GOVERNANCE ISSUES AND TRANSITION ECONOMIES[1]

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I. INTRODUCTION

In this paper, I address issues of governance, and more specifically of corruption, with reference to the transition economies. Problems of governance in general and the pervasiveness of corruption in any society arise not as an infection of an otherwise healthy economy, but as an inevitable characteristic of certain types of social and economic transformations where institutions are weak, competition is limited, and the relationship between the public and private domains is blurred. Such conditions are likely to give rise to widespread, and largely discretionary, interventions by state agencies in the market, an opaque and complex regulatory environment, distortionary economic policies, and the absence of credible mechanism for fair and effective adjudication of social or economic disputes. Opportunities for monopolistic control, for rent-seeking and for extralegal activities proliferate, creating what is known as endemic or entrenched corruption. Clearly, such societies, and the economy they engender, cannot be viewed as healthy, even when for periods of time they achieve respectable rates of economic growth.

Two corollaries worth noting follow from this view: The first is that such conditions as we describe here are not unique to developing or transition economies, although, for obvious reasons, these economies may be expected to have more of them than do the more advanced economies. Nor indeed is corruption in this sense a cultural phenomenon, being more characteristic of certain societies than others. A second, and for our purposes more relevant corollary is that corruption arising from such conditions cannot somehow be 'nipped in the bud' or 'surgically removed' by a quick administrative fix. Curbing endemic corruption must be a process involving deep-going, economic and institutional reforms aimed at remedying the very ills that lie at the root of corrupt behavior. In this paper, I will therefore focus on the economic causes and effects of corruption and outline what is essentially an economic reform strategy to deal with it. It will be seen that this approach has special relevance for the transition economies.

Corruption and governance

What about governance? And how is it related to corruption?

Clearly, governance is a more general notion while corruption is a more narrow and rather specific concept. An earlier definition viewed governance as "the manner in which power is exercised in the management of a country's economic and social resources for development" (the World Bank, 1992, p.3), although some have found this definition itself somewhat narrow as it ignored the role of civil society and the importance of political institutions and civil liberties (Johnston 1998, p. 87). The OECD highlights three critical features of governance: "the form of the political regime; the process by which authority is exercised in the management of the country's economic and social resources; and the capacity of government to formulate and implement policies and discharge government functions" (OECD 1995, p. 14). Johnston himself proposes a definition of governance as "the degree of institutionalization and openness of the political and economic processes through which social development decisions are made (Johnston, op.cit.). Doubtless, other definitions exist. The important point is that 'governance' has to do with the *manner in which responsibility is discharged,* whether such a responsibility has been acquired through election, appointment or delegation in the public domain (the standard view of governance) or in the realm of commerce (hence 'corporate governance'). Thus, good governance denotes a condition whereby such a responsibility is discharged in an effective, transparent and accountable manner while poor governance is associated with malfeasance in the discharge of a public responsibility.

In this context, it is clear that while corruption, defined most commonly as the 'abuse of public authority for private gain', is almost always rooted in conditions of poor governance, the concept of governance itself encompasses other issues and possibilities beyond the specific meaning of corruption. However, in order not to stray into areas of inquiry far beyond our topic or even beyond my own competence as an economist, and in order to help keep our discussion focused and hopefully relevant, I will restrict myself to discussion of corruption, although as will become clear in the course of the presentation, governance issues in the broader context are never far removed from our field of vision.

Following this brief introduction, I review the economic effects of poor governance, focusing on the larger, macroeconomic consequences of corruption, as has been shown by recent empirical studies. This analysis then sets the stage for the elaboration of a reform-based strategy for combating corruption in the following section III. A brief analysis of structural reforms in the transition economies in Section IV links these reforms to macroeconomic performance and to available measures of corruption. Section V concludes.

II. CORRUPTION AND ITS EFFECTS

Corruption, of course, is not a new subject, nor for that matter is the study of corruption. The subject can be detected in some of the earliest writings by political scientists, sociologists, historians as well as by economists, including the father of modern economic science, the erstwhile Adam Smith.

However, corruption as a subject of research and policy debate has taken on added importance in recent years. Economists, political and civic leaders, heads of international financial institutions as well as governmental and non-governmental organizations have become increasingly involved in a wide-ranging discussion of the adverse effects of corruption and of the urgent need to deal with it. Indeed, "in a recent survey of more than 150 high-ranking public officials and key members of civil society from more than 60 developing countries, the respondents ranked public sector corruption as the most severe impediment to development and growth in their countries." 1/ In the transition economies, the problem of corruption is no less severe or pervasive. Two recent surveys by the Economist Intelligence Unit and by the World Bank ranked the CIS countries highest on their corruption scales of any region in the world (EBRD, 1997, p. 37).

Professional economists have studied corruption for some time, with some of the earlier contributions to the current debate having been made in 1970s and 1980s. Since the early 1990s, however economists have probed deeper into the economic causes and effects of corruption. The results of this work have further reinforced the general view regarding the centrality of the issue to macroeconomic stability, and to sustainable economic growth, especially in developing and transition countries.

General effects

Of course, economists as well as reform-minded policy makers have long known of the corrosive effects of corruption on the health of the body politic and the economy. At the most fundamental level, corruption can undermine the credibility, even the legitimacy of public authority, paving the way to possible descent into social disintegration and anarchy.

