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Poland and the Russian Federation—A Comparative Study of Growth and Poverty

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Taking into account a very broad topic of this paper and limited resources of its authors the latter had to rely, whenever possible, on existing analyses, statistics, and international comparisons and ratings of the IMF, World Bank, EBRD, OECD and several international think tanks and NGOs (Freedom House, Transparency International, Heritage Foundation, etc.). Several earlier studies of our own institution, i.e. CASE and its network partners (like the Institute for the Economy of Transition in Moscow) were of great help in preparing this analysis. The authors are very grateful to OECD for its kind agreement to use results of the earlier CASE research on income distribution in Poland. We also would like to acknowledge the valuable consultation of CASE researcher Katarzyna Pietka who helped us to select and interpret statistical data on income distribution, inequality, poverty, and social expenditures in Poland. However, the authors are solely responsible for the content and quality of this paper as well as for its interpretations and conclusions.
Executive Summary

In the former Soviet Union and Central and Eastern Europe, output declined steeply with the abandonment of communist economic practices. Largely, however, the scale of structural and institutional distortions inherited from the command economy determined the decline. Adjustment triggered by liberalization of domestic and external markets caused significant shifts in demand. Export markets organized on the basis of central planning collapsed, particularly the Council for Mutual Economic Assistance (CMEA) (1990–91) and the Soviet inter-republican market (1992–93). New import opportunities decreased demand for some domestic products before new export opportunities spurred production of other goods. Other microeconomic factors contributing to output decline were dramatic changes in costs following 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. A third group of factors involved such issues as (i) collapse of the mobilization role of the central plan and administrative incentives connected with a totalitarian regime, (ii) expectations and incentives created by the privatization process, (iii) expectations of massive bailouts of state enterprises by the government based on past reform experience under communism, and (iv) lack of skills for working under market conditions.

Apart from these factors, the severity and longevity of the decline depended on the transition strategy the country adopted, particularly the speed of reforms and their consistency. Countries that reformed rapidly, such as Poland, suffered smaller declines and enjoyed quicker recoveries than countries that implemented gradual reforms, such as Russia.

The similarities and differences in Poland’s and Russia’s experience with market reform in the 1990s provide an interesting study of the dynamics of transition from a command economy. Poland was the pioneer of postcommunist political and economic transition, having begun the process in 1989. In Russia the process began two years later, when the Soviet Union collapsed. In the first stage of its transition Poland represented a classic case of rapid reform—sometimes known as shock therapy. Russia’s attempt to follow the same pattern failed for domestic political reasons, leading it down a much slower and less thorough reform path. From the early 1990s Poland enjoyed a geopolitical chance to participate in the process of European integration, which will come to fruition with the accession of eight former communist countries to the European Union (EU) in May 2004.

Economic growth

Output of the Polish economy contracted in 1989–91, as factors of production were redeployed. The short-lived contraction was relatively shallow. Between 1992 and 1998 the Polish economy grew at an average rate of 6 percent, while inflation fell from more than 70 percent in 1991 to about 11 percent by 1998. Macroeconomic stability and institutional reforms encouraged investment, which grew at an annual rate of 16 percent. Increased economic activity reduced the unemployment rate from more than 16 percent in 1994 to below 10 percent by 1998. Over the
same period there was a reduction in poverty of 4 percentage points. Inequality worsened—marginally. After 1998 Poland’s economy experienced a slowdown in economic growth. Apart from exogenous factors such as the Russian financial crisis (which brought a shock in 1998–99) and the general slowdown of the world and European economy after 2000, domestic factors played an important role in slowing Poland’s recovery—among them the slow pace of privatization and restructuring of several important sectors (heavy industries, energy, railways, telecommunication), labor market rigidities, a high level of fiscal redistribution, excessive social commitments and resulting high taxes, reversal of the deregulation trend of the early 1990s, and adjustment costs connected with adoption of the EU’s body of law (acquis communautaire). The economic slowdown significantly undercut the gains in poverty reduction that were achieved between 1994–1998.

In Russia economic contraction was more pronounced. Slow and inconsistent macroeconomic stabilization and liberalization hampered the structural and institutional changes that were necessary to stop and reverse the decline in output. Populist policies slowed the adaptation process and made it more severe. Russia’s negative growth through most of 1990s can be traced to the slow pace and poor sequencing of economic reforms. Comparisons with other countries show that progress in macroeconomic stabilization (especially lowering inflation) was a key factor in subsequent recovery of output. Countries that tamed inflation quickly experienced a speedier and stronger recovery. Moreover, in many Central and Eastern Europe (CEE) countries the early success of economic stabilization helped to strengthen the constituency for further reforms, both political and economic.

