

Institutional Change in Transition Economies



Transition
and
Development

Edited by
Michael Cuddy
and Ruvin Gekker

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Edited by
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Introduction

By institutions the new institutional economics understands the rules of the game in a society (see D. North (1990, p.3)). These rules or mechanisms could be formal or informal. Economic transition from a centrally planned economy to a market economy involves a replacement of one set of institutions and mechanisms, namely such institutions of a command economy as Gosplan, Gosstat, Gosstroiz etc with all allocative decisions made by planners, with another set of market institutions and mechanisms. Originally it seemed that such a replacement could be easily achieved by simply introducing the familiar market mechanisms such as price and trade liberalizations, currency convertibility, privatization etc. The implicit assumption was that the demise of a centrally planned economy would automatically wipe out all its institutions and rules. However, “although formal rules may change overnight as the result of political or judicial decisions, informal constraints embodied in customs, traditions and codes of conduct are much more impervious to deliberate policies” (D. North (1990, p. 6)). The new institutional economics emphasizes that these informal constraints and mechanisms have a tendency to survive a radical change or revolution precisely because they still help to resolve some basic exchange problems among the agents in the economy. This importance of informal mechanisms is crucial to understanding economic transition in Russia and other countries of Eastern Europe.

The present collection of papers is based on the workshop *Institutions and their Change in Transition Economies* which was held in July of 2000 at the National University of Ireland, Galway. The workshop attracted leading experts in transition economies from the United States, United Kingdom, Russia and Ireland. The participants focused their attention on institutional changes in transition economies, which have been occurring over the last decade. In particular, they concentrated on an ongoing tension between informal constraints and mechanisms and the new formal rules and mechanisms that have gradually evolved through the transition period. Experiences are drawn, primarily, from Russia. The papers are grouped into three sets. The first set, Part I, analyses, synthesises and provides some generalisations on the institutional adaptations, as a market economy slowly emerges in a fog of shifting rules and varying interpretations. The second set, Part II, analyses the behaviour of business and the taxation authorities as they try to minimise and maximise the taxation take, respectively. The third set, Part III, sets out the challenges facing the central and regional governments in delivering equitable public service levels across regions of vastly different economic levels, while, at the same time, trying to stimulate regional economic growth, so that each region might make its fair contribution to the national cake.

Part I: Institutional Changes in The Russian Economy opens with R.E. Ericson's paper “The Russian Economy: Market in Form, but ‘Feudal’ in Content”. He emphasises the pivotal role of the institutions, in particular the political and legal

environment in determining the evolution and performance of the market economy. The current institutions in all societies, normally, evolve over centuries. However, that evolution was abruptly and radically altered in Bolshevik Russia to support the autocratic and centrally planned system. A new direction was once again taken in the 1990s with a decision to move to a democratic market driven economy. Dismantling of the centrally planned system and effective removal of central control combined with price liberalisation and removal of state controlled bodies gave the semblance of a market system economy, but without the supporting institutions. What has emerged is ostensibly a market system but with exchange relationships and networks dominated by those of the old regime. They are controlled by local and regional elites, who have now usurped local powers in the absence of central control. In exchange for the maintenance of artificial borders to these local virtual fiefdoms and the right to participate in economic exchange, local enterprises must pay a seniorage to the local power brokers, the local authorities. These contributions are hidden in the intricacy of the issue of permits, licences and taxation concessions, which are exercised and controlled by the local authorities.

A market economy has certain characteristics, which include the voluntary participation of economic agents; the rights and freedom of actions enshrined in property rights; the existence of a 'real' money for exchange and interdependent holding of value; and an interdependent system of flexible, market responding prices. However the new laws and institutions are firmly rooted in content and implementation on the Soviet system, while many of the old industrial sub-hierarchy and the elites, which controlled them, remain effectively in place. Since legal norms are ambiguous and not enforceable in an objective fashion, local politicians and functionaries operate in this twilight zone to interpret, invent and police operational rules for those who are willing to pay the seniorage demanded. Accommodation is easily reached between old partners from the defunct system, the local political elites and the new economic elites.