One of the more pernicious characteristics of corruption is the negative externalities it engenders in the functioning of a modern economy.

More specifically, focussing on the economic role of the state, corruption tends to impede the effective discharge of the three central functions of the state in a modern economy: those of macroeconomic stabilization, allocation of resources and redistribution of income and wealth (Tanzi, 1995).

As regards stabilization, corruption can divert state revenues to private interests, inflate or misallocate government spending and, in the process, contribute to larger budget deficits and macroeconomic instability. Similarly, by introducing arbitrary distortions to costs and prices, and by implicitly taxing capital (through pay-offs and kickbacks or management time spent in securing approvals), corruption can lead not only to serious misallocation of resources but also to reducing the capacity of the state to correct such distortions. Finally, by rewarding those who are best connected to the source of power and authority, corruption can also aggravate existing inequality in incomes and wealth.

In the interest of brevity, I will not dwell upon the *causes* of corruption, as these have by now been amply discussed by both researchers and policy makers alike. I do however wish to emphasize one root cause of corruption that economists generally view as fundamental, and perhaps highly relevant for both diagnosis and treatment of corruption.

There is no longer much dispute concerning the proposition that corruption tends to thrive in any economy dominated by a heavily interventionist state, where regulations are pervasive, obscure, and are applied capriciously, where tax rates are high and tariff structures are complex and restrictive, where procedures are opaque and bureaucratic, where exemptions from taxes or provision of other state privileges (e.g. subsidies) are negotiated on a case by case basis. Clearly, the treatment of corruption in these circumstances must go to the root of the problem by pressing for an orderly devolution and rationalization of the role of the state in the economy along with the reform of markets to ensure a healthy and competitive environment.

Let me now turn to the costs of corruption. In this regard, I will focus on the *economic costs* while remaining conscious of other, less tangible costs such as the impact of corruption on morale of civil servants, on the degradation of professional standards and so on. By economic costs I mean the costs to the economy at large in terms of lost output, lower growth or greater inequality, and in this connection recent studies have begun to generate some interesting results.

Corruption and economic performance

One such study, by Paolo Mauro of the IMF, sought to analyze the impact of corruption on investment and growth. 2/ Mauro used as a measure of corruption an average of two indices compiled by two private firms (Political Risk Services, Inc. and Business International); one or both of these as well as another index compiled by Transparency International have been used as a basis for the study of corruption in recent years. These indices rank countries on the quality of governance (i.e. absence of corruption) according to surveys of businessmen operating in these countries, with a score of "0" indicating the absence of corruption and "10" denoting rampant corruption. Of course as surveys of businessmen's opinions, these indices carry well known, and widely noted biases of their own. In any event, Mauro's careful analysis showed that an improvement in a country's 'corruption index' by one standard deviation (about 2.4 points on a scale of 0 to 10) is associated with an increase in the national investment ratio of four percentage points, and an improvement in the rate of growth of 0.5 percent of GDP. These numbers are not insignificant. Another aspect of Mauro's analysis addressed the impact of corruption on the composition of government spending, and here the analysis showed that higher corruption levels tend to be associated with *reduced* spending on education. In other words, corruption tends to shift government spending away from what is generally recognized as beneficial spending by government.

Another study by Shang-Jin Wei 3/ of Harvard University, currently a visiting scholar at the IMF, examined the impact not on investment in general, but on foreign direct investment (FDI), now widely recognized as a critical factor in the transfer of technology and growth in developing and transition countries. This study found that a worsening in the 'corruption index' of a country by, say, one point on a scale of 0 to 10, is equivalent to raising the marginal tax rate by nearly 4.7 percentage points and is associated with a reduction of FDI of nearly 9.0 percentage points. In addition, Mr. Wei analyzed not only the *level* of corruption, but also the *uncertainty* generated by corrupt practices, uncertainty being highly adverse to FDI. Wei thus analyzed the *distribution* of rank scores given by the different surveys to a specific country. He found, for example, that for the same level of corruption of say 3.70, an increase in uncertainty from the level of Singapore (0.64) to that of Mexico (1.32) is equivalent to an increase in the tax rate by 32 percentage points, an outcome that is clearly detrimental to FDI.

I indicated earlier that corruption tends to shift government spending away from what is considered a productive activity of government—investment in human capital or education. In this regard, a recent study by Tanzi and Davoodi 4/ explored the association between government capital spending and corruption. Most of us are of course familiar with the notion of 'white elephants', which generally refers to massive capital projects whose cost and size go far beyond what may be economically justified. What Tanzi and Davoodi found is that indeed corruption tends to be associated with excessive government spending on capital projects, and that this bias tends to lower productivity and growth. Furthermore, by shifting resources to the construction of projects, less money is available for operation and maintenance, an activity which has been found to be relatively more productive at the margin. Finally, corruption tends to be associated with a reduction in the *quality* of government financed capital projects. We are all familiar with the roads that need to be rebuilt in only a few years, public buildings that function badly and so on. Thus by operating through the allocation of government funds to unproductive or low quality capital projects, corruption also tends not only to waste taxpayers money, but also to lower the growth rate of the economy on this account as well.