Russia was mired in a slow reform equilibrium for several years. Strong economic growth began only in 1999 and continues. Between 1999 and 2002 the real GDP registered an average growth rate of 5.9 percent, while inflation was brought down from 86 percent in 1999 to 16 percent by 2002. Employment in 2002 was 67 percent of the 1991 level, but recovering gradually. The high growth achieved in Russia since 2000 may be explained by (1) the devaluation following the 1998 crisis; (2) the depth of the previous output decline and the deployment of reserves, such as idle capacity; (3) positive effects of economic reforms conducted in the 1990s (particularly privatization), and (4) high oil prices on international markets.

**Employment structure and labor market developments**

In both Poland and Russia a substantial share of the labor force moved from industry to a broadly defined service sector (a move more dramatic in Russia). At the same time, the share of employment in agriculture declined—more so in Poland than in Russia. Both countries (especially Russia) had been heavily over industrialized, while market services were underdeveloped. Poland, which managed to avoid communist collectivization of its agriculture, continues to suffer from over-employment in this sector.

There are striking differences between the countries in the share of employment in small enterprises. The initial differences (16.92 percent of the labor force in Poland and 6.43 percent in Russia) increased in spite of positive dynamics in both countries. In Poland small enterprises
accounted for almost half of total employment in 1998; in Russia small-enterprise employment stabilized at below 20 percent.

Since 1998 employment trends in both countries have changed. Employment in Russia has increased with economic recovery but more slowly than GDP. In Poland, slower economic growth rates have been accompanied by employment decline, the unemployment rate increasing from 1.5 percent in 1999 to 4.3 percent in 2001. Both countries improved labor productivity, but Poland chose a less labor-intensive pattern of economic development, despite rapidly increasing unemployment and rapid growth in the number of people entering the workforce.

Generally, Russia and Poland represent two different patterns of labor market adjustment. In Russia the decline in employment was significantly smaller than the massive collapse of output. The adjustment took the form of lower real wages, wage arrears, hidden unemployment, and a move to low-productivity services. 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.

**Privatization, business formation, foreign direct investment, and trade**

Poland’s experience points to the key role of newly established private enterprises (mostly small and medium-sized) in fostering economic restructuring, absorbing labor resources, and bringing economic recovery. In fact, new business formation was the most powerful force in removing structural distortions inherited from the command economy.

Newly created private firms were less important in fostering economic recovery in Russia, because of over-regulation and a poor business and investment climate. The same factors discouraged foreign direct investment. In 2002 Russia’s cumulative per capita inflow of foreign direct investment (FDI) was seven times lower than Poland’s. Most FDI came to oil and other natural resource sectors. Moreover, throughout its transition period Russia suffered a substantial capital outflow.

In contrast to Poland, large private corporations and conglomerates powered Russia’s growth. Many built their strength in foreign trade and the financial market before moving into natural resources in the mid-1990s, using the loan-for-shares program and other nontransparent privatization schemes in mid-1990s. Manufacturing, agriculture, and the service sector were the last stage of their expansion.

Corporatization and privatization in Russia were more rapid than in the majority of transition countries, including Poland—largely because of the massive voucher-based privatization program of 1992, which quickly transformed the formal ownership of the Russian economy, albeit at the cost of diluted ownership and insider dominance. Privatization in Poland proceeded more slowly and was dominated by strategic foreign investors, which helped to promote inflows of FDI. Together with the private sector inherited from the communist era (accounting for about 25 percent of GDP in 1989) and rapid development of new private firms, privatization in Poland eventually reached Russia’s overall level, but with better quality. In both Poland and Russia the state retained a substantial amount of hard-to-sell shares.
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/d (barrels per day). Energy accounted for around 20 percent of Russian GDP and 40 percent of tax revenues in 2002. Poland had one of the most energy-intensive economies among the countries of Eastern Europe and relied heavily on energy imports from Russia (in addition to its own coal sector and coal-based electric power generation). When prices of oil and natural gas imported from Russia were increased to the world level, trade liberalization and hard budget constraints pushed the Polish economy toward energy-efficient technologies, while low domestic energy prices allowed Russia to hang onto inefficient technologies.

