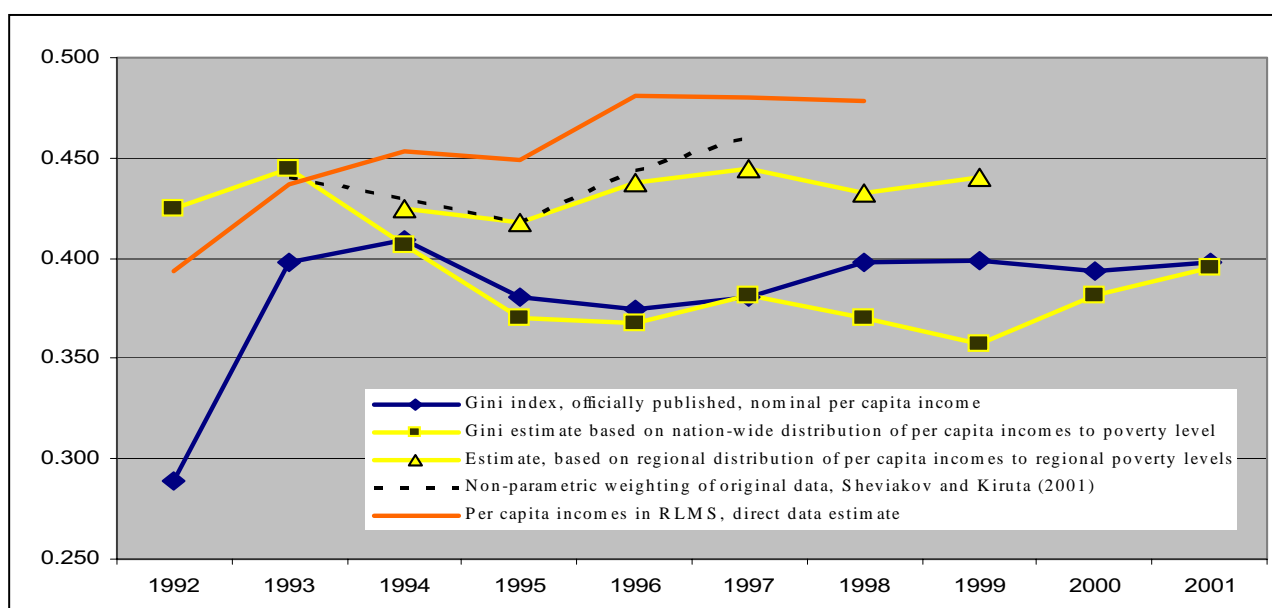
<sup>9</sup> However, some developed countries like Portugal also represent very high Gini coefficient well exceeding 0.4 – see Beblo et al. (2002, p. 21; Table 1.5).

publications (e.g., Goskomstat, 2001; 2002) present different estimates of Gini for the same years in the subsequent issues. Hence, developing longer time series meets methodological obstacles.

Yemtsov (2002) when assessing quality of official estimations of Gini coefficients for Russia points out that methods of processing the household budget survey (HBS) information put the published series far away from the raw survey data. Especially distorted are national-level inequality and poverty indices, which are a product of weighting at the regional level followed by an aggregation of regional distribution by income intervals. He argues that the aggregation procedure is incorrect and inconsistent. Therefore, all national-level officially published data on poverty and inequality have to be taken as a product of this inferior procedure. Goskomstat's procedures of regional data aggregation were also criticized and regarded as completely outdated by Sheviakov and Kiruta (2001).

Not attempting to assess methodologies used by other authors we quote here the result of an alternative Gini assessment presented by R. Yemtsov (2002). The main conclusion coming from **Figure 23** is that one should be very careful with assessment of recent inequality dynamics.

**Figure 23. Gini coefficient for money income per capita in Russia, according to various estimates**



Source: Yemtsov (2002)

According to Sheviakov and Kiruta (2003), inequality in Russia has not declined, in spite of a noticeable contraction of the poverty zone in 2002. They claim that polarization of the Russian society, with insignificant fluctuations, has been growing throughout the whole transition period reaching the largest scale after the 1998 crisis. In the years of economic growth it has consolidated rather than flattened.

The same researchers demonstrate that 45% of the total growth of wages in 2000-2002 was concentrated within 10% of the highest-paid employees (10<sup>th</sup> decile group), and over 60% of the wages' growth – within the 5<sup>th</sup> quintile group of employees. At the same time, the 1<sup>st</sup> quintile group (20 percent of the lowest paid) benefited from less than 3 percent of the total wage increase (Sheviakov and Kiruta, 2003).

Opposite to Russia and CIS, the increase of Gini coefficient in CEE countries was relatively modest. For example, in Hungary it increased from 0.21 in 1987 to only 0.25 a decade later. Even in the Czech Republic, Poland, and Slovenia, where the growth in inequality was more pronounced, the distribution of income remains fairly egalitarian as opposed to Russia. However, alternative methods of computing Gini coefficient (based on consumption instead of income) show a more moderate trend of inequality growth on Poland (see **Table 15**).