Another important aspect of corruption, one which we only mentioned briefly at the outset, is its impact on income inequality and on poverty, a question which has only recently been the subject of some analysis. A study by Gupta, Davoodi, and Alonso-Termé (1998) has found a strong correlation between corruption and an increase in income inequality. Even after accounting for other particular factors, this correlation was found to operate through the impact of corruption on reducing economic growth, the progressivity of the tax system, the level and effectiveness of social spending, the formation of human capital, and on perpetuating an unequal distribution of asset ownership and unequal access to education.

Thus we may conclude that corruption, even by the imperfect measures we now have, tends to be associated with:

- lower investment, including lower foreign direct investment
- reduced economic growth
- a shift in the composition of government spending from more productive to less productive activities, and
- greater income inequality and higher incidence of poverty.

Clearly, a phenomenon that manifests itself in these large and pervasive adverse effects deserves not only our attention as researchers, policy makers and practitioners, but even more important, our concerted efforts to combat it and limit its effects.

III. Combating Corruption: A Reform-Based Approach

In reviewing the policies and instruments that have been proposed or devised by economists, administrators, political scientists, or reform-minded political leaders to combat corruption, one finds that these policies may be shown to belong to one or more of the following three approaches:

1. The first emphasizes *administrative and legal reforms* designed essentially to limit the discretion of public officials by simplifying and rationalizing rules and regulations, increase the probability of detection of corrupt acts and practices through strengthened monitoring and enforcement, and ensure speedy and stiff punishment of proven wrongdoers. The establishment of anti-corruption commissions such as in Hong Kong and Singapore falls within this category.

2. Another approach, often pursued in conjunction with other policies, relies on *moral suasion,* aimed at uncovering corrupt practices and discreting corrupt public officials. This is often done through public information campaigns by the press or by civic groups. Such campaigns have the tendency to activate peer pressure or to bring into play outside interests (aid donors, international civic organizations such as Transparency International and human rights groups) to limit corruption.

3. A third approach, and in our view the most effective over the long term, is the *reform-based approach* which calls for implementing macroeconomic and structural reforms whose ultimate objective is the removal of those conditions that give rise to corruption in the first place by taking measures to help elaborate rules of governance that ensure acceptable levels of transparency and accountability in the public sector, while bringing about a regulatory environment that underpins the operation of open and competitive markets in the rest of the economy.

It should be emphasized that this classification is proposed here only to help lay out an analytic framework for addressing problems of corruption as an issue of economic policy. For in the absence of such a framework, the treatment of corruption in the literature tends to proliferate into taxonomies of types of corrupt practices and lists of 'do's and don'ts' of how to deal with them, amplified by case studies, examples, and anecdotes.

It is important to note that the reform-based approach is clearly the most fundamental and is therefore critical to the success of any anticorruption strategy. For in the absence of basic reforms in policies and institutions to help eliminate the opportunities for illicit rent-seeking and abuse of authority, neither strict rules nor moral suasion are likely to prove effective in combating corruption. Thus, tightening administrative regulations and stiffening penalties in the absence of fundamental reforms are likely only to drive such rent-seeking activities even further underground, while appeals to moral suasion in the presence of tempting opportunities for illicit gains are likely to prove futile.

While this paper focuses on the economic approach to curbing corruption, a few words may be in order concerning the other two approaches and the way in which all three may be related or may be combined to achieve prescribed outcomes. In this regard it is important to emphasize that non of the three approaches is sufficient by itself. An effective anti-corruption strategy would need to employ all three, perhaps with differing emphases depending on the circumstances of the particular country in question. Indeed, most countries where the incidence of corruption is very low (e.g., the Scandinavian countries, New Zealand, Canada, and the Netherlands) are generally seen to have well developed administrative and legal systems, broad public awareness concerning good governance, as well as good economic policy fundamentals and institutions. In the final analysis, all three approaches have to come together to achieve an optimal outcome as even after economic reforms are put in place, clear and transparent regulations will be needed while a vigilant citizenry capable of exerting moral pressure on public officials remains an important safeguard against potential abuse.

Economic reforms as a remedy

The economic reform approach to limiting corruption responds of course to the economic causes of corruption. As such, the approach does not seek quick remedies, but, by focussing on fundamental economic reforms during the transition, it tends to bring about conditions where the opportunities for illicit gains are constrained and, hence, corruption is minimized. As indicated earlier, one of the root causes of corruption is the presence of a heavily interventionist state apparatus which, most often, is reflected in a large public enterprise sector, excessive and complex regulations, and high tax and tariff rates. Such conditions most likely give rise to pervasive and unregulated rent-seeking which often serves as the nexus for corrupt behavior. A comprehensive, reform-based approach to fighting corruption rests on three complementary sets of policies which address the critical issues that arise in the course of the transition, as the balance between state and market is gradually shifted in favor of the latter.

1. The first set of policies aims at the rationalization of the *role of the state* in the economy through deregulation, liberalization, and privatization;

2. The second set of policies seeks the reform of remaining *state functions* through the institution of good practices of governance including the assurance of minimum levels of transparency and accountability; while

3. The third set aims at the establishment of a rule-based competitive environment for the efficient operation of *market activity*.

