

# Globalization and Inequality in CIS Countries: Role of Institutions<sup>1</sup>

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The process of opening and integration into the world economy in the CIS countries has been part of a more complex process of transition from the planned to market economy. Over the last 10 years most of these countries have liberalized their trade regimes versus non-CIS countries, introduced their own currency, and to some extent liberalized flows of direct and portfolio investment. These and other reforms were accompanied by a pronounced output decline, an increase in poverty rates and inequality indexes. Of course, most of these changes in output and income inequality are attributable to the transition process. However, it is still interesting to know whether globalization and trade opening have enhanced or, on the contrary, decreased the negative effect of transition on incomes in transition countries. Comparison of outcomes in various countries suggests that trade policy per se was less important than the ability of governments to enforce it. Countries, where reforms were implemented slowly, but the government institutions did not collapse, experienced smaller overall output decline, and smaller increase in inequality. Countries with weak governments often performed as “passive globalizers”: the trade-to-GDP ratios in them were quite high, partly accounting for capital flight. In contrast to active globalizers, output in these countries declined, while poverty and inequality increased. However, the worst results were seen in countries cut off from international trade, because of being landlocked or at war or in bad economic relations with the neighboring countries.

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## Introduction

The last 15-20 years are often called the years of globalization. Over this period, many countries have dismantled their barriers to international trade in goods and services and financial flows. At the same time, technological progress has led to a serious decrease in transportation costs, and particularly in the costs of information exchange. As a result, the size of the world trade in goods and services has dramatically increased, as have the number and scope of operations of multinational corporations. In the 1990s, financial flows also became globalized, and world-wide mobility of portfolio investment soared. Moreover, globalization became more than a purely economic phenomenon. Not only corporations but also NGOs have started to operate globally in the last 10-20 years.

Globalization has been accompanied by massive changes in economic specialization, income inequality and poverty among and within countries. In developed countries, globalization is often believed to lead to an increase in income inequality between skilled and unskilled labor. This popular belief was questioned by some economists, who argued that an income inequality surge was observed only in the US and the UK, and the differences in labor market reactions to globalization cannot be explained using trade theory arguments. Alternative explanations include influence on inequality of technology progress, or changes on the labor market (Aghion 2001, Atkinson 1999). As regards developing countries, it is not clear how globalization has affected inequality in them. As Dollar and Kraay (2001) show, changes in inequality vary greatly across countries which have stepped up their integration into the world economy over the last 20 years. The effect of globalization on growth and poverty is more clear, though: growth rates in globalizer countries increase with an increase in trade flows, and such acceleration of growth leads to a massive decrease in world-wide poverty.

Transition countries of the CIS were not left out of the globalization process. The Soviet Union was a rather closed economy with a state monopoly on international trade, non-convertible currency and state control over foreign direct investment. Countries which emerged after its disintegration have a much weaker regulation of foreign trade, foreign exchange and foreign capital flows. The breakup of the USSR has brought about an increase in trade, capital flows and travel of individuals from CIS to non-CIS countries, although trade among the CIS countries somewhat decreased. This paper looks at changes in growth, inequality and poverty in the CIS countries to find out whether any of those changes have resulted from changes in trade policy and globalization or have been caused by other factors.

This paper is closely related to two strands of literature: that studying the effect of globalization on growth and inequality,<sup>3</sup> and literature, which tries to answer the question which

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<sup>3</sup> A good summary of this literature can be found in CEPR (2002) and World Bank (2002)

factors – institutions, trade policy, or geography – mainly affect a country’s ability to grow. Recently, Dollar and Kraay (2002) argued that changes in trade policy have a much stronger effect on growth than changes in institutions. Their approach was questioned by Rodrik, Subramanian and Trebbi (2002), who showed that institutions have the largest direct effect on income, while geography and trade affect income mainly via the quality of institutions.

The experience of transition countries seems to suggest that the effects of globalization largely depend on the quality of institutions. The best results among transition countries in terms of growth have been achieved by Central and East European countries, joined by China and Vietnam in Asia. Both sets of countries can be viewed as “globalizers”: they have both reduced trade barriers and secured the world’s highest ratios of FDI to GDP. Asian countries, however, are still relatively closed to international trade and foreign capital flows. At least, the level of protection against imports or of capital controls in China is higher than in Russia, whose growth and poverty reduction performance in the last 10 years has been much more modest than that of China. It is often argued that the decisive factors of success or failure of growth in transition economies during the first 10 years of transition were the quality of government institutions, their ability to prevent disorganization of the economy at the beginning of transition and to guarantee both domestic and foreign investors property rights protection (Blanchard Kremer 1997, Roland 2000, Popov 2000, Sonin 1999, Bergloef and Bolton 2002, Yudaeva et al. 2002). This paper argues that the same factors have affected the ability of transition economies to benefit from globalization.

While in all CIS countries regulation of international trade and capital flows is more liberal than was the case in the USSR, regulations still vary significantly across countries. In Belarus, Uzbekistan, and Turkmenistan there is a variety of non-tariff barriers to international trade, state control over production of and international trade in a number of goods, restrictions on convertibility of local currency and capital flow controls. By contrast, Kyrgyzstan, Georgia, and Moldova are members of the WTO. They have no non-tariff barriers to trade, and tariffs on imports to these countries are very low. At the same time, countries, which pursued more active trade policies, were not the most successful in the first ten years of transition.

The reason behind better performance of less liberal countries seems to be the ability of their governments to prevent their own, and, more generally, economic disorganization. It was mostly slow reformers that managed to do it, but not all of them. In any case, trade policy and globalization by itself were surely a much less important factor of countries’ performance than institutional transition. In the future, when the quality of institutions improves, trade policy may become a more important determinant of economic development. However, geographic location and relationships with neighboring countries also affect this process. For example, Kyrgyzstan, the first WTO member among the CIS countries, and the country known to be a fast reformer, might have been unable to increase its trade flows and attract much FDI in recent years because of protectionists policies of

neighboring Kazakhstan and Uzbekistan and restrictions on transit of Kyrgyz goods imposed by these countries.

What effect does globalization have on countries with bad institutions? Experience of the CIS countries, for example of Russia, shows that they can suffer from “passive liberalization”. Due to the weakness and corruption of customs authorities in such countries, import levels can be higher, and tariff collection lower than the current tariff regime allows. This may result in a substantial increase in trade flows, a part of which finances capital flight. However, in contrast to “active globalizers”, such countries fail to reorient their exports from extractive to manufacturing industries. Weak institutions are also a barrier to FDI inflows, even in the most profitable extractive sectors. Experience of Russia shows that income inequality in such countries may assume enormous proportions because of the increased gap between incomes in exporting and importing industries, which is not compensated by inter-sectoral labor mobility or a well-functioning social security system. As shown by Kolenikov and Shorrocks (2002), such an increase in inequality can lead to a rise in poverty rates. Only countries with strong governments, which can control integration and guarantee protection of foreign investor rights, can benefit from globalization in terms of output growth without aggravating income inequality.

The paper is organized as follows. Section 1 provides a detailed analysis of trade policies, output and inequality in the CIS countries, and argues that trade policy by itself was only a minor factor of output and inequality changes which occurred in the CIS countries in the 1990s. Section 2 uses an example of Russia to show what effect globalization may have on output, inequality and poverty under the conditions of weak institutions. Section 3 refers to cross-regional Russian data to demonstrate that globalization may be beneficial for CIS countries subject to institutional improvements. Section 4 argues, however, that landlocked countries may have difficulty benefiting from liberalization because of their geographic position. Section 5 concludes and provides suggestions for further research in this area.

## **Cross-country evidence.**

In their study of economic effects of globalization, Dollar and Kraay (2001) show that in the last 20 years developing countries which liberalized their trade policy and increased the volume of trade with other countries, have been more successful economically than the countries which continued protectionist policies. Countries, which opened their economies, have experienced an increase in growth rates and a decrease in poverty rates in comparison with the preceding periods. Since the list of these countries includes China and India, globalization has resulted in a massive decrease in the world poverty in the last 20 years. Dollar and Kraay (2001) refer to countries, which opened their economies, as globalizers.