**Table 15. Gini coefficient for equivalent consumption in Poland**

Indicator	1994	1995	1996	1997	1998	1999	2000	2001	2002
Gini coefficient for equivalent consumption	0.248	0.242	0.245	0.256	0.260	0.265	0.271	0.271	0.278

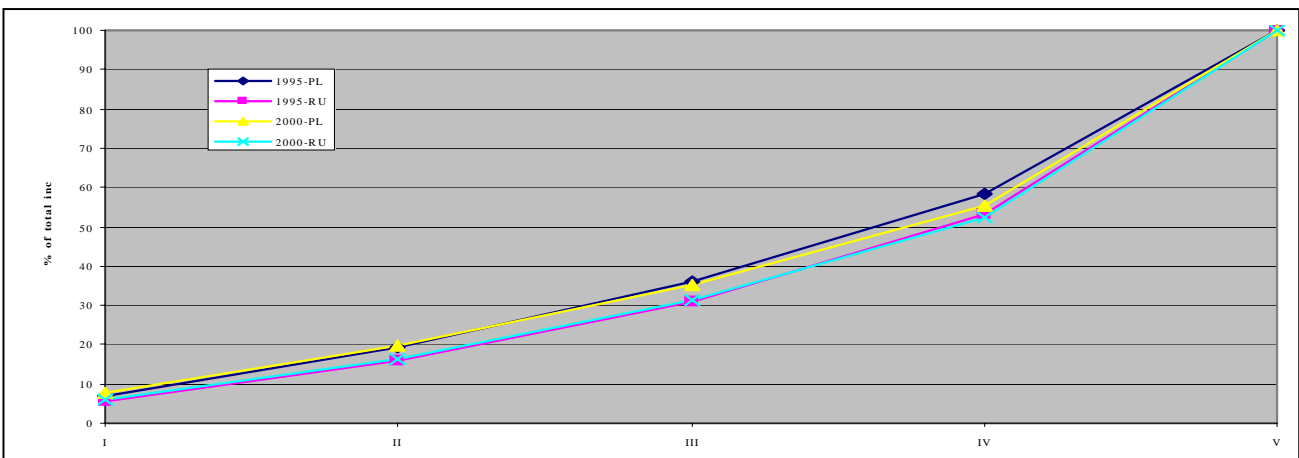
Source: World Bank (2003b)

**Table 16. Income distribution by quintile income groups in Poland and Russia**

Income group	1995- PL	1995-RU	2000-PL	2000-RU
I (lowest)	6.8	5.5	7.6	6
II	12.5	10.2	12.0	10.4
III	16.8	15	15.4	14.8
IV	22.2	22.4	20.2	21.2
V (highest)	41.8	46.9	44.7	47.6

Source: CASE estimations for OECD, based on Warsaw University HBS database for Poland and Goskomstat (various publications) for Russia

**Figure 24. Lorenz curve for quintile income groups in Poland and Russia, 1995 and 2000**



Source: CASE estimations for OECD, based on Warsaw University HBS database for Poland and Goskomstat (various publications) for Russia

Analysis of the distribution of total income by quintile income groups of population<sup>10</sup> allows for another comparison of income inequalities in the two analyzed countries and their dynamics. As it is demonstrated in **Table 16** in relation to each quintile group and cumulatively in the graphical form (a so-called Lorenz curve) in **Figure 24**, income inequality is higher in Russia as compared to Poland but evidently growing in the latter (the trend in Russia is less clear). It is roughly consistent with the earlier findings related to Gini coefficient.

According to Forster et al. (2002) research, between early and mid 1990s income inequality and poverty grew in all countries of Eastern Europe. In Poland, however, the trend was reversed at the end of the decade. What concerns interregional income disparities, it increased in Russia, and decreased slightly in Poland by the end of the 1990s, and this result is consistent with different measures of inequality.

#### **6.4. Factors potentially influencing income inequality**

The phenomenon of rising income inequality and its striking differences between CIS and CEB countries can be analyzed in various ways. For example, looking at income components it becomes clear that increased inequality of wages significantly contributed to higher income inequality in all the transition countries but particularly strongly in the case of CIS and Russia. The concentration coefficients for wages have risen from about 0.23 on average in CEB countries in the late 1980s to about 0.32 in 1996; and from 0.25 in the CIS in 1989 to over 0.5 in 1996-97 (Milanovic, 1998a; World Bank, 2000b). According to Milanovic (1998a), increasing dispersion of wages was responsible for the increase of between 3.5 and 8 Gini points in Central Europe. Using comparable data from RLMS, Commander et al. (1999) found that increasing wage dispersion alone would have been responsible for a nearly 9 point increase in Russia's Gini but its overall effect was dampened by the dramatic decline in wage share in a total population income. So changes in income composition should be considered as the main factor driving changes in income distribution in Russia after 1992 (the similar conclusion is correct for other transition countries as well - see below).