Partly because of its smaller size, Poland’s economic growth is more export-driven than Russia’s. Oil and natural gas lead Russia’s export structure, which is dominated by energy resources. Poland export growth has relied on manufactured products, including increasing intra-industry trade with the EU. The share of the EU market in Poland’s exports is stable at around 70 percent, twice that of Russia. Poland’s reliance on manufacturing trade with the EU has hastened the restructuring of Polish industry and increased its competitiveness—a virtuous cycle. In the case of Russia, underpriced energy inputs have slowed the process of restructuring sectors outside oil and gas, keeping them internationally uncompetitive and exposing them anti-dumping restrictions.

**Fiscal policy**

Russia experienced severe fiscal imbalances from the late Soviet period until 1998, which led to subsequent currency crashes in the run-up to the full-scale financial crisis that began in August 1998. Since 1998 Russia’s fiscal situation has radically improved—first as a result of ruble devaluation and later as a consequence of high oil prices—but the country remains vulnerable to any future decline in world oil prices.

Poland’s fiscal position fluctuated less dramatically than Russia’s in the 1990s, though it was never close to balance. In the early 2000s it started to deteriorate, leading to a rapidly increasing deficit and debt-to-GDP ratio that could undermine macroeconomic stability and the prospects of the new economic recovery that began in mid-2003. Poland has also found itself in a tax-and-spend trap, with the ratio of general government expenditures to GDP being in the range of 44 to 48 percent. The main fiscal burden comes from excessive social expenditures that crowd out public investments. They also lead to high indirect labor costs (payroll taxes), which are responsible for at least part of the country’s labor-market rigidities and unemployment.

Russia represents a lower level of fiscal redistribution and a lower share of social transfers in total budget expenditures, lowering fiscal pressure but affording less room for cushioning poverty and income inequalities. The same can said about lower health and education expenditures in Russia.
Income inequality and poverty

Poland and Russia started their transition with low levels of inequality, reflecting the income policy of the communist regime and low levels of formal private-sector activity. With the transition to market economies, inequality has increased dramatically in most Commonwealth of Independent States (CIS) countries. Today, Russia’s high level of inequality resembles that typical of many developing economies. In Central and Eastern Europe, the post-transition increase in inequality (as measured by the Gini coefficient) has been relatively modest.

Poverty studies in both countries show that people living in rural areas and small towns, and in economically undiversified regions, are more likely to be poor. Poverty increased in Russia during the first phase of transition and peaked in 1998–99. Although the economic recovery that began in 1999 brought a noticeable improvement, the poverty challenge is still very serious—about a quarter of the population is poor. Rural households have benefited less than urban households from the recovery. Poor social services have contributed to the expansion of a poverty zone in Russia. Growing unemployment is one of the primary factors behind poverty in Poland.

There are two major groups of poor in Russia and in Poland. The old poor group covers those who lived below the poverty line already before transition. This group consists of one-parent families, families with many children, disabled persons, single pensioners, and socially marginalized persons. The new poor group in both countries includes families with children, young families, a considerable proportion of rural population, and families of the 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 sociodemographic type of families is not associated with 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 portion of pensioners, families of migrants, and displaced persons.

Some key lessons that can be gleaned from the experience of Russia and Poland are:

Successful macroeconomic stabilization and extensive liberalization are the basic preconditions for overcoming declines in output following the transition from a command to a market economy. Countries that delay stabilization and liberalization suffer longer and deeper output contraction and wait longer to enjoy the benefits of post-adaptation recovery. The initial phase of economic recovery, particularly when following a deep, adaptive decline in output, usually does not require a serious investment effort because recovery is driven by reallocation of existing resources. Later, however, new investments and sources of financing become a crucial condition of continuing growth. The scale and quality of investment, in turn, depend on the business and investment climate.

The same factors that determine business and investment climate are also extremely important for reducing poverty and inequality and building an atmosphere of fairness and social justice. Removing regulatory distortions; eliminating sources of rent extractions and corruption; creating free and equal access to business activity; and increasing efficiency of delivery of basic public goods such as law enforcement, administration of justice, technical infrastructure,
education, and public health improve the quality of life and mitigate feelings of inequality and alienation among large segments of society.