When judged by policy measures taken during the 1990s, most of the CIS countries can also be viewed as globalizers. By 2002 only one country, Turkmenistan, has kept pervasive state control over international trade, and massive restrictions on convertibility of foreign exchange. Two other countries with massive government intervention in international trade activities, and a non-transparent foreign exchange regime are Uzbekistan and Belarus. All other countries have convertible currency and almost no government control over trade flows. Some countries, such as Kyrgyzstan, Georgia, and Moldova, have already become members of the WTO and have very low level of tariff protection. Among the remaining countries, several regard WTO accession as their political priority, lowering their tariff barriers in the last few years. For example, in Russia the average tariff rate was 9.1% in 2000, and in the Kyrgyz Republic - 5.15% in 2001, which is comparable and below the levels observed in countries, classified as globalizers by Dollar and Kraay (2001).<sup>4</sup>

Liberalization of foreign trade policy by the CIS countries was accompanied by an increase in trade flows with non-CIS countries. This increase in trade was often comparable to that seen in globalizer countries (see Table 2). For example, in Russia, the ratio of trade with non-CIS countries to GDP increased from 15% in 1985<sup>5</sup> to about 40% in 1999, while globalizers showed an increase from 16% in 1970 to the average of 33% in the 1990 (Dollar and Kraay, 2001). At the same time, intra-CIS trade dropped drastically (Djankov, Freund 2001). Only in Belarus the share of CIS in total exports increased from 1989 to 2001, while in all other CIS countries it decreased, in some - by more than a half. Some decline in intra-CIS trade was economically rational: in Soviet times the republics of the USSR traded too much with each other, and too little with other countries. However, not in all cases the magnitude and pace of decline were economically desirable. While the decline in the share of the CIS in Kazakh exports from 75% to 26% resulted from reorientation of exports to the West following development of new oil fields and was, thus, beneficial for the economy, this was not the case in Armenia, where the share of the CIS in exports fell from 73% to 37%, and in Moldavia, which showed a fall of the CIS share from 83% to 58% (Table 2.1). Nowadays, most of the CIS countries are quite open both in terms of trade policy and trade flows. Overall, the ratio of trade to GDP in the CIS countries is rather high by international standards (Table 2), often exceeding 100%. The ratio of trade to GDP does not depend on trade policy, however. According to World Bank data, in countries with the most liberal trade policies<sup>6</sup> the average trade in goods and services to GDP ratio in 1999 was equal to 88%, which is slightly lower than the average trade-to-GDP ratio in countries with the least liberal trade policies (89%).<sup>7</sup> The highest ratio of 99% was observed in the intermediate group of countries.<sup>8</sup> However, in 1997-1999 the most liberal countries still had the

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<sup>4</sup> In Table 1 presents classification of the CIS countries' trade policies, as reported in EBRD (2002).

<sup>5</sup> Actually, this is a USSR trade/NMP ratio.

<sup>6</sup> EBRD index 4 and 4+

<sup>7</sup> EBRD index from 1 to 2+

<sup>8</sup> Source of the data: World Bank WDI dataset.

lowest average trade-to-GDP ratio, while the highest ratio was observed in countries with the least open policies. Moreover, two of the three countries with the least liberal policies, Belarus and Turkmenistan, have the ratio of trade in goods and services to GDP above 1, while only one country of the most liberal group shows such a high ratio. The least open country, however, is Uzbekistan, with the trade-to-GDP ratio of 0.37 in 1999. World Bank series of trade in goods and services were not available for years after 1999, and I had to use a somewhat different EBRD series of merchandise trade. EBRD data for 2000-2001 show that the trade-to-GDP ratio in countries with liberal policies decreased further over that period, but increased in countries with non-liberal policies. The average ratios for the three groups of countries for 2000-2001 are as follows: 0.65 in the most liberal countries, 0.95 in the intermediate group, and 1.26 in the least liberal group.<sup>9</sup> Since most of the countries in the most liberal group are landlocked and often surrounded by less liberal countries, the decline in the trade-to-GDP ratio in these countries may result from protectionist policies pursued by their neighbors. Section 4 will consider this subject in more detail.

As mentioned above, in addition to current account liberalization in the 1990s, the CIS countries undertook impressive liberalization of capital account. In the Soviet Union, the national currency was non-convertible, while national currencies of most of the CIS countries are convertible now. The inflow of foreign capital to the Soviet Union was prohibited or at least strongly regulated by the state on a case-by case basis. The first steps to liberalize FDI inflow were taken as early as the last years of the USSR, with most of the CIS countries liberalizing the FDI regime even further. Some legal obstacles to inflows of FDI still exist in most CIS countries, but these obstacles are usually not higher than in countries which have been very successful in attracting FDI recently, such as China. Nonetheless, in terms of attracting foreign direct investment, the achievements of the CIS countries were quite modest by standards of transition economies (Table 3). In 2000 and 2001 net average FDI inflows to these countries were 3.2% and 3.1 % of GDP respectively.<sup>10</sup> This is, of course, much higher than the average for developing countries, but substantially lower than 5.5% and 4.9%, observed in countries of Central-Eastern Europe, and Baltics, and even lower than 3.9% and 5.0% registered in South-Eastern European countries. What is even more worrisome, however, is that most of FDI has gone to oil and gas rich Kazakhstan, Turkmenistan, and Azerbaijan, while FDI inflows to countries poor in natural resource have been quite insignificant.

Portfolio investments in the CIS countries were quite modest. The only country which attracted significant amounts of portfolio investment is Russia. According to Garibaldi, Mora, Sahay, and Zettelmeyer (2002), Russia is the only transition economy, where portfolio investment was higher than direct investment in some periods of the 1990s. Importantly, shares in the largest and the

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<sup>9</sup> In EBRD data the ratio of trade to GDP in Uzbekistan is substantially higher than in World Bank data. Since Uzbekistan has a multiple exchange rate system, the discrepancy may be due to use by EBRD and the World Bank of different exchange rates to construct GDP in current dollars. I constructed GDP in dollars for 2000 and 2001 using GDP in national currencies and average annual exchange rates as reported by the EBRD (2002).

<sup>10</sup> Gross FDI inflows to GDP ratio is somewhat higher: in 2000-2001 Russia made some FDI abroad.

most successful Russian companies are now traded in US markets. Another specific feature of Russia is that in the last couple of years its outward FDI has exceeded FDI inflows.

While trade and portfolio investment in many CIS countries has been quite low, a number of the CIS countries received direct transfers from abroad. In addition to loans and grants from international financial institutions, private transfers were common, at least in some countries. For example, in Armenia a sizable proportion of such grants came from Armenian diaspora in Western countries, but much more often money was sent to their families by labor migrants, who went to work in other CIS countries. While the breakup of the Soviet Union has led to a decrease in trade between the former republics, it has also given rise to this new labor migration phenomenon. Many citizens of the CIS countries, who were unable to earn a living in their own countries, went to other countries of the former USSR, mainly to Russia, where they had better chances of getting a job, although frequently an illegal one. The Russian construction sector attracted most of such cheap labor from the CIS countries. Unfortunately, I am not aware of any reliable estimates of the number of such migrants. There is no doubt, however, that this phenomenon has helped to reduce the poverty rate in some of the poorest CIS countries, such as Armenia, Moldova and Turkmenistan.

As is well known, in the early 1990s all CIS countries experienced substantial output decline. The smallest total decline of slightly more than 16% was registered in Uzbekistan, while the largest decline was seen in Georgia, where GDP decreased by more than 75% over that period. Of course, external liberalization cannot take all the blame for this output performance. External liberalization was only a small part of the multi-faceted process of transition from the planned to market economy, which CIS countries embarked on in the early 1990s. This process involves reduction of the role of the state in all areas of the economy, not only in external relations. Some countries were affected by military conflicts at the beginning of transition, and it is those countries which experienced the deepest decline. The question that is interesting to answer is to what extent globalization intensified or reduced the impact of other factors.