Two interesting results emerge: (a) Enterprises survive which produce normally unmarketable products but which are exchangeable and usable within an integrated production system of obsolete technologies; and (b) Through this internal trade and mutual concessions between the local administration and enterprises, public services are maintained. Thus local employment and public services are maintained at the expense of economic and financial efficiency.

Ericson schematises this system into what he calls "industrial feudalism". The social, economic and political organisation of production is akin to that of medieval Europe, except that industrial rather than agricultural produce dominates and thus 'industrial feudalism' is the model which best describes current relationship between the local political and the local production elites. There are a number of core attributes. There is an absence of or weak central control, which has been usurped by local political elites. There are diffused property rights and a weak appeal system, which must defer to the local controlling power. There is a mixing of public and private roles of political elites, sustaining economic and social activity, while providing handsomely for themselves and theirs from the fruits of local value added.

Having created quasi dependence on the state at all levels, it is not surprising that the various socio-economic factors should continue to look to the state to resolve all problems. Having passed economic resources to enterprises, it is also not surprising

that the government should look to enterprise for the financial resources for its political and social activities. So regional governments have set about managing their regions, protecting them from outside competition and extracting the price of operations from compliant enterprises. Local self sufficiency and controlled trading and investment relationships with outside entities have ensued. The disquieting aspect of this activity is the extent to which private gain is the objective of, or is extracted from, it.

There is a dichotomy of market structure in Russia today. First, there is a relatively flexible and unimpeded structure in new areas of economic activity or areas, which were not well developed under the soviet system, for example, new financial instruments, retailing of imported goods, food and final industrial products and for exported commodities. Second, there are the other economic sectors consisting mainly of intermediate inputs into the production process, which are predetermined by non-market forces. In this network of economic interactions, economic efficiency has little meaning. This second set exploits the dysfunctional capital market and low inter-enterprise labour mobility, while the transactions are carried out in a fog of unequal barter trading, hiding cross subsidisation and tax concessions and transfers between enterprises and public authorities.

The failure to expose vast parts of the Russian economy to market forces has left it with an industrial structure not too different from the Soviet period and certainly one that in a market economy would not be sustainable. It was not monetised or exposed to economic valuation or opportunity cost and was thus riddled with economic inefficiencies. In addition it incorporated many social services provided by way of income in kind to workers. Few of these enterprises, which remain relatively unchanged, would survive exposure to market competition. At present, there is an interlocking system of firms, liaising with the local authorities, where transactions are carried out using barter and deferred payments with each other and tax deferrals with the local authorities. Real prices reflecting real input/output relationships are obfuscated. Costs are covered by non-market prices and subsidies through an opaque system of transfers from the more to the less efficient and lubricated/facilitated by the local authorities as intermediaries. The local development of the financial sector (under the patronage or franchise of the local authority), linking intricately to the local enterprise (local equity holder) has added to the flexibility and sustainability of the system and its enterprises.

Although Ericson postulates three possible future directions for the Russian economy, namely, a return to state authoritarianism, feudal conflicts and alliances leading to increased stability or an evolution towards a real market environment, President Putin has signaled a move toward the third option. He is moving carefully toward fulfilling at least some of the market requirements. He is re-establishing central control and insisting on the subservience of local authorities in the discharge of duties and responsibilities assigned to them. He is insisting on the uniform enforcement of federal legislation, including those governing property rights, throughout the Federation and the separation of political from economic interest and the public from the private interests of elected representatives. He is pushing for transparency in inter-enterprise and local authority dealings and the dissolution of non-viable enterprises, while securing definite access to the tax liabilities of the viable enterprises.

The future success of the Putin policy will hinge critically on the clarity of communication and the degree of “enforced” control in the descending power structure in the discharge of public responsibility. A call for patriotism where private interests are sacrificed for the public good, which was so well responded to in the past, is deeply needed at this time.