One could also add a fourth set of policies dealing with the elaboration of clear and effective relationships linking the state to the market economy, although I believe this element to be implied by the first set of policy reforms and, in any event, problems in this area would certainly diminish if success on the other three fronts is achieved.

It is important to note that the three components of a reform-based approach to combating corruption essentially mirror the transition process itself. Indeed, this approach is useful not only for those economies commonly known as transition economies, but also for developing counties emerging from centralized systems of planning and state dominance of economic activity inherited from the early post-colonial period. Thus, by emphasizing the role of policies and institutions, this approach not only makes the problems of corruption in transition economies more easily understandable (corruption being closely associated with policy distortions and weak institutions), it also helps us view the transition process itself as an opportunity for enhancing good governance and limiting corruption by pressing for good policy fundamentals and effective institutions.

Although it is not my intention to expound fully on the theme of the role of the state in a modern economy, a subject that clearly has been uppermost in the minds of this audience for some time, a few remarks on the first set of policies dealing with this issue may be in order.

The first is that in our enthusiasm to devolve certain state activities and functions to the market, we must remain mindful of the risks of too rapid a devolution (i.e., when even the minimum conditions needed for success are absent) or too drastic a diminution of the powers of the state. Although I am not an expert on Russia, but clearly what were intended as reforms designed to rationalize the role of the state and promote good governance and efficient markets in this transition economy have paradoxically produced the opposite effects as central state powers were stripped or dissipated to weak and unprepared regions while privatization proceeded in a chaotic and unhealthy environment. The combination has led to massive rent-seeking and widespread corruption in the newly created market economy while a weakened state has been unable to discharge, to a satisfactory degree, such key functions as raising adequate tax revenue, providing basic services, or safeguarding property rights, much less provide for a competitive and healthy regulatory environment for the private sector.

Although other transition economies experienced these massive dislocations to a lesser degree, the early enthusiasm for a drastic shift to markets has been tempered by a heightened recognition of the importance of a reasonably strong and effective state structure not only to help safeguard state functions but also to ensure a healthy environment in the private sector as well. Thus, the role of the state must go beyond that of a 'night-watchman'. Indeed, recent writings on the subject speak of healthy partnerships between the public and private sectors and propose a rich and productive set of relationships binding the government and private sectors in a joint endeavor for the public good (EBRD, 1997, p. 3).

There are a number of areas where such collaboration is important, perhaps critical. One such area is pensions. In the transition economies, the problems are especially complex because of the inherited rights and obligations toward present beneficiaries in a changed environment. But the problems of pensions in general raise issues that now, after much discussion and debate among experts, have come to be recognized as requiring the collaboration of the government and private sectors. This is so, because of the enormous amounts of resources involved, the exceptionally long periods over which resources need to be managed (and the ever-present opportunities for deception and fraud if such management is unsupervised), and the need to construct appropriate regulatory frameworks which require a long time to develop, test, and render effective.

Thus, on the question of the role of the state in the economy, and more specifically on the relationship between the public and private sectors, earlier, simplistic and stark characterizations have given way to a more nuanced and sophisticated view.

The second set of policies aims to ensure that those functions that remain in the public sector after an orderly devolution are subjected to appropriate systems of checks and balances. This domain comprises the more traditional functions of the state such as the maintenance of law and order, providing basic health and education services, assisting the needy, and managing the state apparatus, including the collection of state revenue and the management of government expenditure. In this domain, the assurance of integrity derives not from the cleansing effects of market forces, but from establishing appropriate safeguards for transparency and accountability. This may be done with reference to the following operational principles:

- Government must articulate clear objectives and publicly announce policies that help achieve these objectives. Furthermore, the government must ensure, through an open and democratic process, that there is widespread support for these objectives and policies.

- The government must conduct its operations, and especially discharge its fiscal responsibilities, in a fully transparent manner.

- The government must be held accountable for its actions and their consequences. In the first instance, such accountability is made effective by the division of powers (legislative, executive, and judiciary), but at the operational level, accountability is assured by an independent external audit authority.

Of course, transparency and accountability of government are necessary but not generally sufficient to curb corruption. Good policy fundamentals and effective institutions are also needed. For example, a policy of providing tax incentives or exemptions or transfers and subsidies, even if legal and transparent, is in the first instance inefficient and hence wasteful of taxpayers resources, but it also has a tendency of engendering abuse and fraud. Similarly, restrictions on trade or excessively high tax and tariff rates are also known to induce evasion, bribery, and fraud.

Finally, reform of the government or public sector requires administrative rules and regulations that promote good conduct on the part of public officials. These may be regulation-based and/or incentive-based. Administrative reforms entail measures that help prevent corruption by making it too costly for its practitioners (through, for example, stiff penalties), while incentive-based reforms focus on improving incentives to good performance through, for example, civil service reform, including the introduction of such practices as merit-based recruitment and promotion, incentive-based wages and competitive wage scales, administrative autonomy and so on. Better pay incentives, when accompanied by other economic and administrative reforms have been found effective in reducing corruption. Indeed, empirical studies have shown that, across countries, there is a negative correlation between the relative wage in the public sector (taken as a ratio to the average wage in manufacturing) and the level of corruption. Van Rijckeghem and Weder (1997) found that an increase in the relative wage from 1 to 2 improved the corruption score of a country by 1.6 points (out of 10). It is no coincidence that the civil service in both the Hong Kong SAR and Singapore, considered among the cleanest in the world, receive wages that are, on average, among the highest in the world.