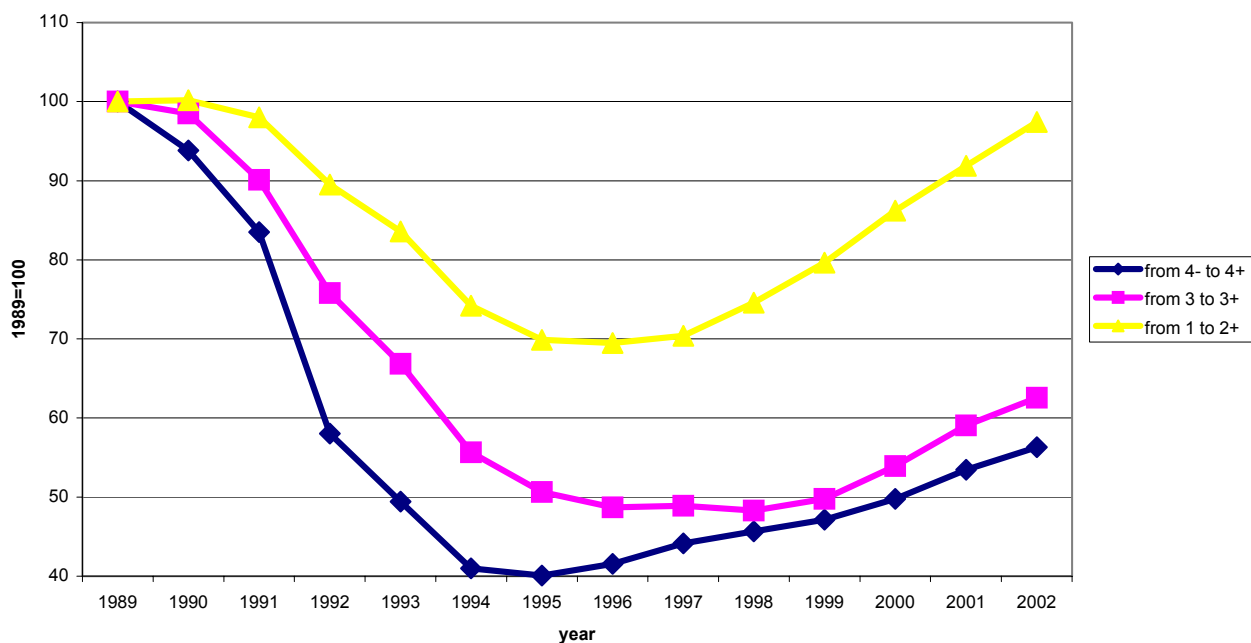
Literature provides several explanations of difference in growth patterns of transition economies. According to the first one, countries with bad initial conditions, i.e. with a lower initial degree of liberalization of the economy, a higher dependence on trade within the SMEA and USSR, and longer years under Communism, experienced a deeper fall in output at the beginning of transition.<sup>11</sup> So, according to this explanation, it is terms of trade shock, which followed installment of barriers to CIS trade, that adversely affected these countries' output. The second set of explanations says that more active reformers were able to return to the growth path faster and to grow faster.<sup>12</sup> So this strand of literature suggests that trade liberalization and globalization positively affect growth of transition economies. Unfortunately, while these two theories may be appropriate for explaining differences between CEE and CIS countries, they fail to explain the differences in

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<sup>11</sup> Campos and Coricelli 2000, De Melo et al. 1997

growth patterns among the CIS countries. Direct comparison of growth performance of countries with different external liberalization strategies suggests that trade policies have so far played a very minor role in explaining differences in growth rates of the CIS countries. Figure 1 shows growth pattern of all CIS countries in the 1990s depending on the EBRD index of external liberalization (index itself is reported in Table 1). The EBRD index refers to trade policy in the early 2000s. I use the index to group countries over the whole period of transition, because the rankings of countries according to external liberalization were more or less stable throughout the transition period. Figure 1 shows that countries, which pursued the least liberal policies, experienced a more drastic output decline and recovered faster than very liberal and modestly liberal countries. The picture does not change much after the exclusion of war-affected countries (Figure 2), most of which subsequently became very liberal, or if analysis is confined to the post-1998 period (Figure 3).