The quality of economic institutions is strongly correlated with the quality of political institutions, political reform, and democratization. Free political competition, free media, civil-society networks, and effective protection of civil rights generally help in improving economic institutions and fighting social pathologies such as corruption. Political freedom and democracy can also help in building domestic ownership of a reform program.

Finally, the international community can create external incentives for building good institutions and following good policies. The enlargement of the EU is a good example of the effective exporting of good institutions and policies from high-income to middle- and low-income countries.
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 Poland and Russia. 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 will cover 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 what may give an interesting food for thought of what kind of growth challenges Russia can meet in the near future (under assumption that both growth episodes are comparable enough). The selection of these two concrete countries for a comparative study is justified by the fact that each of them represents another transition history, strategy and trajectory.

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’. 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 enjoyed a geopolitical chance to participate in the process of European integration, which is just coming to its successful end (EU accession of eight former communist countries from 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.

Although the main focus of this paper is put on the post-adaptation output recovery period the analysis will start from the short characteristics of the previous period, i.e. adaptation output decline because the observed differences in both countries (in terms of size, length and specific causes of this decline) determined various starting points to the growth stage. This is the topic of Section 2 of this study. In Section 3 we present a general characteristics 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 provide an overview of various composite indexes illustrating 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 some lessons learned from the Russia and Poland reforms, growth and poverty developments.
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. However, the size of this decline varied according to what strategy the country adopted, conditions at the beginning of the transition, or external shocks.

Apart from short-term costs of macroeconomic stabilization, 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 of lags in supply side responses, 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, decreasing investment rate and change in the structure of investment demand, rationalization of inter-regional links (especially in Russia), elimination of forced substitution, 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).

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 process¹, 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.

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. There is evidence that the countries,

¹ 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 Dabrowski, 1993) or ‘privatization death’ (Mertlik, 1993).
which preceded with reforms in the fast manner, for example Poland, suffered smaller decline before stabilization than countries implementing gradual reforms, such as Russia.

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

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. Countries that tamed inflation quickly experienced a speedier and stronger recovery in output. 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.

Note: data for 2003 are based on WEO (2003) and authors’ forecast
Source: TransMonee (2002); WEO (2003)
Post-Adaptation Recovery: General Characteristics

As we mentioned in Section 2 Poland’s output decline was relatively short (two years only) and full recovery started already at the end of 1991. Figure 2 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 1990s fast growth in Poland was accompanied by the continuous output decline in Russia while strong Russia’s recovery in early 2000s overlapped with the phase of serious growth slowdown in Poland. Due to its particularly long and severe period of output decline, Russia became delayed of one ‘phase’, comparing to Poland. Hence, we decided to extract a ‘recovery’ phase from each country growth statistics, eliminating in this way the above mentioned ‘time mismatch’ (see Figure 2).

Figure 2: Annual rate of real GDP growth in recovery period

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

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 percent in 1996 and 1997 (see Figure 3). In Russia, average annual growth rate of gross domestic investment during 1991-2001 was negative and amounted to -14.6 percent. The situation has changed only in 1999, and positive growth rates have been achieved in 2000-01 (+18.6 percent and +17.0 percent accordingly).
Figure 3: Gross fixed investments, annual percent change (constant prices)

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

The first stage of recovery in transition economy seemed to base on a pure catching-up effect using mostly the existing resources freed by the ‘adaptation’ output decline and facilitated by the systemic changes accomplished to date. It cannot be excluded that Russia with recorded deeper output decline had more simple reserves and, therefore, more room for a catching up growth. However, it is clear that sustainability of economic growth depends critically on further reform steps.

Another conclusion, which can be drawn from Figure 2 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. The phenomenon of declining growth trend could be well observed in the case of Poland. After peaking up in 1994-1997 the growth rate started to go down systematically and reached a very low level (close to 1 percent) in the period of Q4 2000 – Q1 2003. Apart from exogenous factors such as an 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 percent of GDP), excessive social commitments and resulting high taxes, reversal of deregulation trend of the early 1990s, and adjustment costs connected with adoption of EU acquis communitaire.
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-lived (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 percent in 2001, 0.8 percent in 2002 and 1.7 percent in 2003, comparing to 9.8 percent in 1999) and substantially reduce current account deficit - from 8.1 percent of GDP in 1998 to 3.1 percent of GDP in 2001 (World Bank, 2003a, 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.

It is possible that 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.

**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 take us closer to the answer do 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.