Nevertheless, recent and ongoing research and calculations show that wage differentiation in Russia remains high and is still growing. For example, Sheviakov and Kiruta demonstrate that ratio between average monthly wages of 10% highest-paid employees to average wages of 10% lowest-paid employees amounted to 31.9 in 1999, 33.5 in 2000, and 38.9 in 2001.

The statistically registered growth in wage differentiation in Poland has been significantly lower compared to Russia: the ratio between wages in the highest and lowest decile groups has increased during 1989-1997 from 2.4 to 3.5 (in private sector – from 3.3. in 1991 to 3.9 in 1997).

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<sup>10</sup> Distribution by decile groups was unavailable for Russia.

Inter-industry differentiation in wages in Russia has reached the proportion of 8.4 to 1 by 2000. The highest wages has been recorded in fuel and energy complex, in non-ferrous metals and in the sphere of finance, credit and insurance; the lowest wages are characteristic for budget sphere, light industry and agriculture. In a number of sectors, including agriculture, health, education, science and culture, over 60% of employees receive wages which do not exceed the subsistence minimum. Although in Poland employees from similar sectors were also among the losers, the scale of their relative impoverishment was not so severe.

Overall, the sectoral differentiation of wages in Poland in 2000 appeared to be much lower. According to GUS (Central Statistical Office) data, the ratio of average wages in the highest and lowest paid sectors was about 3.8:1. The most highly paid industries included computer and related activities, refined petroleum products, tobacco products, mining of coal<sup>11</sup> and lignite. The textile and leather industries were the worse paid. In contrast to Russia, average wages in the lowest paid sectors were almost three times higher than the subsistence minimum (GUS, 2001, s. 165-166).

Social policy and social transfers should potentially correct income inequality caused by wage differentiation and other source of incomes. This is the main justification of their existence. However, international experience shows that effectiveness of social policy in reducing poverty level and income inequality depends on at least two groups of factors – fiscal potential and institutional arrangements. In both respects one can observe the big differences between CEB and CIS countries what can be explained, directly or indirectly, by different levels of institutional development. In particular, Central European countries represent very high shares of social expenditures in their consolidated budgets, much higher than other middle-income countries on average (see Section 4.5). They varied from a one third (in Poland) to a quarter (in Czech Republic, Slovakia and Hungary) of GDP, including public services like health, education and culture (see Golinowska and Hagemajer, 1999). Moreover, at the first stage of reforms, as GDP declined, this share tended to grow. This created an opportunity to correct excessive income differentiation and reduce poverty.

Was this chance used by high-spending countries? According to Svejnar (2004; following Garner and Terrell, 1998; and Commander et al., 1999) social transfers contributed to reducing income inequality in Central Europe, while worked in the opposite direction in Russia. Cerami (2003) conclusion was that social transfers in Central and Eastern Europe significantly improved economic conditions of families in need. However, they did not guarantee eradication of poverty.

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<sup>11</sup> In spite of permanent loss-making by enterprises from this sector.

**Table 17. Poland – redistribution role of taxes and transfers**

Coefficient	1995		2000	
	Before transfers	After taxes and transfers	Before transfers	After taxes and transfers
Poverty threshold = 60% of current median income				
H = head-count ratio	44%	19%	46%	15%
I = poverty gap ratio	62%	34%	62%	26%
PG = Gini coefficient among the poor	53%	23%	53%	15%
Poverty threshold = 50% of current median income				
H = head-count ratio	37%	13%	40%	8%
I = poverty gap ratio	66%	39%	66%	30%
PG = Gini coefficient among the poor	59%	26%	57%	17%

Source: CASE estimations prepared for OECD based on Warsaw University HBS database

The results of two other empirical studies demonstrate that cash transfers net of direct taxes reduce income inequality in Poland. According to Styczen and Topinska (1999) analysis based on 1996 HBS data, in the two lowest income groups ca. 95% people got positive net transfers while the highest income groups suffer, on average, net redistribution losses.

According to CASE empirical study carried out for OECD in 2003 and using Warsaw University HBS database for 1995 and 2000 (see **Table 17**), transfers and taxes together reduced radically inequality - in 2000 even more than in 1995. However, both analyses do not allow for separating the redistribution role of transfers alone.

In CIS countries and Russia, the overall size of social transfers has been much lower not necessarily as a result of the conscious policy choice but mostly due to institutional inability to improve tax collection. There is also little doubt that their targeting is extremely poor and contributes to increasing income inequality rather than reducing it (see Ovcharova, 2003a).

According to RLMS (2003, p. 9) social transfers provided almost half of the income (45.9%) received by the middle-income quintile. Their share is higher for the second quintile (49.2%) than for the bottom 20% of the households (40.2%). Although some progress has been achieved compared to 1998<sup>12</sup>, when the poorest quintile received only 24.5% of its income from the social transfers and the upper quintile received 16% (in 2002 – 13.7%), social policy still fails to cushion income inequality.