**Figure 1: Growth rates depending on the trade policy index**

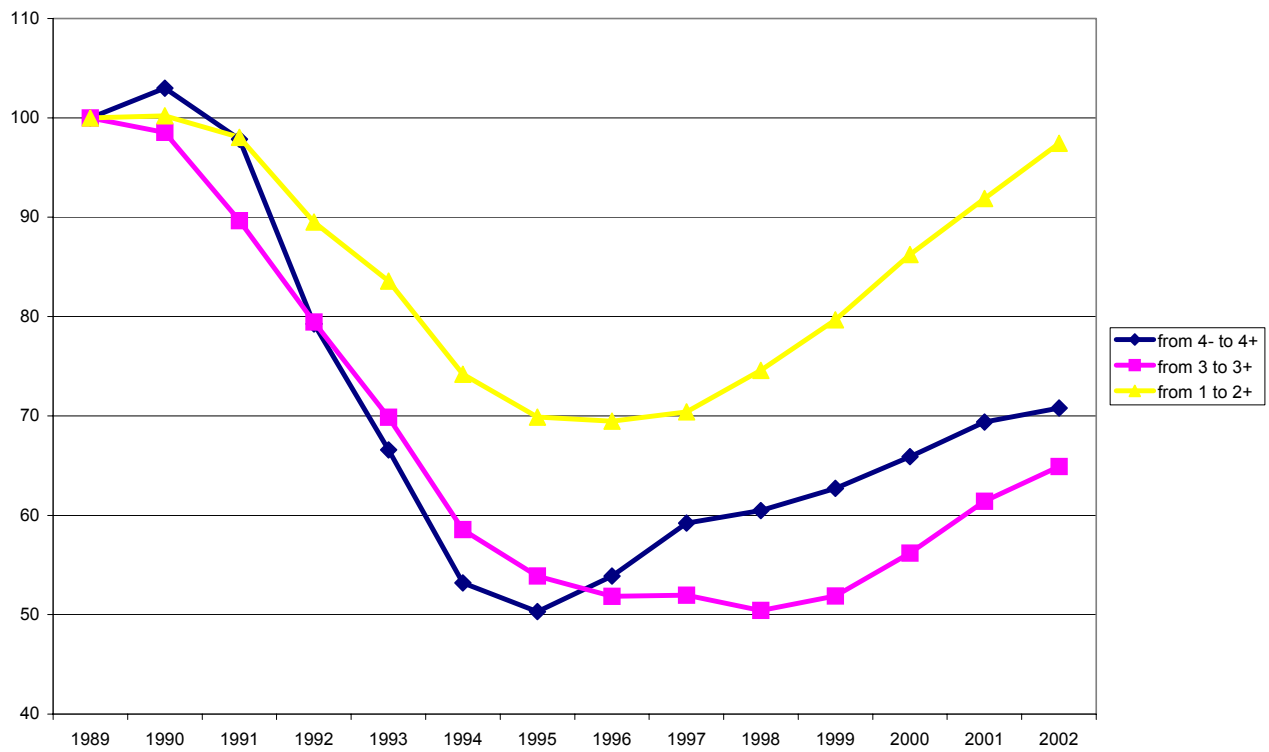


Source: EBRD

**Figure 2: Growth rates depending on the trade policy index. Countries, affected by a war, excluded**

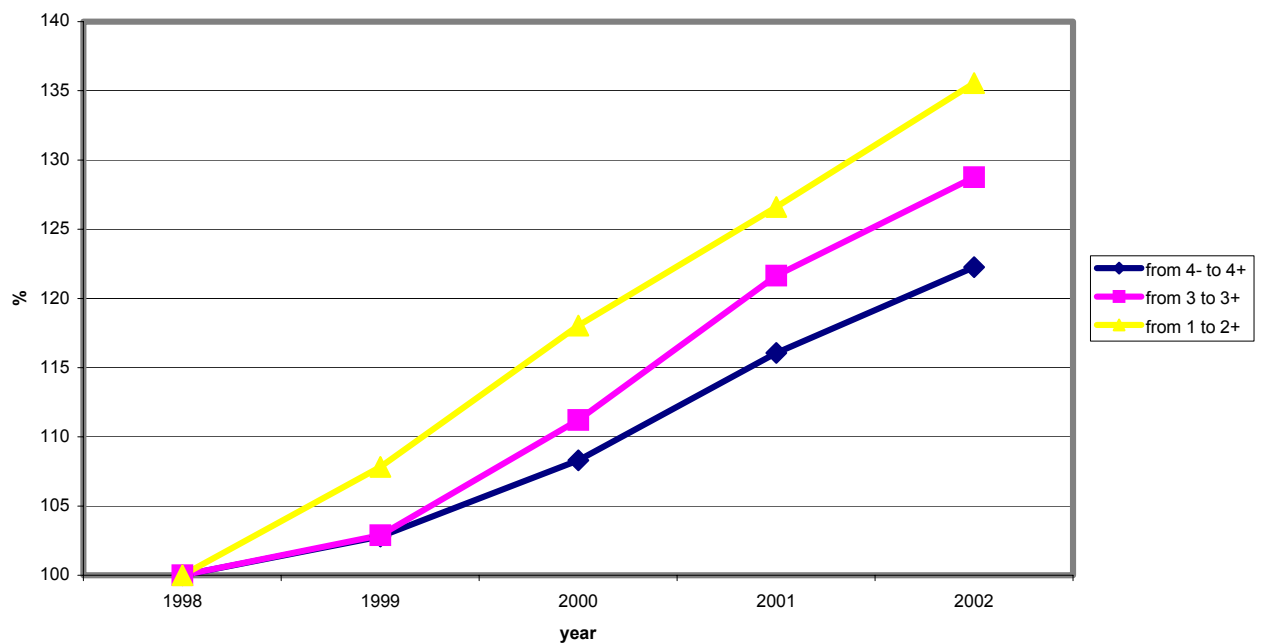
<sup>12</sup> Berg et al (1999), Berkowitz and De Long (1998, 1999), Fischer et al. (1996), Fischer and Sahay (2000)





Source: EBRD

**Figure 3. Growth rates depending on the trade policy index. 1998=100**



Source: EBRD

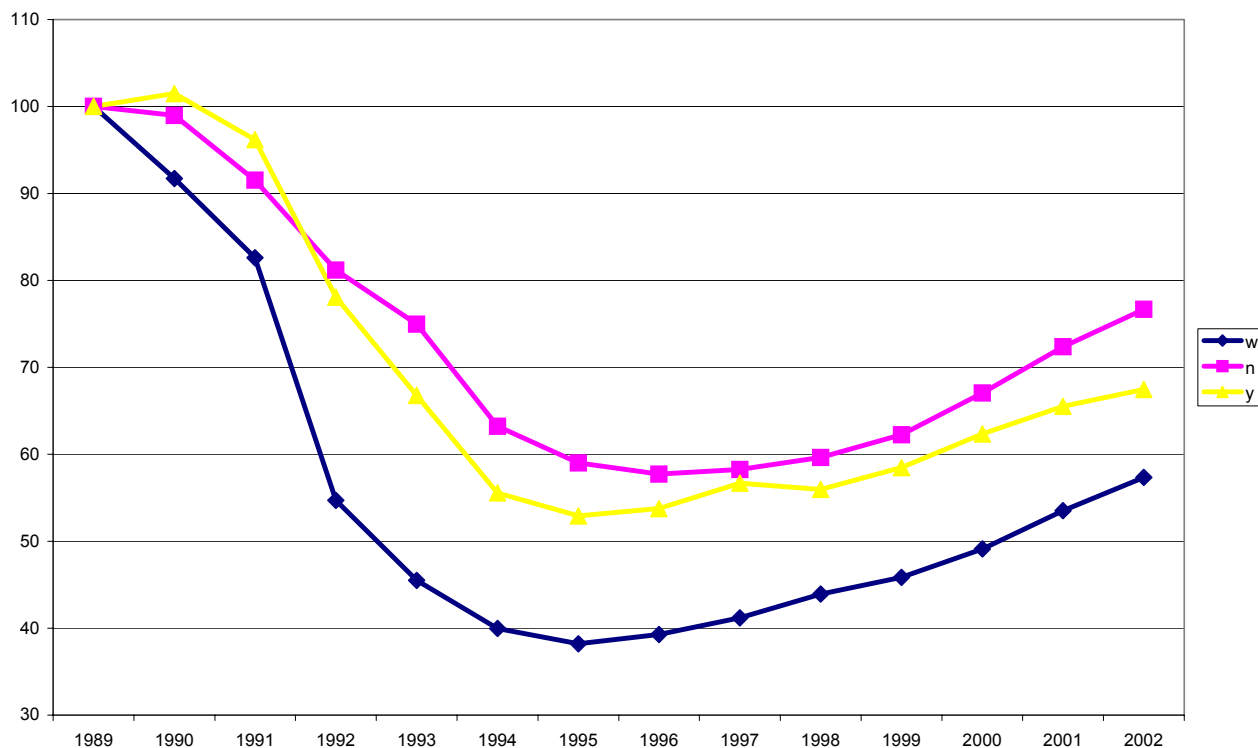
Recently, several economists have offered such explanations of growth patterns in transition countries as the collapse of the government and quality of public institutions.<sup>13</sup> According to this explanation, massive and protracted output decline in some CIS countries was caused by the collapse of the government and its inability to create environment promoting economic growth. CIS countries, which managed to keep stronger governments, experienced a less dramatic output decline. The CIS countries started to grow only after consolidation of governments. The nature of institutions

<sup>13</sup> Sonin (1999), Popov (2000), Bergloef and Bolton (2002), Yudaeva et al. (2002).

seems to matter less than their overall ability to provide a growth-promoting environment. The growth success of CEE countries can be explained by their success in building well-functioning market economy institutions in the early years of transition. China, which is also a transition economy, has managed to establish a good climate for growth and investment, while keeping some institutions of the planned economy intact. In fact, comparison of experience of China and Russia shows that institutional experimentation can be more beneficial for growth than copying of Western institutions (Mukand and Rodrik 2002).

As mentioned in the introduction, several researchers have found relationships between trade openness, geography, and quality of the institutions. Has globalization played any role in shaping institutions of transition economies? The answer appears to be yes, but only in the case of CEE countries. Roland and Verdier (1999) proposed a theory according to which it is the desire of CEE countries to become members of the EU, which works as an expectation coordination mechanism in building institutions in these countries. Since all economic agents in these countries see EU institutions as a model of future institutions of their countries, it is easier to make institutions work in these countries. By contrast, in the CIS there has been a lack of consensus on what kind of institutions these countries need. This has weakened the government and has had a negative effect on growth. Moreover, almost none of the CIS countries have ever had independent governments in their history and had to build some institutions (for example customs) from scratch. This has slowed down a return to growth path in some CIS countries. EBRD (2001) makes a connection between this theory of expectations and institution building and the process of globalization. They argue that strategy of integration into the world economy, and accession to international organizations, such as the WTO, will help other transition economies to improve their institutions and growth rates. As shown above, this theory has not so far been confirmed, and countries which have joined the WTO have not started to grow faster than the ones, which have not joined or even are not planning to join the organization in the future. Throughout the transition period, the slow reformers among the CIS countries, which have retained a number of pre-transition institutions, seem to have had better growth rates than the fast reformers (Figure 4).