The third and final set of policies in the reform-based approach seeks to establish an open and competitive market sector with a regulatory environment that ensures a level playing field for economic operators, helps enforce contracts and ensures property rights. Clearly, this is a long-term process in the transition economies as elsewhere, and given its familiarity to this audience, I need not elaborate.

IV. Governance, Structural Reforms, and Economic Performance

Transition economies have been undergoing massive and deep-going transformation which has drastically diminished the role of the state in the economy, given rise to a diverse and expanding private sector, and, in the process, has redefined the relationship between the state and the market. Although not considered perfect as measures of the role of the state in the economy, levels of government revenue and expenditure have generally been on the decline: for the 15 countries for which data are available, average revenue dropped from 33.0 percent of GDP in 1993 to 27.4 percent in 1997, while average expenditure levels declined from 40.7 percent to 30.7 percent during the same period.[2] The share of the private sector in the economy has also consistently risen. The EBRD reports that by mid-1997, the private sector share had reached or exceeded 50 percent in 19 of the Bank's 26 countries of operation, with some countries' shares approaching or exceeding comparable ratios for a number of OECD countries (EBRD, 1997, p.14).

Shifts in the relative sizes of the public and private sectors say nothing of course about the relationship between the two. Indeed, the waves of privatization that have swept the transition economies have produced different outcomes in terms of the extent of residual state holdings in privatized enterprises, the dispersion of ownership in the privatized firms, the distribution of ownership as between insiders and outsiders, and the extent of foreign participation. As is widely observed, the experience of the Russian Federation in this regard is almost unique because of the dominant role played by large domestic financial-industrial groups. In any event, while the diversity of outcomes is in part a reflection of the diversity of policies and institutions in the individual countries, this diversity also gave rise to different types of relationships between governments and the private sector as may be reflected in changes in financial flows in the form of subsidies and transfers, the spread of tax laws and regulations, and the development of regulatory frameworks for the enterprise and financial sectors. These relationships have not yet stabilized and continue to evolve. Furthermore, the different transition economies have achieved varying degrees of progress in defining these relationships. As shown in Chart 1, the CEE and the Baltics are shown to have achieved the greatest progress in structural reforms, the dispersion pattern reflecting some convergence within regions as well.

The progress has also varied across areas of interaction between the public and private sectors. In the areas of subsidies, all transition economies reduced their budgetary subsidies to enterprises but off-budget financial flows are much more difficult to monitor and probably remain a problem in several countries. Concerning the regulatory environment, several countries, notably the Czech Republic, Estonia, Hungary, and Poland made considerable progress in terms of the introduction and wide application of modern pledge, bankruptcy, and company laws, key elements in a modern regulatory framework for private sector activity. In the area of taxation, most countries introduced modern VATs and countries aspiring to

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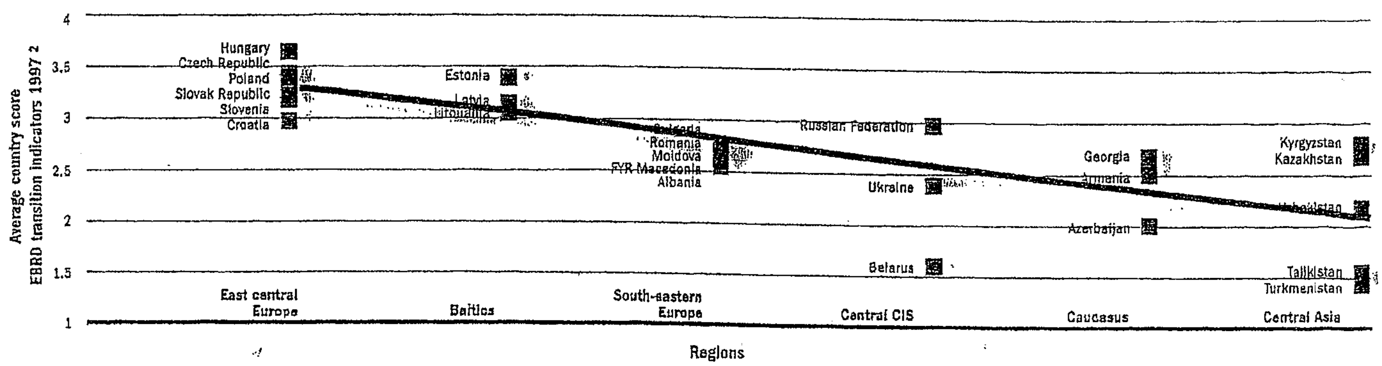
[2]It should be pointed out that these data may exaggerate the true size of what is genuinely 'private sector', as state enterprises and authorities are often spun off to nominal private owners while the state retains control.

membership in the EU (e.g. Czech Republic, Estonia, Hungary, Poland, and Slovenia) are making efforts to harmonize their tax systems with those of the EU. In general, as shown in Chart 2, more progress has been achieved in the area of *liberalization* (of prices, trade, and exchange systems), followed by those reforms involving *redistribution* of assets (large- and small-scale privatization), while in the most difficult area requiring building or *rebuilding structures and institutions* (e.g. enterprise restructuring, overhaul of banking systems, regulation of securities markets) progress has been understandably slower.