**Employment structure and labor market developments**

*Figure 5* provides us with a general picture of changes in employment structure of two countries in consideration recorded between 1990 and 1998\(^2\). 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 comparing 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 surprise. Former communist countries were heavily over-industrialized (especially former USSR

\(^2\) 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.
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 also a certain margin of redundant labor (although much smaller than in case of Poland) in its ineffective state- and collectively-owned farms (sovkhозы and kolkhoзы).

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 4). The initial differences – in 1989 the analyzed share accounted for 16.92 percent in Poland and only 6.43 percent in Russia – did not disappear thorough the decade of 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 percent), while in Russia it stabilized below 20 percent (18.59 percent 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 4 – Hungary and Lithuania – this share was even higher: 55.10 percent and 54.93 percent respectively. Note that Lithuania started in early 1990s from the similar level as Russia.

**Figure 4: Share of Employment in Small Enterprises, 1989-98**

![Graph showing share of employment in small enterprises from 1989 to 1998 for Poland, Russia, Hungary, and Lithuania.](image)

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

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

**Figure 6** illustrates a comparison of employment and GDP dynamics in first nine years of transition. While in Poland strong output recovery was accompanied by a very modest growth in employment – by 1.1 percent in 1994, 0.3 percent in 1995, 3.5 percent in 1996 (the only year with stronger increase of employment), 1.3 percent in 1997 and 1.4 percent in 1998 – Russia’s severe output decline was connected with substantial but less dramatic fall of employment – by 3.4 percent in 1994, 6.4 percent in 1995, 3.4 percent in 1996, 3.1 percent in 1997, and 2.7 percent in 1998. It means that Poland recorded a continous increase in labor productivity and Russia – its continous decline.
Figure 5: Employment structure by sectors in Poland and Russia, 1990-1998, in percent of total employment

Source: World Development Indicators 2003
After 1998 employment trends in both countries have changed. Employment in Russia started to increase on the top of economic recovery but at slower pace than GDP (apart from 1999 when it increased by 8.0 percent; in the next two years employment growth rate amounted to 1.4 percent and 1.3 percent, respectively). In Poland slower growth rates were accompanied by employment decline: by 1.5 percent in 1999, 3.3 percent in 2000, and 4.3 percent 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 6: Employment and GDP dynamics in Poland and Russia, 1990 = 100**

![Employment and GDP dynamics in Poland and Russia, 1990 = 100](image)

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

**Figure 7: Unemployment in Poland and Russia (according to ILO definition), 1990-2001**

![Unemployment in Poland and Russia (according to ILO definition), 1990-2001](image)

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

Employment dynamics has been mirrored in the unemployment statistics presented in **Figure 7**. 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 gives 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 8 (in Poland these differences are much smaller) and by research addressing the phenomenon of unofficial (‘grey’ or ‘black’) economic activity.

**Figure 8: Total (ILO definition) and registered unemployment in Russia, percent of labor force**

![Bar graph showing total (ILO definition) and registered unemployment in Russia, 1992-2002.](image)

Source: State Statistical Committee (Goskomstat)

According to estimates of Johnson, Kaufmann and Shleifer (1997), unofficial economy represented 42 percent of GDP in Russia, 49 percent in Ukraine, and over 60 percent in Azerbaijan and Georgia in 1995, while Poland recorded one of the lowest shares (well below 20 percent). 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 comparing to mid-1990s (as result of labor market rigidities, high taxes, and increasing overregulation) and 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. Labor moved to low-productivity services. Together

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3 Hidden unemployment has been estimated in Russia at 8-25 percent 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 has combined work in formal and informal sectors.
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 labor market is more flexible de facto (not necessarily de iure) what is demonstrated, among others, by higher actual nominal wage flexibility.

**The Role of SME and FDI**

The experience of 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 process and removing structural distortions inherited from a command economy.

The stylized picture of a two-sector economy well illustrates the first decade of transition in Central Europe and Baltic region. One part of the economy, mainly SOEs in heavy and military industries, big industrialized construction, and often socialized 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 enables 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.

The analysis conducted in the previous subsection allows to speak about the limited role of the newly created private firms in fostering economic recovery in Russia, due to overregulation and poor business and investment climate (see Section 5). The poor employment statistics is additionally confirmed by equally unsatisfactory contribution of small firms to total value added. The gap between Poland and Russia is even bigger.