**Figure 4: Growth Rate depending on initial government turnover.**

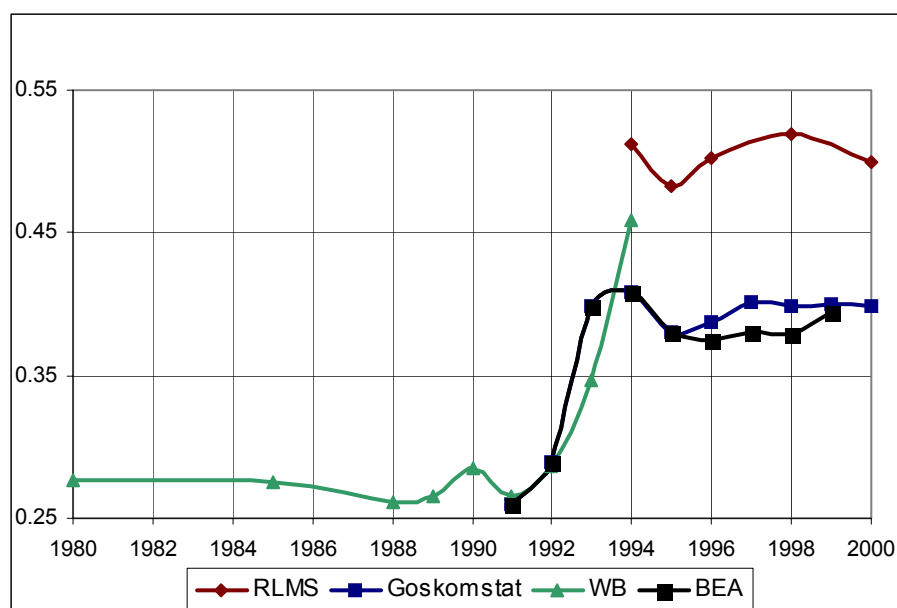


Source: EBRD.

Notation: 'w' are countries affected by the war, 'n' are countries, where government did not change at the beginning of transition, 'y' are countries, where government changes at the beginning of transition.

Comparison of inequality indexes across CIS countries produces a picture similar to that of growth rates. In the Soviet Union the level of inequality was quite low, comparable to that in most of developed countries (Milanovic 1998, Atkinson and Micklewright 1992). At the beginning of transition, the level of inequality rose in all transition economies but in different proportions. In CEE countries an increase in inequality was smaller than in the CIS countries. In some CIS countries, for example in Russia, inequality increased to the level observed in the most unequal countries in the world, such as Brazil. Most of the inequality increase occurred already at the beginning of transition (see Figure 5 for the dynamics of inequality change in Russia)

**Figure 5: Gini coefficient in Russia**



*Source: Authors calculations, using RLMS, Goskomstat, World Bank (WB), Bureau of Economic Analysis (BEA).*

While all data on the CIS countries are of poor quality, data on poverty and inequality are particularly deficient and difficult to compare across countries. Measures of poverty and inequality are computed based on household surveys. Sampling of household surveys was poorly designed in the Soviet Union: it was biased towards working population and had some other faults (Klugman 1997). Some countries have improved sampling of their household surveys since then, but in others it has deteriorated even further. It appears also that in some countries no household surveys have been conducted in recent years either by their own statistical agencies or by other organizations, such as the World Bank. Two other problems with household surveys in the CIS countries are high non-response rate, and underreporting of incomes. In the Russian RLMS household survey, for example, expenditures exceeds income by about 30%. Therefore, inequality and poverty indexes computed using measures of expenditure are considered more reliable than the ones calculated using the income measure. Unfortunately, I failed to find expenditure-based indexes of inequality for all CIS countries. This makes cross-country comparison of inequality indexes even less reliable. Table 4 reports Gini coefficients for 1989, 1997 and 2001 in the CIS countries for which the data were available. Where possible, the numbers refer to per household member inequality of expenditure, but such information was not available for all countries. Where inequality of expenditure measure is unavailable, I use inequality of income. The table shows that inequality increased in all CIS countries but to a different extent. Of course, some of the cross-country variance in the measures of poverty and inequality can be explained by differences in calculation methodologies, but I believe that they still reflect the overall picture fairly accurately

While in 1989 the values of the Gini coefficient were quite similar in all countries, in 1997 the level of inequality varied significantly. The highest level of inequality was seen in war-affected Armenia, Georgia, and Moldova, while the lowest level was registered in slow reforming Belarus. Average levels of inequality over groups of countries with various levels of external liberalization are as follows: the most liberal countries show the highest (44.2) and the least liberal - the lowest (34.0) levels of inequality. In all countries, the 1997 level is higher than that in 1989.<sup>14</sup> Unfortunately, data for years after 1997 are available only for a small subset of countries. Available data suggest that the difference between groups of countries with various external liberalization strategies declined between 1997 and 2001, but the lack of data does not allow a strong statement to be made in this respect.<sup>15</sup>

Cross-country comparison of poverty levels is even more difficult than inequality comparisons. The problem is that a comparable poverty line should be used for such comparisons, and such data seems to be unavailable for the CIS countries. Table 5 reports headcount ratios, which I have managed to obtain for these countries. The table shows an intuitive picture: countries affected by war have the highest poverty rates, but there seems to be no relationship between poverty rates and trade policy. Most of the poverty rate increase occurred already in the first years of transition (see Figure 6 for corresponding data on Russia). The main cause of the poverty increase was output decline, but the increase in inequality also had a significant impact on poverty. In fact, in Russia impacts of these two factors were of a similar magnitude (Kolenikov and Shorroks 2002). Poverty in CIS is also quite persistent: using RLMS dataset, Luttmer (2002) shows that after accounting for transitory shocks, about 80% of the poor in Russia remain in poverty for at least 1 year. For countries where data from different time points are available, i.e. for Armenia and Belarus, Table 4 shows that inequality has been declining in recent years. Since these two countries show substantial differences in their external liberalization policies, the decline in the poverty rate seems to have resulted from economic growth rather than from trade strategies alone.

Transition in CIS countries has also led to significant changes in incomes, occupational structure and other characteristics of population around the median. In the 1990s, Soviet type education and work experience lost value dramatically. Therefore, a substantial share of population, which in Soviet times formed “the middle class”, found themselves exposed to the risk of falling into poverty. Specifically, those working in budget-financed organizations (teachers, doctors, scientists) suffered income decline, and many of them preferred to either change their occupation or emigrate. For example, Russian income distribution is currently so unequal that the ratio of median income to the mean income in Russia is quite low and comparable to the level observed in some very unequal Latin American countries (Birdsall, Graham, Pettinato, 2000). Consequently, people from groups

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<sup>14</sup> According to some measures reported by UNDP, Belarus may be an exception with 1997 level of inequality being lower than the 1989 one.

<sup>15</sup> The largest decrease in inequality after 1997 has happened in war-affected countries.

around the median think of themselves as poor, not as part of the middle class. These people suffer from serious job and income insecurity, and such a factor as education, thought to be a source of higher income in other countries, in Russia does not ensure higher income or job security. (Birdsall, Graham, Pettinato, 2000). It should be mentioned that the 1990s are viewed as a period when job insecurity increased not only in transition but also in developed countries. Antiglobalists consider this phenomenon to be a result of globalization, which causes the “race to the bottom” of social security standards. Some economists, however, think that an increase in inequality observed in some developed countries cannot be explained by the conventional trade theory, and was rather caused by changes in social norms as regards equalization (Aghion 2001, Atkinson 1999). In the CIS countries the increase in job insecurity resulted from the transition process, and opening of the economy may have added to it in the case of import-substituting industries. Failure of the social security system translated this increase in job insecurity into a massive increase in income insecurity. However, the lack of a properly functioning social security system is often partially compensated by private transfers from friends and relatives to needy families. At the same time, workers who can compete on the global labor market, experience the least job insecurity.