The shift in composition of income toward higher share of income from self-employment, entrepreneurial activities and private property is another indisputable source of increasing inequality in the transition countries. Commander et al. (1999) argue that in the late 90s rising entrepreneurial income was the single most important factor contributing to rising inequality in Russia even though inequality of entrepreneurial income declined during that period. According to Ovcharova (2001), the fifth quintile group in Russia concentrated 47% of all incomes in 1999, including 38% of the total wages fund, 27% of social transfers, 70% of incomes from property and

<sup>12</sup> The share of social transfers in each income class has changed little since 2000.

62% of other incomes, including incomes from entrepreneurial activities. Sheviakov (2003, Table 5) also links the growth of income concentration with the growth of high incomes from property and business<sup>13</sup>.

On the other hand, authors of the World Bank (2000b, p. 153) report on poverty argue that the rise in the share of self-employment income in the CIS, unlike in the CSB countries, has been largely concentrated in agricultural activities for self-consumption. In Russia self-employment and entrepreneurial income account for more than 40% of total household incomes. The emergence of a large-scale self-employment in the CIS has been a survival strategy in the face of declining incomes from official/traditional sources rather than enjoying entrepreneurial opportunities offered by a liberalization process. So there is a direct link between the emergence of this large-scale 'survival' self-employment and high income inequality in the CIS.

General underdevelopment of SME sector and very limited role of FDI in Russia, as compared to CEB countries, including Poland (see Section 4.2), has at least two negative consequences regarding poverty and inequality. First, it limits the availability of relatively better paid and more prospective jobs. The slow pace of restructuring of 'old' enterprises, which hoard a large number of underemployed or only formally employed workers can be considered as another side of the same coin (see IUE, 2002, p. 4)<sup>14</sup>. Second, numerous barriers of entry limit competition providing incumbents with chances to earn relatively higher profits, wages and salaries (a kind of rent coming from limited competition).

This leads us back to differences in structural and institutional characteristics of transition process and growth profile of the two countries analyzed in this paper and, more generally, between CEB and CIS sub-regions. It seems to be a reasonable hypothesis that huge and fast rise in inequality in Russia may be explained by slow and inconsequent liberalization, delayed macroeconomic stabilization and the lack of enterprise restructuring in the first years of transition, which allowed to build monopolistic positions by those who had access to power and capturing the state by the narrow groups of vested interests. The latter managed to modify economic policy according to their interests and expected benefits, limiting competition and concentrating their economic power, often at a high social cost. As a result, rent seeking and corruption instead of fair and open competition became the main sources of business success (World Bank, 2000a; 2002).

Oligarchic capitalism has deprived the rest of society of equal access to business activity<sup>15</sup> because of the bureaucratic 'red tape' connected with widespread corruption. Distorted political institutions caused that society has lacked many instruments of controlling a government, which exist in democratic countries, such as stable political parties accountable to electorate, fair election

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<sup>13</sup> Unfortunately, we could not find sufficient statistical data that could allow a more comprehensive (and cross-country comparable) quantitative analysis of the role of non-wage income components in the rise of inequality so we must limit our overview to presenting some anecdotal evidence related mostly to Russia.

<sup>14</sup> Slow pace of restructuring of 'old' enterprises and their dominance in many regions also contributes to deterioration of entry conditions for the new firms.

<sup>15</sup> What can be considered as an important social policy tool in transition economies where individual business activity provides very often the best way of professional and social re-adaptation.



process, independent and impartial judiciary, free mass media, and civil society organizations. Apart from purely economic pauperization caused by the prolonged output decline and high inflation there have been frustration and political apathy coming from the above described deprivation. In addition, poverty, inequality and lack of elementary social justice have very often a self-reinforcing character through a channel of populist policies. They contribute to bad political choices, which, in turn, impede chances to reform flawed institutions and policies.

Unfortunately, lack of sufficient statistical data does not allow for quantitative verification of the above narrative hypotheses. For example, one might suspect intuitively that the specific features of the Russian privatization program (like 'loans-for-share' tenders in 1995-1996, limited access of foreigners and transnational corporations to privatization tenders) and the environment in which it was conducted (limited liberalization, macroeconomic disequilibrium) should have increased income and wealth differentiation above what could be observed in Central Europe. Unfortunately, we can refer to some anecdotal and very indirect evidence only, like the absolute dominance of Russian oligarchs in the international rankings of billionaires/ millionaires in Central and Eastern Europe (one of them published by the Polish weekly *Wprost*).