Corruption and organised crime, which normally arouses so much disdain in modern society and which now appears so endemic in Russian society in transition, at least according to the popular western media, is treated in robust and realistic terms by J. Leitzel in his paper “Corruption and Organized Crime in the Russian Transition”. He sets a framework for discussing this topic. He also sets out a precise definition of corruption and its evolution over time, in particular the popular association of corruption with the transition economy, the possible advantages (as well as disadvantages, which are already quite well rehearsed) and possible approaches to dealing with the issue.

He confines the definition of corruption, in the present discussion, to the misuse of public office for private use. This may be linked to, or supported by, organised crime for mutual benefit. There is nothing especially new in this in modern industrialised societies. He interrogates the term transition and concludes that the objectives and process of transition are reasonably clear but that the starting point is far less obvious. He argues that certain costs, which have been identified with transition, are not new at all, but that covert activities in the Soviet period have been brought out into the open. Bribery and extortion were an intrinsic part of the Soviet economy. For example, since the managed demand and supply of goods was in disequilibrium, an active black economy was bridging the gap, to which the authorities turned a blind eye but which, inevitably, had to be paid for by bribes. Also, in getting access to the legally allocated inputs, which were decreed for enterprises in fulfilling quotas, bribes were a common means of lubricating the process.

He also suggests that some of the new costs identified with transition are indeed the results of partial or inadequate reforms. Legislation governing property rights is often ambiguous and left to the interpretation of local authorities. The latter also retain considerable discretion over the rules regarding the licence to operate locally, while effectively controlling local real estate markets. Hard budget constraints led to the destruction of social enterprises, while excessive taxation, extortion and protection rackets prevented the development of small enterprises. The liberalisation of international trade in natural resources led to various rent seeking activities linked to protection rackets.

Protection rackets are, generally, associated with poorly resourced policing. However, they are also linked to the demise of the communist party, which was the power base, which controlled illegal payments in the old system. The vacuum created was disputed territory for control of who to pay and for what. This vacuum has been filled by organised crime, which has thrived on old connections. The increased market activity has created additional targets from which to extract revenue.

Finally, Leitzel challenges whether changes during transition can be measured according to western criteria, in the context where the market is trying to break out, as against a context where the market has been evolving over a very long period. For example, in developed industrial society when we examine the impact of a monopoly

the comparison is with a competitive situation; however in Russia, it makes little sense to compare it with a competitive situation, since such an environment does not and did not exist. In general, the norms, which are accepted in advanced industrial market economies, are not the current norms in Russia.

Leitzel argues that in addition to the negative aspects of corruption that there are also positive aspects, which should not be minimised and that instead of focussing on the elimination of corruption, policy should be one of harm limitation. Corruption facilitates greater flexibility in the system, thus lowering the existing level of inefficiency. It enables socio-economic actors to circumvent bad rules, in particular to evade inefficient taxes. It offers an incentive to officials to make the system work. It allows contact between socio-economic actors and government and provides feedback to policy makers to reshape alternatives to the existing inefficient rules.

Leitzel is optimistic about the future evolution of the market environment in Russia. To support his optimism, he cites the general desire to abandon the unpleasantness, particularly by those who have been successful (by fair or foul means). They wish new effective legislation/rules to be implemented. He also sees the present level of disorganisation of corruption and crime as analogous to that of the communist party before its demise. and so feels that it can be eventually eliminated. However, he cautions against a crackdown, since the outcome is too unpredictable, given the ambiguousness and ubiquity of corruption and associated crime. He sees corruption as being positively related to the concentration of power and the level of discretion associated with this power, and negatively related to accountability. Corruption may be reduced, therefore, by addressing the elements in this equation, namely, the limitation of the power of local authorities, restructuring the power and discretion of officials and increasing the accountability of both. The development of civil society through non-governmental organisations would greatly assist this evolution in demanding greater transparency in local government and its activities. The continuing liberalisation of society, more effective policing and enforcement of legislation and, above all, a commitment by politicians to the rule of law would create an environment more compatible with the market requirements.