In 2002 Russia’s per capita cumulative FDI inflow was 7 times lower than in Poland. Most of FDI came to oil sector and other natural resource sectors. Moreover, through all the transition period Russia suffered a substantial capital outflow. The prosecution against biggest Russian oil company YUKOS in 2003 may only encourage further capital outflow.

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.

**The role of energy sector**

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/d (EIA, 2003; see also Figure 9). The energy accounted to around 20 percent of Russian GDP in 2002, and the energy sector generated up to 40 percent 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 positions, and decrease social costs of a reform package implemented in the beginning of 2000s. On the other hand, it decreased incentives to reform ineffective public services such as national defense, police or other law-enforcement agencies. It also allowed to finance the Chechen War II without visible negative consequences for fiscal balances. Deterioration of non-oil fiscal balances in the beginning of 2000s (reflecting a trade-off between a real fiscal adjustment and consuming ‘windfall’ oil revenue) is well illustrated in Figure 10.

**Figure 9: Russian oil production and consumption, 1992-2002**

![Russian Oil Production and Consumption, 1992-2002](source:EIA)

If Russian transition followed the Polish (other Central European) 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.

Poland had one of the most energy-intensive economies among the countries of Eastern Europe and heavily relied on the 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 policy of hard budget constraints pushed Polish economy to 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.

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 reversal of 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).
Export and import dynamics and structure, the role of European integration

Comparing 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 11 shows that in the second half of 1990s and early 2000s export dynamics of Poland systematically outpaced that 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 11: Export and import dynamics in Poland and Russia

![Graph showing export and import dynamics in Poland and Russia](image)

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 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 12b). Poland, on the other hand, had been increasing its export primarily due to manufacturing industry products (see Figure 12a), including the increasing share of intra-industry trade with the EU countries. The share of EU market in Poland’s export is stable (ca. 70 percent) and twice higher comparing to Russia where it has decreased over decade of 1990s and contains mainly oil and natural gas. On the import side, there is more similarities between two countries although manufactured goods of the EU origin play much bigger and increasing role in the case of Poland.

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

Let us look briefly 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, restructuring of the 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 (see previous subsection) 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) 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 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 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 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). The European market was always protective against products from Russia and CIS (Aslund and Warner, 2003). The oil was the only good that was welcomed by the European countries, however, its export has been limited by the underdeveloped transportation infrastructure.

**Figure 12a: Sectoral composition of Polish export**
Fiscal policy pattern

Poland and Russia experienced serious fiscal tensions through 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 13) – 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. However, as we discussed in Section 4.3 high oil revenues mask gradual deterioration of non-oil fiscal balances what can become a serious problem when world oil prices go down.

Poland’s fiscal position represented less dramatic fluctuations during the period of 1990s though was never close to balance, i.e. zero deficit. In the early 2000s it started 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 13 and Table 4). It can seriously undermine macroeconomic stability and prospects of the new economic recovery phase observed from mid-2003.

Source: World Bank (2003b)
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 percent. The main fiscal burden comes from excessive social programs what is illustrated in Figure 14 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 responsible for at least part of labor market rigidities and resulting high unemployment rate (see Section 4.1).

**Figure 13: General government balance, percent of GDP**

![General government balance chart](chart13.png)

Source: World Development Indicators Database

Russia represents lower level of fiscal redistribution (of ca. 10 percentage points of GDP) and lower share of social transfers in total budget expenditures (also approximately of 10-11 percentage points of GDP). The latter eases fiscal pressure and redistribution burden (comparing

**Figure 14: Structure of general government expenditure in Poland and Russia, 01**

![Expenditure structure chart](chart14.png)

Source: World Development Indicators 2003
to Poland) but, on the other hand, gives less room for cushioning poverty and income inequalities. The same can said about lower health and education expenditures in Russia.

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 percent, the similar low rate of CIT and the single social tax with a regressive scale.

**Privatization**

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 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 a rapid formal ownership transformation of the Russian economy. However, voucher program had also 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 marginal role of vouchers. Together with the private sector inherited from communist era (ca. 25 percent of GDP in 1989, including agriculture) and rapid development of new private firms (see Section 4.2) it gave eventually the similar summary picture as 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 retained a substantial amount of share holdings, which were 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 temporary held by the state.

**Social dimension of growth patterns**

This section intends to 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 live 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.