A recent study of the Russian middle class carried out by BEA (2000) shows that incomes of groups, in which individuals think of themselves as part of the middle class, are located in the upper part of the income distribution (BEA 2000). Clearly, this self-definition is based on views on the level of consumption typical of the middle class in the West. This part of the population has much more secure jobs than the poorer one. For example, BEA (2000) reports that most of the middle class even if they suffered from the 1998 crisis, were able to recover soon. Most of these people have skills which allow them to compete on the global labor market. While education does not prevent falling into poverty, people from the upper part of the income distribution have a higher level of education than others. For example, about 69% of entrepreneurs in Russia have a university degree. Many educated young people, mostly big city dwellers, have managed to get well-paid jobs in “new sectors”, such as banking, investment banking, business consulting, etc. Since many companies in these new businesses are foreign or provide services to foreign investors, globalization seems to have been a factor increasing income inequality in the CIS and widening the gap between incomes of educated people of the older and younger generations. At the same time, job security is higher for people whose incomes were positively affected by globalization than for the rest of the population.

To summarize, the data on growth rates, inequality and poverty show no or negative relationship between external liberalization and indicators of welfare in the CIS countries in the 1990s. This result seems to contrast dramatically with the results, reported by Dollar and Kraay (2001) for developing countries. The difference lies in the institutional performance of the CIS countries and developing globalizer countries. Most of globalizer countries studied by Dollar and Kraay (2001) had fairly strong government institutions, which, in addition to pursuing trade

liberalization policies, managed to create a good investment climate. In most of the CIS countries governments were weak, and, therefore, their trade policies did not affect growth. In fact, there are at least three countries on the Dollar and Kraay (2001) list, which appear to be countries with weak governments, and their output, inequality and poverty indexes show dynamics very similar to that of the CIS countries. These countries are Rwanda, Nicaragua, Haiti. While these countries have registered a substantial international trade increase in the last 20 years, they have also experienced a GDP decline and an increase in poverty rates. I believe that trade flows, as well as trade flows in most of the CIS countries have increased not because of the government policy aimed at opening of the economy, but because of the inability of the governments to close country borders effectively. I call this phenomenon “passive globalization” and in the following section I demonstrate effects that such globalization can have on output and inequality, and provide some ideas regarding sources of these effects.

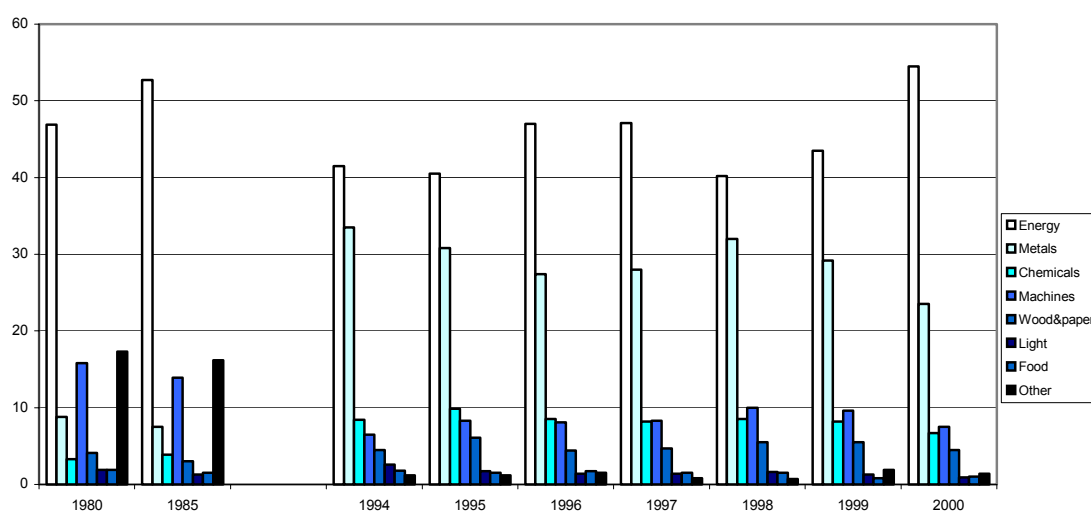
## **Relationship between globalization and quality of the government: passive globalization**

In countries with weak and corrupt governments an officially stated trade policy is not important by itself because due to corruption the effective rate of protection in such countries can differ substantially from that officially stated. As an example, Table 6 reports official tariff rates, and the ratio of collected tariffs to imports for Russia. Even if the official tariff rates are not very high in Russia, the ratio of collected tariffs to imports is even lower. But even this ratio may understate the degree of evasion: there is anecdotal evidence that goods which are subject to high tariffs are often declared under different commodity items subject to lower tariff rates.

Since trade barriers in countries with weak governments are not enforced, such countries can suffer from “passive globalization”. In other words, these countries can achieve high trade flows, higher than their official trade policy provides for, but experience no positive effects on growth, which globalization produces in developing countries with strong government institutions. The question is why passive globalization does not have such a positive effect on growth as “active globalization”. To answer this question, I look at the trade structure first. Dollar and Kraay (2001) report that successful globalizers have changed their trade and production structure from natural resources and agriculture to manufactured goods. The CIS countries have not so far shown such a trend. Figure 6 below compares the export structure of the Soviet Union and the largest CIS state - Russia.<sup>16</sup> The Soviet Union’s exports were already biased toward energy. Russia has retained this predominance of natural resources in exports. The only difference between Russian and USSR’s export structures is that Russia exports much more metals than the USSR did. Similar stories can be told about other CIS countries: in resource-rich countries, such as Kazakhstan, other industrial

sectors than oil have almost disappeared since the beginning of transition (Koluzhnova et al. 2002). Resource-poor countries, such as Armenia, have experienced a substantial increase in the share of agriculture in GDP at the expense of industry (Manasyan and Jrbahsyan 2002, Iradian and Minassian 2002). In a recent paper, Berkowits, Moenius and Pistor (2002) show that bad institutions in the exporting country create obstacles to exports, and, therefore, to production of complex (diversified manufacturing) goods. Hence, collapse of the government in the CIS countries intensified their de-industrialization and concentration on extraction of natural resources.

**Figure 6: Export structure of USSR (1980, 1985) and Russia (1994-2000)**  
 (% of total non-CIS export)



Source: Goskomstat

Another important difference between successful globalizers and transition countries is that in most countries of the first group inequality decreased after trade liberalization or increased only mildly, while in all CIS countries inequality increased, in some of them quite dramatically.<sup>17</sup> Could “passive” globalization have played a role in such an increase in inequality? The traditional trade theory, for example the Hechsher-Ohlin model, suggests that trade liberalization may lead to an increase in incomes of exporting sectors, and a decrease in incomes of importing sectors. Russian household survey data seem to suggest that this prediction holds for Russia, but I believe that it holds in other CIS countries as well.

Recently, RLMS, a household survey very popular among researchers, has started to provide information on sectors of the economy where participants of the survey are employed.<sup>18</sup> Detailed

<sup>16</sup> In the case of Russia only non-CIS export structure is considered.

<sup>17</sup> China is an important example of a successful globalizer, which has also experienced an increase in inequality in the last 20 years.

<sup>18</sup> The Russia Longitudinal Monitoring Survey (RLMS) covers about 4000 households. It has been conducted since 1991, although pre-1994 data are considered to be of poor quality and do not form a panel with post-1994 data. Data are



data on industries are available only for the rounds of the survey conducted in 1994-1996. To the 1998 and 2000 rounds, I assign the industry where the individual in question was employed in 1996. This procedure may result in a completely wrong industry assignment in 2000, because almost 80% of all individuals who participated in this round reported that they had changed their jobs since the previous rounds of the interviews. Therefore, the graphs below should be interpreted as presenting information on wage and income development of people initially employed in relevant industries rather than as containing information on current wages and incomes of people employed in these industries.