The same concerns the role of oil, gas and other raw materials sectors in Russia. Drawing from experience of other oil-rich or resource-rich developing countries and comparing to Poland, which does not have substantial and internationally tradable natural resources (apart from heavily loss-making coal industry and some copper production), this factor should help to explain part of extremely high inequality in Russia. Again, we do have only some indirect evidence. Russian regions with substantial oil, natural gas and electricity production are among those which represent gross regional product per capita, population money income per capita and wages higher than national average. Average level of wages and salaries in these industries is three to five times higher than the average for the whole economy. The level of inequality in the majority of resource-producing regions also remains higher than average (see Sheviakov and Kiruta, 2002, p. 36). Statistical analysis carried out by authors of this study shows that Pearson correlation ( $r$ ) between region's share in the country production and S80/S20 (income polarization) ratio amounts to 0.536 in the case of oil and 0.573 in the case of electricity in 2001. Some anecdotal case stories of rapid expansion of the privatized resource-producing companies (examples of LUKOIL, YUKOS, SIBNEFT', Russian Aluminum, Norilsk Nickel, etc.) additionally support the above hypothesis. On the other hand, a very high Gini coefficient in some resource-poor CIS countries (Georgia, Kyrgyzstan or Moldova – see **Table 14**) demonstrates that the presence of abundant natural resources, particularly oil and gas, is not necessarily the main factor causing income inequalities.

## 6.5. Poverty scale and dynamics

**Table 18** tries to give a comparative picture of poverty rates in Poland and Russia using various definitions of poverty and data sources<sup>16</sup>. A much higher scale of poverty in Russia (when compared to Poland) is the only undisputable conclusion which can be drawn from this analysis. The difference in the case of fixed poverty lines (2 or 4 USD daily) is many-fold.

**Table 18. People living at the given poverty line and below as % of the total population**

Definition of poverty line	Country	1992	1993	1994	1995	1996	1998	1999	2000
World Bank USD 2 a day	Poland						1.2		
	Russia <sup>b</sup>	14.3	14.3	7.4	11.8	13.3	18.8		
Relative poverty line <sup>a</sup>	Poland		12.0	13.5		14.0	15.8	16.5	17.1
	Russia		22.8 <sup>f</sup>						
World Bank USD 4 a day	Poland			10.0 <sup>c</sup>			18.4 <sup>e</sup>	10 <sup>d</sup>	
	Russia						50.3 <sup>e</sup>	53 <sup>d</sup>	64 <sup>g</sup>

Notes: (a) 50% of average expenditure per OECD consumption unit; (b) 2.15\$ a day; (c) Milanovic (1998b), data for 1993-1995; (d) Less than 4\$ a day. UNDP Report. Data for 1996-1999; (e) 1997-1999; (f) 1993-1996; (g) 2001.

Sources: Beblo et al. (2002), p. 31, GUS data for 2002, World Bank (2000b), p. 38.

In order to assess poverty dynamics in each country it is better to resort to national sources of poverty data in spite of their numerous imperfections mentioned earlier. In case of Russia there are two primary data sources: Goskomstat's assessment of poverty based on a nationally and regionally representative Household Budget Survey (HBS) sample of about 50 thousand households carried out continuously on a quarterly basis, and the Russian Longitudinal Monitoring Survey (RLMS) carried out by the University of North Carolina<sup>17</sup>.

**Table 19. Poverty rate in Russia according to annual Goskomstat publications\***

Item	1992	1994	1995	1996	1997	1998	1999	2000	2001	2002
% of the total population	33.5	22.4	24.7	22.0	20.7	23.3	28.3	28.9	27.3	25.0
Annual percent change	...	...	109.0	89.5	93.8	112.2	121.2	85.0	94.0	90.9

Note: \* According to the level of average per capita money incomes.

Source: Official Goskomstat data (Goskomstat Yearbooks)

**Table 19** shows the proportion of population living under the official poverty line in Russia<sup>18</sup> according to annual Goskomstat publications. However, methodology used to estimate the number of people with money incomes below subsistence level has been repeatedly changed over time. Thus data for subsequent years are hardly comparable. For instance, if we use the method of income estimation of 1992 (the number of persons registered as poor at that time was 33.5%) then in 1994 the share of population below the poverty line would have been 34%, and in 2000 – 28%.

<sup>16</sup> A limited comparability of national poverty indicators (subsistence minima) is the main obstacle to cross-country analyses of poverty levels. However, individual country analyses of a longer data series are also risky because the national methods of minima construction were frequently reassessed. Thus, all poverty data require a great caution in their interpretation.

<sup>17</sup> Data for this survey have been collected by Goskomstat (September 1992 - November 1993) and the Institute of Sociology of the Russian Academy of Sciences (December 1994-October 2001). Project was initially financed by the World Bank and later by the USAID.

<sup>18</sup> Minimum subsistence level in Russia at the end of 2001 amounted to ca. RUR 2,000, which makes it roughly comparable to USD 2.15 a day poverty line used by the World Bank /OECD for transition economies.