**Household consumption**

As real wage and real income dynamics involve several methodological weaknesses, the dynamics of household consumption seems 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 15. Household consumption per capita in Poland and Russia**

![Household consumption per capita in Poland and Russia](image)

Source: World Development Indicators 2003

We can see from **Figure 15** that both Poland and Russia started their transition with approximately the same level of household consumption per capita. However, the transformation in Poland went together with increase in per capita consumption when 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.

**UNDP Human Development Index**

Among many composite indices of quality of life developed throughout the past two decades 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 1**, 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 CEB 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 1**, including Russia.

**Table 1: Human Development Index Trends 1985-2001**

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<td>0.781</td>
<td>0.738</td>
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</table>

Source: HDR (2003)

**Income inequality – general picture**

Majority of post-communist countries, including Poland and Russia started its transition with some of 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 2**). 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 2: Transition countries: Gini coefficient of income per capita

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<td>0.320</td>
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</table>

Notes: (a) - unless indicated otherwise, estimates are based on interpolated distributions from grouped HBS data, reported to the MONEE Project; (b) – HBS data; 1997-98: Flemming and Micklewright (1999, Appendix B), 1999-2001: www.worldbank.org/research/transition/heididata/Ydata.xls; (c) - IRC estimates from RLMS, rounds 5-10.


Today, Russia ranks among the world’s highest levels of inequality, resembling the level of inequality typical for many developing economies with relatively inegalitarian distributions of income (see Svejnar, 2004).

Table 2 might suggest that in 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 continue 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

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4 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)
Russia in the years of economic recovery. These doubts are related, in first instance, to official methodology of weighting and aggregation of regional data in Russia.

According to Shaviakov and Kiruta (2003) empirical research, 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 percent of the total growth of wages in 2000-2002 was concentrated within 10 percent of the highest-paid employees (10th decile group), and over 60 percent of the wages’ growth – within the 5th quintile group of employees. At the same time, the 1st quintile group (20 percent of the lowest paid) benefited from less than 3 percent of the total wages growth (Sheviakov and Kiruta, 2003).

Opposite to Russia and CIS, the increase of Gini coefficient in CEE countries was relatively modest. In Poland where the growth in inequality was more pronounced, the distribution of income remains fairly egalitarian, comparing to Russia. However, alternative methods of computing Gini coefficient (based on consumption instead of income) shows a more moderate trend of inequality growth on Poland.

Analysis of the distribution of total income by quintile income groups of population\(^5\) allows for another comparison of income inequalities in the two analyzed countries and their dynamics. As it is demonstrated in Table 3 in relation to each quintile group and cumulatively in the graphical form (a so-called Lorenz curve) in Figure 16 income inequality is higher in Russia, comparing 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.

**Table 3: Income distribution by quintile income groups in Poland and Russia**

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>I (lowest)</td>
<td>6.8</td>
<td>5.5</td>
<td>7.6</td>
<td>6</td>
</tr>
<tr>
<td>II</td>
<td>12.5</td>
<td>10.2</td>
<td>12.0</td>
<td>10.4</td>
</tr>
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<td>III</td>
<td>16.8</td>
<td>15</td>
<td>15.4</td>
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<td>IV</td>
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<tr>
<td>V (highest)</td>
<td>41.8</td>
<td>46.9</td>
<td>44.7</td>
<td>47.6</td>
</tr>
</tbody>
</table>

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

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

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\(^5\) Distribution by decile groups was unavailable for Russia
Russia, and decreased slightly in Poland by the end of 1990s, and this result is consistent with different measures or inequality.

**Figure 16: Lorenz curve for quintile income groups in Poland and Russia, 1995 and 2000**

![Lorenz curve graph]

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

**Factors potentially influencing income inequality**

The main factors influencing income inequality in Russia and Poland are:

- Increased inequality of wages significantly contributed to higher income inequality in all transition countries but particularly strong in the case of Russia

- Efficacy of social policy and social transfer system. Social transfers in Poland improved economic conditions of families in need. However they did not guarantee eradication of poverty. In Russia the overall size of social transfers has been much lower not necessarily as a result of the conscious policy choice but mostly due institutional inability to improve tax collection. In addition, there is little doubt that their targeting is extremely poor and contributing to increasing income inequality in Russia rather than reducing it

- 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.
Poverty scale and dynamics

General conclusion coming from poverty analysis 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.