All industrial types of activities reported by RLMS were assigned to 8 groups of industries: machine building, light, chemical, food, metallurgy, wood and paper, construction materials, and repairs. Then I assigned all industries to one of the following groups: exporting (metallurgy, wood and paper), import-substituting (machine-building, light, food), nontradables (construction materials, and renovation), and industries with large trade volumes in both directions (chemical).<sup>19</sup> To make the assignments I used information on the export-to-output, import-to-output ratios, and intra-industry trade index of each industry. These ratios were constructed using data on industrial output obtained from the Russian statistical agency Goskomstat, and State Customs Committee data on export and import of goods.

Since wage data in RLMS are considered to be unreliable, I compare per capita expenditures of households across sectors where the head of the household is employed (Figure 7).<sup>20</sup> To construct the graph, I deflated expenditures by the regional poverty line. Incomes of households, where primary income earner is employed in the exporting sector, are consistently higher than in households where income earners are employed in all other industries, with the exception of non-tradables in 1998. The difference between exporting and importing sectors increases over time. As mentioned above, for 1998 and 2000 I assign to individuals the industry in which they were employed in 1996. Hence, my graphs trace income differentials not so much across industries, as across people initially employed in relevant industries. This comment is particularly important for the 2000 round, because many people reported changing jobs prior to this round. Since incomes of households where the primary income earner is employed in exporting and import-substituting sectors in 1996 diverge in 2000, Figures 7 provide weak evidence that globalization might add to an increase in income inequality. Note that since I use household expenditures as a proxy for income, the data also suggest that in Russia families cannot fully diversify cross-sectional differences in income within families. In terms of the effect on poverty, average per capita incomes are above the poverty line (and even above 1.5 times the poverty line) in all industries and all periods, but the risk

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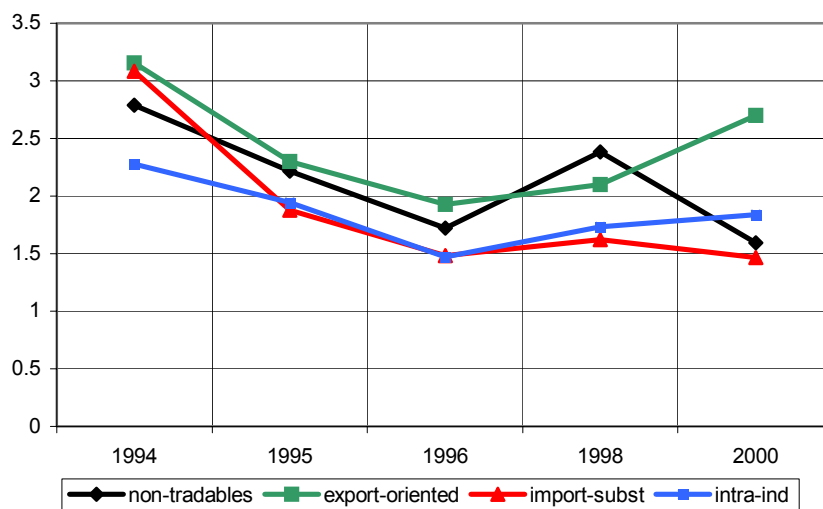
available for 1994-1996, 1998 and 2000. The survey is conducted by the University of North Carolina at Chapel Hill together with the Institute of Sociology of the Russian Academy of Science.

<sup>19</sup> These industries are subsequently referred to as to intra-industry trade industries.

<sup>20</sup> Comparison of wages as reported in RLMS provides strong evidence of an increase in the gap between exporting and import-substituting sectors during the 1990s.

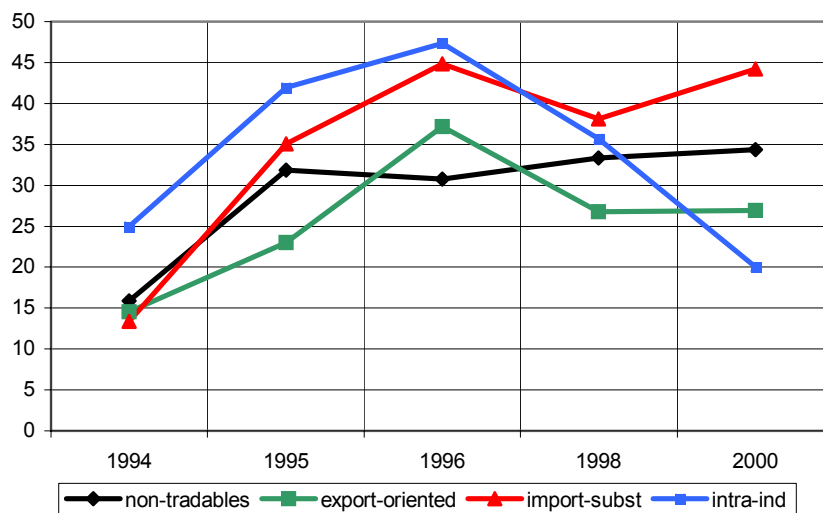
of falling into poverty is higher for those working in import-substituting industries. Figure 8 shows that the poverty rate among those working (or those who used to work) in import-substituting industries is close to 45% during the 1996-2000 period, while among those, who used to work in export-oriented industries the poverty rate declined below 30% in 1998-2000. The lowest poverty rate (20%) in 2000 was documented among those employed in industries with a high index of intra-industry trade in 1996.

**Figure 7: Per capita household expenditure, by industry where primary income earner is employed (deflated by poverty line)**



*Source: authors calculations using RLMS.*

**Figure 8: Poverty rates by industry of employment of primary income earner**



*Source: authors calculations using RLMS.*

While theory predicts changes in the wage structure after trade liberalization, it also predicts changes in the structure of the labor force: exporting sectors should increase their share in the labor force, while the share of import-substituting sectors should contract. This may result in a temporary increase in unemployment and higher probability of a job change among those who initially worked

in import substituting sectors. Neither of the two predictions holds in RLMS. In total, 29.1% of people employed in exporting industries in 1994 reported being unemployed in at least one of the following survey rounds. Among workers initially employed in import substitution sector, 31% reported being unemployed in one of the following rounds. In fact, the lowest incidence of unemployment was registered in non-tradable industries: only 23% of all workers reported being unemployed in one of the following rounds, and nobody was unemployed for more than one round. Industries showing a high index of intra-industry trade are in the middle with 26.1% of unemployed. Most workers reported being unemployed in one or two rounds, although 1.2% of those initially employed in an export-oriented industry, 1.5% of those employed in import substitution, and 4.3% of those initially employed in intra-industry trade sectors reported being unemployed in all rounds after 1994. As regards the probability of changing a job, prior to the 2000 round, about 31% of those employed in import-substituting industries in 1994 reported changing jobs at least once, while for exporting industries this figure was below 25%. With the 2000 round taken into account, the picture looks different: everyone employed in exporting industries in 1994 reported changing a job/occupation by the fall of 2000, while in import-substituting industries this figure is only 96%. The lowest figure (93%) is observed in non-tradable industries.

It should be mentioned that the overall RLMS sample is small, and the number of unemployed and of people reporting changes in occupation, is very small in it.<sup>21</sup> In addition, the sample of unemployed and those who changed occupations is not representative as regards industrial structure. Therefore, the results reported above should be treated with caution. Nonetheless, they suggest that such a huge increase in inequality, as was observed in Russia, can be at least partially attributed to poor labor mobility and high correlation between within family incomes. This problem may be especially relevant in Russia, because other CIS countries have much smaller territories and smaller degree of regional economic specialization. However, I believe that, in one way or another, this problem exists in other CIS countries as well.