However, if we consider income from the unregistered economic activity the share of the poor will shrink to 22% in 1994 but will grow up to 29.9% in 1999 (see Maleva, 2002).

**Table 20. Poverty rate according to alternative Goskomstat survey, % of total population**

Poverty line	1998	1999	2000
Below subsistence minimum	37,8	50,2	40,0
Below 50% of the subsistence minimum	9,8	16,8	10,3

Source: Goskomstat data

In addition, Goskomstat conducts, from time to time, sample HBS which, *inter alia*, are also used for calculating poverty lines. These surveys, however, use subsistence minima estimated specially for every household type rather than officially adopted ones and average per capita disposable incomes instead of money incomes. Besides, they use quarterly rather than median yearly data on incomes. As a consequence, the obtained results differ markedly from the official annual publications (see **Table 20**).

The RLMS (**Table 21**) has used its own adjusted poverty line (in rounds 5-10) based exclusively on consumer food product basket. It refined the official all-Russia poverty line incorporating regional price variations, regional food baskets and adjustments for family size.

**Table 21. Poverty rates according to RLMS, % of total population)**

Poverty line	1992 (IX)	1994 (XII)	1996 (X)	1998 (XI)	2000 (X)	2001 (X)	2002 (X)
Total under poverty line	11.1	17.0	34.6	38.1	26.5	18.9	14.6
Below 50% of poverty line	3.0	6.8	18.5	15.9	9.1	6.9	5.5
50-100% of poverty line	8.1	10.2	16.1	22.2	17.4	12.0	9.1

Source: RLMS (2003).

General conclusion coming from the analysis of **Tables 19-21** (and taking into consideration earlier methodological remarks) is that the scale of poverty in Russia systematically increased during the first phase of transition (accompanied by a deep output decline), reaching its maximum in years 1998-1999 what was at least partly connected with the consequences of 1998 currency crisis. When economic recovery started in 1999 it brought a noticeable reduction of poverty. However, the poverty challenge is still very serious; about a quarter of the population is estimated to be poor (see World Bank, 2003c). While poverty levels have recently fallen for both rural and urban households, rural households have benefited proportionately less than urban households from the post-crisis economic recovery (see below).

Poverty rates in Poland recorded in **Table 22** differ from Russian ones in terms of definition and methodology although they are rather comparable over the analyzed period. They allow us to draw the observation that the scale of poverty has been systematically growing over the transition period, even in the years of fast economic growth. This kind of conclusion seems to be consistent with systematically growing Gini coefficient (see Section 6.3 and **Tables 14** and **15**).

**Table 22. Poverty rate in Poland, as % of the total population**

Poverty line	1994	1995	1996	1997	1998	1999	2000	2001	2002
Relative poverty line	13.5	12.8	14.0	15.3	15.8	16.5	17.1	17.0	18.4
Subsistence minimum	6.4	5.4	4.3	5.4	5.6	6.9	8.1	9.5	11.1

Note: Relative poverty line – 50% of the average expenditure basket estimated on the basis of HBS.

Sources: Beblo et al. (2002), p. 31; GUS (2002a).

## 6.6. Major poverty sources and vulnerable groups

There are two major groups of poor in Russia and in Poland. The ‘old’ poor group covers those who lived below poverty line already before transition. In Russia this category includes, according to various estimates, from approximately 11-12% (Mozhina, 1995)<sup>19</sup> up to about half of the total population (Ovcharova, 2003b) – one-parent families, families with many children, disabled persons, single pensioners, and socially marginalized persons. The ‘new’ poor group includes in both countries families with children, young families, a considerable proportion of rural population, families of unemployed (both registered and unregistered ones, especially in rural areas). The trend towards feminization of poverty has also been apparent. A characteristic feature of poverty in both countries is the inclusion of families with economically active parents and one or two children. This socio-demographic type of families is not associated with a high-risk poverty but is currently prevalent among the poor.

In Russia, as distinct from Poland, the category of ‘new poor’ also includes a large part of pensioners, families of migrants and displaced persons. In case of Russia having job does not guarantee, in many instances, from impoverishment: employed persons account for about 40% of the total number of poor (Surinov, 2001).

In both countries there is a high degree of correlation between poverty and a place of family residence (see **Table 23**): persons living in rural areas and small towns, in the depression or economically monoculture regions are facing a much greater risk of low income and poverty. In Russia, with its vast territory, the inter-regional differentiation of poverty is higher as compared to Poland.

<sup>19</sup> In the Soviet era it was generally recognized that about 10% of the population were living in poverty, although some estimates put this figure as high as 15%.