Poverty rates in Poland recorded 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 scale of poverty has been systematically growing over the transition period, even in years of fast economic growth. This kind of conclusion seems to be consistent with increase in the Gini coefficient (see Table 2).

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 percent (Mozhina, 1995)\(^6\) up to about half of the total population (Ovcharova, 2003) - 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 been also 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 the case of Russia having job does not guarantee, in many instances, from impoverishment: employed persons account for about 40 percent of the total number of poor (Surinov, 2001).

\(^6\) In the Soviet era it was generally recognized that about 10 percent of the population were living in poverty, although some estimates put this figure as high as 15 percent.
Table 4: Factors influencing inequality and poverty in transition countries, as percent of total inequality, 2000

<table>
<thead>
<tr>
<th>Factors</th>
<th>Bulgaria</th>
<th>Hungary</th>
<th>Poland</th>
<th>Romania</th>
<th>Russia</th>
<th>Slovakia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Region of residence</td>
<td>13.8</td>
<td>7.8</td>
<td>9.8</td>
<td>12.1</td>
<td>22.2</td>
<td>15.4</td>
</tr>
<tr>
<td>Type of settlement</td>
<td>11.2</td>
<td>6.5</td>
<td>8.9</td>
<td>17.2</td>
<td>11.2</td>
<td>22.5</td>
</tr>
<tr>
<td>Education</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Considering the structural features</td>
<td>6.9</td>
<td>10.4</td>
<td>5.3</td>
<td>8.3</td>
<td>11.1</td>
<td>8.4</td>
</tr>
<tr>
<td>Without considering the structural features</td>
<td>6.2</td>
<td>13.6</td>
<td>11.9</td>
<td>11.8</td>
<td>19.2</td>
<td>9.2</td>
</tr>
<tr>
<td>Number of children per working member of the household</td>
<td>6.9</td>
<td>6.5</td>
<td>12.5</td>
<td>9.5</td>
<td>11.1</td>
<td>2.8</td>
</tr>
<tr>
<td>Size of the household</td>
<td>3.4</td>
<td>3.9</td>
<td>17.8</td>
<td>9.5</td>
<td>3.2</td>
<td>7.4</td>
</tr>
<tr>
<td>Gender composition of the household</td>
<td>12.0</td>
<td>5.2</td>
<td>6.2</td>
<td>7.0</td>
<td>2.4</td>
<td>9.8</td>
</tr>
<tr>
<td>The age structure of the household</td>
<td>6.0</td>
<td>5.2</td>
<td>1.8</td>
<td>5.1</td>
<td>7.9</td>
<td>4.2</td>
</tr>
<tr>
<td>Employment</td>
<td>13.8</td>
<td>6.5</td>
<td>15.2</td>
<td>15.9</td>
<td>1.0</td>
<td>7.4</td>
</tr>
</tbody>
</table>


In both countries there is a high degree of correlation between poverty and a place of family residence (see Table 4): 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 comparing to Poland.

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 1990s.
According to RLMS (2003), at the end of 2002 23 percent of employees suffered from wage arrears (most of them two months or less), a considerable reduction from the November 1998 rate of 64 percent. 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 a bigger actual role of a labor law and its enforcement and strong position of trade unions.

A low effectiveness of social security services 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 percent of the total money income of the Russian population and 7.8 percent of GDP. At the same period, all social benefits accounted for merely 2 percent of total money incomes and for 1.1 percent of GDP (Goskomstast, 2002). For comparison, overall social transfers in Poland accounted for 23.4 percent of the total population money income (social benefits – 3.4 percent), and for 17.5 percent of GDP.

Both in Poland and in Russia pensions account for about 80 percent 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 percent of the pensioners’ subsistence minimum; by 1998, this ratio was reduced to 48 percent and reached its lowest point (45 percent) in 1999. The average pension size amounted to 94.9 percent of the subsistence minimum in 2001, and reached 102.1 percent 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, comparing to Poland. Automatic indexation being beneficial for maintaining a real purchasing power of pension benefits has, however, negative fiscal consequences. In spite of very high social insurance contribution in Poland, approaching the level of 50 percent 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 entitlement 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 percent 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 it shown in Table 4 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 4 gives only a very rough and imperfect picture of this phenomenon.

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 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 bases 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 became a crucial condition of 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. The 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 (comparing to pre-transition period) can be seen as an 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, what 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 the 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 group 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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