V. Popov in his paper "Strong Institutions are more Important than the Speed of Reforms" challenges the debate on whether shock therapy or gradualism is more likely to be effective in bringing about reform. He argues that the debate is wrongly focussed and that it is the strength of institutions rather than the speed of reform, which is critical to the success of the transition process. His supporting evidence comes from an econometric study carried out on 28 transition economies in Europe, Asia and Africa. The key element in his analysis is the decoupling of production decline and production expansion during transition. Production decline comes primarily from an initial distortion in the production mix and international trade. Production in centrally planned economies is biased against consumer goods and so liberalisation in production and expenditure, combined with a reduction in state expenditure, leads to a drop in production. On the other hand, institutional flexibility, in facilitating the re-allocation of production factors to the expanding sectors in transition, is key to increased output and thus to the speed and success of reform. Increased supply depends on the ability of business to induce real assets and labour away from activities of

declining demand, to be able to support this through access to the financial means and to have the legal and physical protection to ensure the integrity of the business activity.

It is well known that informal rules and mechanisms played a very important role in the Soviet system. The managers in a command economy developed a great variety of informal devices to cope with uncertainties and tautness of a planning process. In fact, during perestroika the role of these informal mechanisms was greatly enhanced due to the demise of some institutions that used to put some constraints on them. It is natural then that during transition many managers have continued to rely on the informal networks and mechanisms that they previously built. C. Gaddy and B.W. Ickes in their paper "An Evolutionary Analysis of Russia's Virtual Economy" show that this reliance on informal networks or mechanisms was a natural adaptive strategy for many enterprises to survive a so called shock therapy. Shock therapy was supposed to introduce hard budget constraints. Hence those enterprises that utilized such survival strategies as barter, tax offsets or tax arrears, could be less affected by the shock. Naturally other enterprises could also imitate behavior that they would perceive as being successful adaptation to the shock. Therefore, these adaptive or 'virtual' strategies will rapidly spread in the system. In fact, by utilizing a simple evolutionary model, Gaddy and Ickes show that such a virtual economy where all enterprises choose virtual strategies can be evolutionary stable. In this simple model all enterprises can choose among three strategies: M (Market), V (Virtual) and S (Soviet). Let $\pi(i,j)$ be the payoff to an enterprise choosing strategy i when all other enterprises choose strategy j ($i,j = M,V,S$). Gaddy and Ickes assume that the payoff to being a market enterprise is the greatest when other enterprises also choose M, and it is lowest when other enterprises choose S. They also assume that an economy fully populated by Soviet-type enterprises is least efficient, while the market economy is most efficient.

Hence we have:

$$\pi(M,M) > \pi(V,V) > \pi(S,S)$$

and also:

$$\pi(M,M) > \pi(M,V) > \pi(M,S)$$

$$\pi(V,V) > \pi(V,S) > \pi(V,M)$$

$$\pi(S,S) > \pi(S,V) > \pi(S,M).$$

The following payoff matrix is consistent with the authors' assumptions above:

	M	S	V
M	5	0	3
S	0	3	1
V	2	3	4

where the numbers are payoffs to a row strategy against a population of column strategies. Therefore, $\pi(V,V) = 4$, $\pi(M,M) = 5$, $\pi(S,S) = 3$, $\pi(M,V) = 3$, etc.

Gaddy and Ickes argue that $\pi(V,V) > \pi(M,V)$ due to the fact that when a market enterprise operates in an economy dominated by virtual enterprises it is under threat because of the fiscal pressure from the government. Notice also that while the authors treat the payoffs from (M,S) and (S,M) symmetrically (that is, $\pi(M,S) = \pi(S,M)$), they do not treat symmetrically the payoffs from (V,S) and (S,V) (that is, $\pi(V,S) \neq \pi(S,V)$). However, it is easy to check that if we will use the alternative payoff matrix:

	M	S	V
M	5	0	3
S	0	3	1
V	2	1	4

Then we still will have three pure strategy equilibria in the game: (M,M), (V,V) and (S,S). Hence the behavior will remain similar since we still have two basins of attraction (for an illustration see Figure 2 of the paper). One is the market economy (M,M) and the other is the virtual economy (V,V). In fact, given the replicator dynamics in their paper, the authors' result is robust with regard to various permutations in the payoff matrix. Hence when most enterprises are M, then being a market enterprise will dominate being a virtual one. However, if there is a sufficient mass of non-market enterprises, then it will pay to be virtual. It should be pointed out that if we assume that virtual enterprises are more likely to interact with other virtual enterprises, then the virtual trap could be more easily achieved compared to the case of random interactions.

The informal rules and mechanisms were present in all transition economies. The important difference between Russian economy and some successful Central European Economies (CEE), according to Gaddy and Ickes, is this. In the case of Russia, the energy and resource sectors made it possible for a large share of enterprises in the industry to survive through adaptation of informal rules and mechanisms. In the case of successful CEE, the cut off of the Soviet supplied cheap energy made it more difficult for the enterprises there to adopt informal rules. Hence the new formal rules and mechanisms could take root there but not in Russia.

V. Mau in his paper "Russia's Economic Policy at the Beginning of the New Phase" analyses the development of the Russian economy as enunciated in different planning documents under the reign of the new president, Putin. He is optimistic that the various weaknesses identified in the economy à la Ericson and Leitzel and the policy implications emerging in Popov's paper are central to the new policy direction.

Under Putin, political stability, which is the precondition for economic stability and growth is being realised. He has reasserted the supremacy of the central authority; there is harmony between the government and parliament; a clear understanding between the centre and the regions is being established, where the power and responsibility of the latter is clearly recognised. Regional access to central funds, which previously was based on political strength is being replaced by equal access to all regions.

There are however a number of weaknesses, which are critical to the efficient workings of the economic system. Although the Central Bank has played an important role in maintaining the internal and external stability of the rouble, there has been a general failure of the banking system, particularly in its role of inter-mediation between savers and investors. There is, also, a bureaucratic jungle to be negotiated by business in setting up and operating enterprise. This, allied to poor policing and law enforcement, makes it very difficult for enterprise, particularly small and medium size enterprise, to emerge and grow. This is evidenced by the fact that despite the boost to import substitution and exports of 1998 financial collapse, the industrial sector has failed to respond. There had been little increase in investment and minimal foreign direct investment.

New economic policy proposed in the Greff report and the short and medium term policy response from Putin has two principal components, namely, the strengthening and expansion of social policy to underpin the long-term development of the economy and creating the environment for market development. The state will, basically, leave the development of the industrial and commercial services sectors to the private sector and, according to Mau, "comparative advantage" will be established through competition. This is a rather strong assumption of neo-classical economics for which there seems to be no compelling evidence in international economic development. In addition, according to Mau, it is proposed that the development of certain public services, like transport and energy, be left to the private sector. This seems a rather foolhardy suggestion, given the recent experiences in the UK with transport and in California with energy, where the private sector has failed to deliver essential public services in a manner acceptable to the demands of the economy. These experiences are in countries where the private sector is at a rather mature state, in contrast to Russia where it is still in its infancy.

There is, thus, a very strong emphasis on social policy and creating the market environment for enterprise to develop but there is insufficient emphasis on how the value added is going to be generated to finance these policies. The industrial plan is weak or non-existent and there is no attempt at preparing an industrial operational programme. Industrial sectors are not prioritised. The role of the state in key industrial sectors is not elaborated. However, the role of the state, in transition Russia, must continue to be large. Private enterprise will have extreme difficulty in providing the necessary investment in the absence of developing financial and stock markets. Even if these markets were developed, some privileged incentives would be necessary to move investment in the desired direction. The private banking sector will not, however, be able to finance business investment in the short to medium term, so the state must have a significant role in the whole inter-mediation process.