**Table 23. Factors influencing inequality and poverty in transition countries, as % of total inequality, 2000**

Factors		Bulgaria	Hungary	Poland	Romania	Russia	Slovakia
Region of residence		13.8	7.8	9.8	12.1	22.2	15.4
Type of settlement		11.2	6.5	8.9	17.2	11.2	22.5
Education	Considering the structural features	6.9	10.4	5.3	8.3	11.1	8.4
	Without considering the structural features	6.2	13.6	11.9	11.8	-	9.2
Number of children per working member of the household		6.9	6.5	12.5	9.5	11.1	2.8
Size of the household		3.4	3.9	17.8	9.5	3.2	7.4
Gender composition of the household		12.0	5.2	6.2	7.0	2.4	9.8
The age structure of the household		6.0	5.2	1.8	5.1	7.9	4.2
Employment		13.8	6.5	15.2	15.9	1.0	7.4

Source: Ovcharova (2003b)

In Poland, the risk of entering the poverty zone is significantly higher for low-skilled persons with a low education level, as well as for those dependent on old non-restructured enterprises. In Russia, poverty is more characteristic for families where both parents are employed in 'low-paid' sectors of the economy – education, health, science, culture, as well as for middle-level technical workers, previously employed in defense industry, defense-related R&D, etc., i.e. for highly skilled labor force with a higher education level.

As distinct from Poland, there were large-scale and prolonged wage, pension and social benefits arrears in Russia that contributed to the expansion of the poverty zone in this country. They continue to exist, although on a considerably smaller scale than in the second half of the 1990s. According to RLMS (2003), at the end of 2002 23% of employees suffered from wage arrears (most of them two months or less), a considerable reduction from the November 1998 rate of 64%. Wage arrears are characteristic not just for unprofitable enterprises but for prosperous ones as well; prolonged wage arrears are more typical for low-paid employees. It means that not paying wages and salaries on time has become a cheap method of financing working capital of many enterprises. In Poland these phenomena acquired a much smaller scale and were rapidly surmounted in the beginning of transition, probably due to a bigger actual role of a labor law and its enforcement and strong position of trade unions.

A low effectiveness of social assistance became another factor contributing to the expansion of poverty zone in Russia. As distinct from Poland, the major category of poor in Russia are pensioners, especially single old-age ones, and persons that depend on the support of the social security system. These differences can be explained for by the limited size of social transfers and pattern of its distribution (see Sections 4.5 and 6.4).

In 2000, total social transfers accounted for 14.4% of the total money income of the Russian population and 7.8% of GDP. At the same period, all social benefits accounted for merely 2% of total money incomes and for 1.1% of GDP (Goskomstant, 2002). For comparison, overall social transfers in Poland accounted for 23.4% of the total population money income (social benefits – 3.4%), and for 17.5% of GDP.

Both in Poland and in Russia pensions account for about 80% of total social transfers. In Russia, the size of a minimal pension is still below the pensioners' subsistence minimum. In 1992, minimal pension in Russia made up 85% of the pensioners' subsistence minimum; by 1998, this ratio was reduced to 48% and reached its lowest point (45%) in 1999. The average pension size amounted to 94.9% of the subsistence minimum in 2001, and reached 102.1% by the end of 2002. In Poland, the average pension in 2000 exceeded the subsistence minimum 2.8 times.

The main reasons of differences between the relative size of average pension in both analyzed countries are: (i) the absence of automatic pension indexation in Russia and its presence in Poland; (ii) a much higher cumulative inflation in the transition period in Russia compared to Poland. Automatic indexation, being beneficial for maintaining a real purchasing power of pension benefits, has, however, negative fiscal consequences. In spite of a very high social insurance contribution in Poland, approaching the level of 50% of a payroll (including contribution to the Labor Fund, sickness and disability insurance), the Social Insurance Fund (being responsible for the PAYG pension pillar) is in a deep and permanent deficit covered by budget transfers (which are reflected in the large size of social expenditures – see Section 4.5). On the other hand, the financial equilibrium of the Pension Fund in Russia has been secured mostly by forgetting or postponing indexation in the environment of high or moderate inflation. In both countries the future financial sustainability of the PAYG pension system (without compromising level of pension benefits) must be secured by increasing the effective retiring age and cutting numerous entitlements to early retirement and other pension privileges.

The percentage of poor people receiving social benefits in Russia is lower compared to the national average what brings us again to the conclusion that system of social assistance in this country increases income inequalities instead of reducing them (see Section 6.4). Although the Polish system of social assistance is not free from serious shortcomings either, it is much better targeted towards those in need, and the relative size of benefits is significantly larger. E.g., in 2000 the child benefit was equal to the subsistence minimum in Poland while it amounted to only 4.8% of the subsistence minimum in Russia.

Growing unemployment became one of the primary factors of poverty expansion in Poland. In Russia, the rate of labor force fired was much lower compared to Poland, and the process itself was extended over time. As a result, hidden unemployment (in the form of forced unpaid leaves, forced part-time work, etc.) became widespread. Both in Poland and Russia, poverty among unemployed is 1.5-2 times higher comparing to average poverty figures.