Chart 1: Regional Patterns of Reform[1]

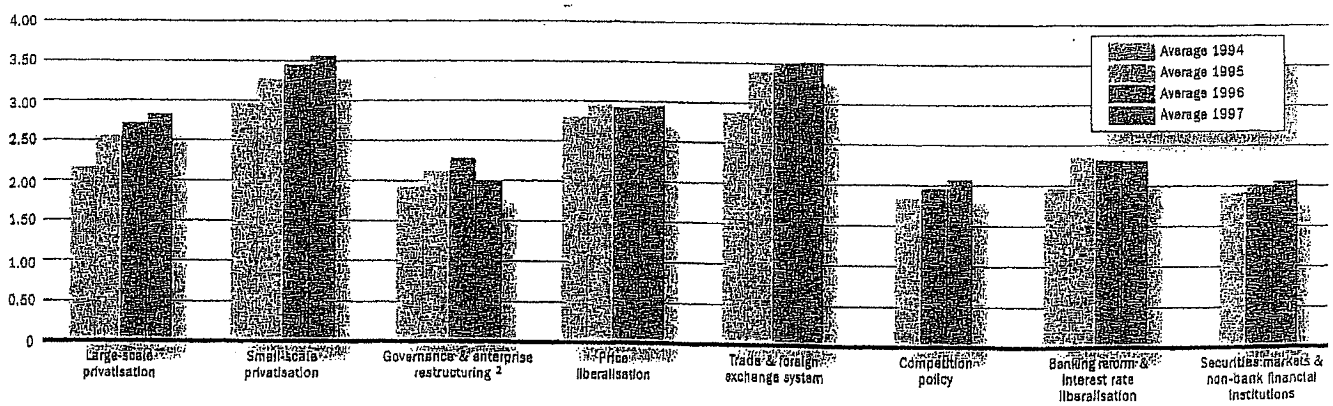


1 The line in this graph depicts the average score on the 1997 transition indicators across all countries in the given region. The placement of each country name represents the distance of that country's average score from the average for the region as a whole.

2 This represents the average score for each country on the 1997 transition indicators in Table 2.1 on all reform dimensions with the exception of private sector share of GDP. Pluses and minuses are calculated as +/- 0.33.

Source: EBRD, 1997, p.21.

Chart 2: Average Annual EBRD Transition Indicators by Dimension (1994-97)[1]



1 For each dimension of reform in each year, the average score is calculated across all of the countries in Table 2.1 of the *Transition Reports* since 1994. Pluses and minuses are calculated as +/- 0.33. The score of 4* used in previous years is equivalent to 4+ or, according to the above standard, 4.33.

2 The decline in this dimension from 1996 to 1997 reflects the finer distinctions associated with the introduction of pluses and minuses rather than a reversal of previous progress made in this dimension.

Source: EBRD, 1997, p.20.

Measuring structural reforms in transition

Tracking progress in restructuring in the transition economies, the EBRD has developed indices of transition constructed on the basis of assessments of cumulative progress in the movement from a command economy to a market economy. For lack of an absolute measure, progress is assessed against the standards of advanced industrial countries. Summary indicators are thus constructed for each of the key 'dimensions' of the transition and a score is given on a scale of 1 to 4 with pluses and minuses introduced in 1997 to indicate minor variations. Although different classifications are possible, the EBRD has chosen two categories: "advanced reformers" and "less advanced reformers"; these two groups and their composite scores for the period 1994-97 are shown in the accompanying Table 1 (which does not incorporate the pluses and minuses), while Table 2 gives the detailed data for 1997 for the various 'dimensions' of the transition. It is interesting to note that, on average, both groups of countries have made progress even in the short period of four years. Moreover, although the gap remains wide, it appears that it has been narrowing as the percentage improvement in the "less advanced reformers"(20.0 percent) was much greater than its counterpart for the "more advanced reformers"(6.2 percent).

It is not my intention to question the methodology or the classification, as this clearly is not the subject of this paper, but I find both to be broadly satisfactory and, in any event, very useful for our purposes. After all, we are concerned here with broad trends and in this regard these indices are sufficiently illustrative. Not surprisingly, the CEE and the Baltics show greater progress than the CIS, although there are exceptions.

Structural reform and governance

It is worth remembering that the reforms underlying these indices are all consistent with the notion of improved governance as described earlier, as they all aim, in one way or another, at reducing the opportunity for rent-seeking and monopoly control, enhancing the transparency and accountability of governments and providing basic regulatory frameworks for the operation of an open and competitive market economy. Unfortunately, we do not have comprehensive data on corruption in the transition economies which cover several years. A recent study by Lambsdorff (1998) did however compile indices for 11 of the 26 countries discussed here. The figures reveal higher scores, i.e. better record on governance, for the advanced reformers, with an average for the six countries for which data are available being 5.06 (on a scale of 0 to 10), a score that is already higher than that of Italy, Taiwan, Malaysia, South Korea, or Brazil. The "less advanced reformers" on the other hand, had an average score of 2.93, with Bulgaria and Romania having the best scores at 3.94 and 3.44 respectively. Not surprisingly, the Russian Federation scored lowest of all 11 countries.