The creation of competitive advantage must be assisted by public policy – government must draw up an indicative plan, however rudimentary, identifying those sectors which are essential to the future development of the economy, and support private research, development, technology and trade in these sectors. The state must also be significantly involved in investment to finance economic growth. This policy has been successfully implemented by the newly developed economies and was central to the success of the longer established developed economies. Active economic development policy is called for where the institutional environment is essential – here

the emphasis on legal enforcement and decrease in bureaucracy as enunciated by Putin is a welcome direction – but for now it is insufficient to launch the economy onto the path of economic development.

Part II: Taxation in Transition Economies consists of three papers. R. Gekker in his paper “Soft Budget Constraints and Tax Arrears in Transition Economies”, utilizes Kornai’s concept of soft budget constraints (SBC) to provide an analytical explanation of tax arrears in Russia. According to Kornai, a paternalistic state is the cause of the SBC. The paper introduces some simple dynamic models that account for the existence of the SBC in transition economies. The author uses the definition of SBC as ex-post tax subsidies paid by the state to loss-making enterprises in transition economies.

It should be pointed out that big Russian firms simply reproduce a hierarchical system of bargaining with the state that was typical for the Soviet type economy. The bargaining occurs after firms have already accumulated their tax debts. Quite often the firms might also accumulate wage and interenterprise arrears. Many of these enterprises should be declared bankrupt. However, the implementation of bankruptcy law was neglected in Russia. As a result, the manager of the firm who typically is not its owner, is able to transfer valuable assets from the firm to his privately owned affiliates. Tax arrears, tax offsets, barter and wage arrears make firm’s accounting non-transparent and facilitate the transfers of financial assets and valuable inputs.

A simple sequential game describes a bargaining between the government and the firm. The author assumes that the government maximizes both its tax revenues and the private benefits of the firm, that is, that the government is paternalistic. On the other hand, firms maximize only their private benefits. A soft budget constraint exists if tax arrears are tolerated by the government. Proposition 1 then establishes the existence of the SBC under certain parameters in the model.

It should be pointed out that the existence result of Propositions 1 applies only to firms that are in financial distress. R. Gekker then examines another sequential game where the managerial effort supplied could successfully restructure the firm. Without such effort, however, the firm will remain unstructured and will continue to produce old goods. Proposition 2 establishes the existence of the SBC in this model and it also answers the question under what parameters in the model the firm will choose to restructure.

In his paper “The Tax System and the Peculiarities of the Russian Economy” M. Alexeev examines how tax evasion, corruption of tax administrative officials and widespread use of non-monetary means of payments and payment arrears affect the functioning of the Russian tax system. The author emphasizes the effects of the tax system’s response to the above peculiarities on the economy at large.

In Section 3, Alexeev sketches an argument that shows the problem with a possible misperception on the part of the government about the extent of the tax evasion in the economy. For example, the problem with the overestimation of the degree of tax evasion is that there is no reliable feed back to correct the misperception leading to suboptimal outcomes.

Suppose there are two groups of taxpayers: one group consists of intrinsically honest taxpayers ($e_i(k) \equiv 0$ for all k for $i \in H$), where H is a set of honest tax-payers,

and $e_i(k)$ is the amount of effort used by a risk neutral taxpayer to evade tax given the intensity of anti-evasion requirement k). The other group of taxpayers is characterized by $e_i(k) = e(k) > 0$ for all relevant k , $i \notin H$. Also assume that the honest taxpayers represent certain proportion v of all taxpayers in the economy. Then the socially optimal value of k could be found by solving:

$$\text{Min}_k \{(1-v) e(k) + C(k)\},$$

where $C(k)$ represents the purely administrative compliance cost that anti-evasion requirements impose on the taxpayers.

The first-order conditions for this minimization problem are:

$$\partial C / \partial k = -(1 - v)e'.$$

Differentiating the above expression with respect to v and solving for $\partial k / \partial v$, we have:

$$\partial k / \partial v = e' / (C'' + (1 - v)e'') < 0,$$

that is, the optimal value of k is inversely related to v . Hence, if the government underestimates the proportion of honest taxpayers in the economy, it would set the intensity of anti-evasion requirement k higher than it is socially optimal. It should be pointed out that the increase in k may reduce the number of honest taxpayers in an open economy, because k may raise the honest taxpayers' costs above the world market price of the good. In that case then the government's initial misperception that everybody in the economy evades may become a self-fulfilling prophecy.