As shown in **Table 23**, rural residence and dependence on agriculture source of income is another factor increasing poverty risk. As statistics on rural poverty in both countries are very scarce and incomplete, making any comparative analysis very difficult for methodological reasons, **Table 24** gives only a very rough and imperfect picture of this phenomenon.

**Table 24. Population below the relative poverty line, % of population of the respective group, on the basis of HBS**

Population group	Country	Subsistence minimum					50% subsistence minimum				
		1998	1999	2000	2001	2002	1998	1999	2000	2001	2002
Population average	Poland	15.8	16.5	17.1	17.0	18.4	5.6	6.9	8.1	9.5	11.1
	Russia	37.8	50.2	40.0	na	na	9.8	16.8	10.3	na	na
Urban population	Poland	10	12.4 <sup>a</sup>	na	11.2	12.2	3.4	4.7 <sup>a</sup>	5.8 <sup>a</sup>	5.8	7.0
	Russia	34.6	47.7	37.0	na	na	8.0	14.9	8.5	na	na
Rural population	Poland	25	29.9 <sup>b</sup> 24.7 <sup>c</sup>	25.8	25.8	27.9	9.1	13.3 <sup>b</sup> 9.2 <sup>c</sup>	12.9 <sup>b</sup> 8.6 <sup>c</sup>	15.0	17.4
	Russia	46.7	56.8	48.1	na	na	14.7	22.2	15.1	na	na

Notes: (a) – employees; (b) – farmers; (c) – employees-farmers (bi-professional)

Sources: Goskomstat (2002); GUS (2000b; 2001b; 2002b); Beblo et al. (2002); HDR (2000).

Both mentioned factors, i.e. rural residence and dependence on agriculture source of income cause discrimination in terms of material status and living standard. Apart from obvious disadvantages of rural areas in respect to availability of technical and social infrastructure it is also a strong evidence of structural backwardness of agriculture sector in both analyzed countries. In spite of completely different structural and institutional legacies of communist period (large state-owned and collective farms in Russia vs. small private farms in Poland), both countries failed so far to reform this important sector, which has negative economic (low productivity) and social consequences.

## 7. Lessons Learned

Although post-adaptation growth periods in Russia and Poland happened at different times and represented different structural characteristics, the experience of both countries may provide some interesting lessons for others. These are:

- Successful macroeconomic stabilization and far going liberalization occurred to be the basic preconditions to overcome adaptation output decline in transition economies and to start economic recovery. These countries, which delayed stabilization and liberalization for

any reason had to suffer longer and deeper output contraction and later enjoyed benefits of post-adaptation recovery. In addition, they had to pay higher social costs in terms of poverty, and income and wealth differentiations

- The initial phase of economic recovery, particularly when immediately following a deep adaptation output decline, usually does not require a serious investment effort (because it is based on reallocation of the already existing resources) and does not involve serious macroeconomic tensions (in terms of inflation pressure or current account deterioration). Later on, however, the new investments and healthy sources of their financing become a crucial condition of a continuing growth trend. In turn, the scale and quality of investment depend on a broadly defined business and investment climate.
- In the era of globalization and the world of free capital mobility, investment and, consequently, growth chances of any individual country depend on the quality of its institutions and policies, their credibility and sustainability. A favorable business and investment climate can be characterized by a broad set of parameters such as stable macroeconomic policy, liberal trade and business regime, low fiscal burden and business-friendly tax system, flexible labor market, effective protection of property rights and contract enforcement, stability and transparency of legal and regulatory system, quality of basic public goods delivered by government, level of corruption, rent opportunities, etc.
- Increasing income and wealth inequality (compared to pre-transition period) can be seen as unavoidable price of departing from communist egalitarianism and centrally planned economy. Nevertheless, in many countries this process seemed to go too far and too quickly, which reflected sustaining structural and institutional distortions in economic and political sphere and low effectiveness of the social policy tools. The latter represent limited capacity to correct income and wealth inequalities because of fiscal constraints and a danger to distort labor market if government social intervention is going too far.
- The same factors which determine business and investment climate are also extremely important for reducing poverty and inequality and building an atmosphere of social justice (or fairness). The consequent policy of removing regulatory distortions, elimination of sources of rent extractions and corruption, creating a free and equal access to business activity, and increasing efficiency of basic public goods such as law enforcement, justice administration, technical infrastructure, education or public health care can contribute to improving quality of life and eliminating excessive inequality and feeling of alienation among vast groups of society.
- Quality of economic institutions and chances to improve business and investment climate, including fighting corruption and other social pathologies, are strongly interrelated with quality of political institutions, progress in political reforms and democratization. Free political competition, free media, civil society network and effective protection of civil rights



generally help in improving economic institutions and fighting social pathologies. Political freedom and democracy can also help in building domestic ownership of reform program.

- Finally, the international community can create the external incentives to build good institutions and conduct good policies. EU Enlargement process can serve here as the best example of the effective mechanism of 'exporting' good institutions and policies from high-income to middle- and low-income countries.

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