As indicated earlier, the corruption indices are averages of four or more surveys of businessmen, political analysts, and the general public (included in the 1997 survey for the first time and drawing on the Gallup International surveys). These indices reflect either actual encounters with corrupt officials by businessmen and others or simply a perception based on general information or academic studies. The reform indices computed by the EBRD on the other hand, rely heavily on actual assessments, mainly by country specialists at the EBRD, of

Table 1. Transition Economies: Indices of Structural Reforms, 1994 - 1997
(Scale of 0-4)

	1994	1995	1996	1997
Advanced reformers				
Croatia	3.2	2.9	3.1	3.2
Czech Republic	3.5	3.7	3.5	3.6
Estonia	3.3	3.1	3.4	3.6
Hungary	3.3	3.7	3.5	3.8
Latvia	2.8	2.6	3.1	3.1
Lithuania	3.0	2.7	2.9	3.1
Poland	3.3	3.6	3.4	3.6
Slovakia	3.3	3.4	3.3	3.3
Slovenia	3.2	3.4	3.2	3.3
Average	3.2	3.2	3.3	3.4
Less advanced reformers				
Albania	2.5	2.3	2.7	2.5
Armenia	1.8	2.1	2.4	2.6
Azerbaijan	1.3	1.4	1.8	1.9
Belarus	1.7	2.1	1.8	1.7
Bulgaria	2.5	2.6	2.6	2.8
FYR Macedonia	2.8	2.3	2.7	2.6
Georgia	1.3	1.9	2.4	2.7
Kazakhstan	1.7	2.1	2.6	2.7
Kyrgyz Republic	2.8	2.8	2.7	2.8
Moldova	2.2	2.6	2.7	2.6
Romania	2.7	2.5	2.6	2.7
Russian Federation	2.7	2.6	2.9	3.1
Tajikistan	1.7	1.6	1.7	1.4
Turkmenistan	1.2	1.2	1.1	1.3
Ukraine	1.3	2.2	2.4	2.4
Uzbekistan	2.0	2.3	2.4	2.2
Average	2.0	2.2	2.3	2.4

Source: EBRD, *Transition Report*, various years.

Table 2. Indices of Progress in Transition Economies, 1997

(Scale of 0-4)1/

	Enterprises			Markets and Trade			Financial Institutions		
	Large-scale Privatization	Small-scale Privatization	Governance and Restructuring	Price Liberalization	Trade and Foreign Exchange System	Competition Policy	Banking Reform and Interest Rate Liberalization	Securities Markets and Non-bank Financial Institutions	Composite Score 1997
Advanced reformers									
Croatia	3	4.25	2.75	3	4	2	2.75	2.25	3.0
Czech Republic	4	4.25	3	3	4.25	3	3	3	3.4
Estonia	4	4.25	3	3	4	2.75	3.25	3	3.4
Hungary	4	4.25	3	3.25	4.25	3	4	3.25	3.6
Latvia	3	4	2.75	3	4	2.75	3	2.25	3.1
Lithuania	3	4	2.75	3	4	2.25	3	2.25	3.0
Poland	3.25	4.25	3	3	4.25	3	3	3.25	3.4
Slovak Republic	4	4.25	2.75	3	4	3	2.75	2.25	3.3
Slovenia	3.25	4.25	2.75	3	4.25	2	3	3	3.2
Average	3.50	4.19	2.86	3.03	4.11	2.64	3.08	2.72	**3.3**
Less advanced reformers									
Albania	2	4	2	3	4	2	2	1.75	2.6
Armenia	3	3	2	3	4	2	2.25	1	2.5
Azerbaijan	2	3	2	3	2.25	1	2	1	2.0
Belarus	1	2	1	3	1	2	1	2	1.6
Bulgaria	3	3	2.25	3	4	2	2.75	2	2.8
FYR Macedonia	3	4	2	3	4	1	3	1	2.6
Georgia	3.25	4	2	3	4	2	2.25	1	2.7
Kazakhstan	3	3.25	2	3	4	2	2.25	2	2.7
Kyrgyz Republic	3	4	2	3	4	2	2.75	2	2.8
Moldova	3	3	2	3	4	2	2	2	2.6
Romania	2.75	3	2	3	4	2	2.75	2	2.7
Russian Federation	3.25	4	2	3	4	2.25	2.25	3	3.0
Tajikistan	2	2	1	2.75	2	1	1	1	1.6
Turkmenistan	2	2	1.75	2	1	1	1	1	1.5
Ukraine	2.25	3.25	2	3	3	2	2	2	2.4
Uzbekistan	2.75	3	2	2.75	1.75	2	1.75	2	2.3
Average	2.58	3.16	1.88	2.91	3.19	1.77	2.06	1.67	**2.4**

Source: EBRD, *Transition Report 1997*, p.14, London.