Alexeev believes that the Russian tax policy makers view virtually all entrepreneurs as tax evaders given the slightest opportunity for evasion. However, if this view is not correct, then the intensity of the anti-evasion measures in the Russian tax law and administration could be greater than it is socially optimal.

In section 4 and 5 the author outlines various measures to fight corruption in tax administration and also the spread of payment arrears (PA) as well as non-monetary means of payment (NMMP) in the Russian economy. For example, he argues that the reduction of statutory tax burden by itself could be too risky to fight corruption in Russia. It should, then, be accompanied by an increase in collection rate, as well as an increase in the tax inspectors' salaries, in order to prevent a drastic decline in the effective tax burden. The author also suggests the introduction of a system of specialized tax courts that should speed up the tax appeal process. If it is introduced, the system could make corruption more difficult and may create a possibility to improve tax inspectors' incentives by linking their bonuses with the taxes collected.

According to Alexeev a planned switch to the accrual method of accounting may help to combat a spread of NMMP and PA in the Russian economy. He claims that an introduction of accrual accounting will put some additional pressure on the sellers to obtain timely payments for their output and will facilitate the auditing of taxpayers.

He notes that the arguments against the accrual accounting are ironically the widespread use of NMMP and the frequency of PA. The opponents of accrual accounting argue that the introduction of the accrual method would create a cash flow problem and also impose an additional burden on the taxpayers precisely because of the current crisis in PA and the use of NMMP. Alexeev provides a spirited defense of the accrual method although he admits that a set of transition rules might be necessary to spread the shifted forward tax liability over some period of time (say 6–12 months). Another concession is to allow small businesses to continue with the cash method as it is typically done in industrialized countries.

M.E. Schaffer and G. Turley in their paper “Effective versus Statutory Taxation: Measuring Effective Tax Administration in Transition Economies” attempt to measure the effectiveness of tax administration in transition economies (TEs) by comparing statutory tax rates with effective tax yields.

Tax deferrals, arrears, write-offs and exemptions in TEs to a certain degree represent a politicization of the tax system. It is extremely difficult to measure the extent of these government concessions. The authors utilize methodology that allows them to obtain aggregate measures of the degree of effectiveness of tax collection in TEs. The methodology is based on one previously used for measuring fiscal or revenue capacity in federal states. With appropriate modifications, Schaffer and Turley apply this methodology to transition countries rather than to states within a federal system.

To measure the effectiveness of tax administration, the authors introduce two indicators. The first indicator represents the ratio of effective tax to statutory tax. Effective tax rates are the realized average tax rates. Statutory tax rates are the rates that taxpayers are required to pay by law. Let Y be the gross tax base and T be actual tax payments. Denote by t the statutory tax rate applied to gross income. Then the effective tax rate e could be calculated by dividing T by Y . The effective/statutory (E/S) ratio is defined as:

$$E/S \text{ ratio} \equiv e/t \equiv T/tY.$$

This indicator measures the extent to which the statutory tax rate diverges from the effective tax rate. For example, a ratio below 1 indicates that the effective tax yield is falling short of what application of the statutory tax rate would yield.

The authors use national accounts measures of income: for VAT, total national income; for social security tax (SST), income from labor; and for corporate income tax (CIT), income from capital. Of course, these measures provide only rough approximations of the actual statutory tax bases. It also should be pointed out that the national accounts statistics of TEs are not particularly reliable. However, these national accounts statistics are both readily available and comparable across countries.

The second indicator attempts to avoid some possible problems with national accounts statistics. The normal tax yield (NTY) relates tax payments adjusted for cross-country differences in statutory rates to GDP, and is defined as follows:

$$NTY \equiv T/GDP \cdot b/t,$$