1/ Pluses and minuses in the original data have been transformed into +0.25 and -0.25, respectively.

structural change in very specific fields. Although the two sets of indices may rely, to a small degree, on the same information, they may be considered largely independent. The important point is that they are clearly correlated, with those countries making the greatest progress on structural reforms also showing the best scores on governance. Thus, in a very general way, and abstracting from other, possibly complicating factors, we can *tentatively* claim that structural reforms involving a devolution and liberalization of state functions, the development of a rules-based competitive environment for the private sector, and the elaboration of a healthy relationship between the state and the market are indeed associated with a reduction in corruption. Clearly, much more careful, empirical analysis needs to be done before this hypothesis is fully tested for the transition economies.

Economic performance

It was stated at the outset that good governance is strongly correlated with good economic performance (or more precisely, corruption is correlated with poor economic performance) and that the means to promote good governance is to press forward with structural reforms. We can now close the circle by looking at economic performance in the transition economies to ascertain if good economic indicators are also associated with structural reforms and, hence, with good governance as well.

To address this question, reference is made to Table 4 which displays the basic macroeconomic indicators for the two groups of transition economies. The data clearly show that the advanced reformers succeeded in recovering from the transitional decline in output earlier, and achieved, on average, higher rates of growth than the other group. On inflation, general government balances, and the current account of the balance of payments, the picture is similar. Broadly similar results are also obtained when trends in income distribution and poverty indicators are also compared, although the data tend to be somewhat sparse (Milanovic, Branko, 1998, and Gupta, Davoodi, and Alonso-Termé, 1998). Most notable, however, is the impact of structural reforms on foreign direct investment—the litmus test for successful reforms (and by implication, for good governance). For the period 1989-96, the average volume of FDI for the advanced reformers was more than three times that of the less advanced reformers. In the former group, Hungary alone, one of the most advanced in terms of structural reforms and good governance, attracted US$13.3 billion, or more than one third of all cumulative FDI in the transition economies during the period 1989-1996. The Russian Federation, because of its size and wealth of natural resources, attracted US$5.8 billion, during the same period, although in per capita terms the figure is only US$40 compared to US$1,300 for Hungary, US$692 for the Czech Republic, US$477 for Estonia, and US$372 for Slovenia. Smaller oil-rich countries in the CIS (Azerbeijan, Kazakhstan, and Turkmenistan) attracted moderate FDI flows in the range of US$118 - 187 on a per capita basis. Data on private capital flows in general also show a substantial increase in volumes in recent years along with marked improvement in borrowing terms; spreads for those countries among the "advanced reformers" which borrowed on the international market were considerably lower than for the less advanced reformers.

Table 3. Transition Economies: Corruption Indices, 1997

Advanced reformers	
Czech Republic	5.20
Estonia	6.16
Hungary	5.18
Latvia	5.11
Poland	5.08
Slovakia	3.65
Average	5.06
Less advanced reformers	
Belarus	2.38
Bulgaria	3.94
Romania	3.44
Russia	2.27
Ukraine	2.61
Average	2.93

Source: Lambsdorff, Johann, forthcoming, "Corruption in Comparative Perception", in *The Economics of Corruption,* ed. by Arvind Jain (forthcoming).

Table 4. Transition Economies: Macroeconomic Indicators, 1994-97

	1994	1995	1996 Estim.	1997 Proj.
		Growth in Real GDP (Change in percent)		
Advanced reformers	2.4	3.7	4.0	4.2
Less advanced reformers	-10.9	-2.7	-0.1	-0.6
		Inflation (Change in percent)		
Advanced reformers	22.2	18.4	11.8	10.1
Less advanced reformers	1056.3	277.1	71.5	72.3
		General Government Balances (In percent of GDP)		
Advanced reformers	-1.9	-2.1	-1.6	...
Less advanced reformers	-7.5	-5.7	-5.5	...
		Current Account Balance (In percent of GDP)		
Advanced reformers	...	...	-5.7	...
Less advanced reformers	...	...	-8.5	...
		Foreign Direct Investment:		
		Annual inflows per country (In millions of U.S. dollars)		**Cumulative per country** 1989-96
Advanced reformers	385	1009	799	3269
Less advanced reformers	134	276	321	904
Excluding Russia	104	160	207	575

Source: EBRD, *Transition Report 1997*, pp.115-126, London.

V. Conclusion

Empirical evidence is accumulating which indicates that corruption is inimical to good economic performance—it lowers growth, reduces investment, distorts government spending, and aggravates income inequality. Although numerous strategies have been proposed to deal with corruption, this paper has advanced the proposition that there are no quick fixes to curb corruption. The ultimate solution lies in structural reforms which seek to create a healthy balance between the state and the market and good governance in both. The transition process itself, underway since the late 1980s in the countries of Eastern Europe and the former Soviet Union, may be viewed as a process of structural change which, if managed badly can provide fertile ground for corruption and waste, but if managed successfully, can be an opportunity to promote good governance and thereby underpin good economic performance.

The record of the various transition economies in the area of structural reform clearly shows that the more advanced reformers have achieved greater success in limiting the adverse effects of corruption and in achieving not only better economic performance, but also in gaining the confidence of international markets. This gives them the added advantage of attracting more private capital flows at better terms and, therefore, helps improve their prospects for achieving even higher rates of sustainable growth in the future.

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