Low geographical mobility of labor in Russia can be only partially explained by large distances between cities and low population density, particularly in the eastern part of the country. Andrienko and Guriev (2001) show that a substantial part of the Russian labor force may be willing to move but lack financial resources to do so. Many Russian firms unwilling to lose labor, tend not to pay their workers in cash in order not to provide funds for workers to move, providing social benefits instead (Friebel and Guriev, 2000). Such labor hoarding, combined with wage arrears, was particularly common in Russia and some other CIS countries before the 1998 crisis. The Russian production allocation, with a lot of industrial enterprises located in mono-towns where there are no other employers, made it easier for firms to resort to such practices (Earle and Sabirianova, 2002).

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<sup>21</sup> In some sector and year combinations, the size of the sample is below 100.

Employment in a mono-town decreases the probability of changing a job or occupation (Sabirianova, 2000).

Low labor mobility suggests that in Russia there were at least two sorts of government failure due to which globalization has had a negative effect on inequality. First of all, Russia lacks a social security system, which would facilitate geographical and professional mobility of labor. Actually, in the 1990s Russia had almost no de-facto unemployment insurance, which also added to the rise in inequality in the country. The second failure of the government was its inability to guarantee that firms meet their obligations to workers, paying wages timely and in cash. Partly, the wage arrears equilibrium was maintained by the government itself: being unable to create a properly functioning social security system, it preferred labor hoarding, combined with wage arrears, to a more actively functioning labor market with higher labor mobility.

## **Could active globalization have helped? Evidence from Russian regions**

The above description of the effects of globalization on the CIS countries does not provide a clear answer to the question whether it was failure of the government that did not allow the CIS countries to benefit from globalization or these countries cannot gain from globalization in principle. To address this issue, I use data on Russian regions. These data are more homogeneous than the cross-country data, and show a wide variation in policies and their outcomes.

In the 1990s regional authorities in Russia received substantial independence from the center. This was a result of president Yeltsin's attempt to secure greater support from the regions in order to counter lack of support in parliament. In exchange for support, he allowed regions to take "as much sovereignty as they could swallow" (Zhuravskaya (1998), Bergloef et al (2002)). As a result, regional economic policies in Russia show a substantial variation, which is often greater than allowed by federal legislation.

Foreign (and inter-regional) trade and foreign investment are two areas of policy, in which variation across regions is particularly significant. In the early-mid 1990s, some regions pursued a strong protective trade policy, and even imposed trade barriers against the export and import of some goods from and into regions. Policies with regard to foreign investors also varied significantly. Despite the popular rhetoric that Russia would like to attract foreign investment, firm owners and regional governors in many regions are afraid of foreign investors and follow a number of informal policies to make their regions unattractive to foreigners.<sup>22</sup> Other regions, such as Novgorod oblast, are known for creating a good investment climate. Such a wide variation in regional policies allows the Dollar and Kraay (2001) exercise to be repeated on Russian regions to see what effects policies

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<sup>22</sup> The famous story of Phillips factory in Voronezh, which was sold for US\$ 1 because of problems with the regional government, provides a good example of such policies.

aimed at integration into the world economy had on growth and income distribution on the regional level.

While there is considerable anecdotal evidence of regional trade barriers, no comprehensive data on such barriers exist, rendering classification of regions on the basis of differences in trade policies impossible. The situation with foreign direct investment is similar, because a lot of measures hostile to FDI are not formalized in regional legislations. Using trade data as a basis for country classification is also problematic. The import of goods from foreign countries is frequently reported in the regions allowing faster customs clearance and lower tariff and bribe payments, instead of those to which goods are actually imported. Inter-regional flows of goods are not reported at all. Therefore I decided to use the FDI/GRP ratio as a criterion of classification of countries as globalizers or non-globalizers. Of course, geographical factors, such as natural resource endowment, can play an important role in explaining regional distribution of FDI. However, it was shown by Manaenkov (2000) and other authors that regional policies are no less important in explaining FDI patterns than geographical factors.

To classify regions as globalizers or non-globalizers, they were ranked according to total FDI they received in 1995-1999 and FDI per capita over the same period. Then, 28 regions, which appear in the upper part of the list, and 28 regions from the bottom part of the list were classified as globalizers and non-globalizers respectively.<sup>23</sup> Both groups of countries look quite heterogeneous. The list of globalizers includes both natural resource-rich regions, such as Tyumen or Sakhalin, and regions known to be fast reformers, such as Samara, Sverdlovsk and Novgorod. The list of non-globalizers also includes two types of regions. In addition to underdeveloped Caucasian and Siberian ethnically-identified republics, regions known as slow reformers, such as Ulianovsk, appear on this list. Data on FDI, FDI per capita, international trade/GDP ratios in 2000, average GRP growth rates in 1997-1999, and growth rates in 1999 for both globalizers and non-globalizers are reported in Table 7. It turns out that regions attracting more FDI also trade more with other countries. The regional data confirm the hypothesis of Dollar and Kraay that globalizers grow faster than non-globalizers. In 1999, the average growth rate of globalizers was 5.5%, while for non-globalizers it was 4.4%. Because of the 1998 crisis, the average growth rate in 1997-1999 was negative in both types of regions, although globalizers showed only a marginally negative growth of -0.1%, while non-globalizers suffered a rather significant decline of -1.8%. These results can be criticized from the point of view that they are affected by presence of natural resource-rich regions in the group of globalizers. To overcome this problem, I calculated average growth rates for the group of globalizers, excluding Moscow, Tyumen and Sakhalin, and for the list of non-globalizers, from which all Caucasian republics were excluded. As a result, the 1999 growth rate of globalizers decreased to 5% while for non-globalizers it increased to 4.5%. The average growth rates in 1997-

1999 actually declined in both sets of regions to -0.5% for globalizers and -2.1% for non-globalizers. Still, even after these changes, globalizers look more successful in terms of growth rates than non-globalizers.

In terms of changes in poverty, globalizers and non-globalizers differ even more. Table 8 shows poverty headcount ratios in 1995 and 1999. Poverty increased between these two years in both sets of regions. However, in the case of globalizers the increase was 2.6% smaller than the average Russian decrease, while the increase in poverty shown by non-globalizers was 4.3% higher than the Russian average. Dropping resource-rich regions from the list of globalizers produces almost no changes in the poverty results, while in the case of non-globalizers, exclusion of Caucasian regions increases poverty even further, because Northern Osetia was very successful in terms of poverty reduction in 1995-1999.

Table 8 also reports regional Gini coefficients in 1995 and 2000. These coefficients were computed from the information on income quintiles available for these two years.<sup>24</sup> There is almost no difference between the two groups of regions when absolute numbers are considered. Judging by the average difference from Russia's mean change between the two periods, non-globalizers appear to become more equal with time than globalizers. Comparison of the 1995 and 2000 ratios of the top to the bottom income quintiles suggests that globalizers are more unequal than non-globalizers, and the gap increases with time. However, this result seems to be almost fully driven by Moscow, which is extremely unequal compared to all other regions, with inequality having increased dramatically from 1995 to 2000.

To summarize, I find weak evidence that more globalized regions in Russia grow faster than other regions. In terms of poverty changes, the results are even more convincing: while poverty increased in all regions, globalizers' increase was below and non-globalizers' - above the Russian average. The results on inequality are mixed and depend critically on inclusion or exclusion of specific regions. Overall, inequality seems to be similar in both sets of regions, showing little change from 1995 to 2000.<sup>25</sup> The only region which differs substantially from all others is Moscow, which is very unequal, with inequality increasing dramatically over time. Of course, globalization cannot fully explain Moscow's inequality, but it might have enhanced some other factors making Moscow so unequal. For example, representatives of such well-paid professions as investment bankers or auditors are mainly located in Moscow, and development of such professions in Russia was related to opening of Russian capital account. Warner (2002) shows that wages of managers working at multinational firms in poor countries are much less correlated with the level of GDP per capita than wages of unskilled workers. He hypothesizes that this difference exists because managers have

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<sup>23</sup> In this section official Goscomstat regional data are used. Information was available on 80 regions, from which I excluded Ingushetia as a region, which suffered most from the war in Chechnya.

<sup>24</sup> For other years Goscomstat did not publish any information on regional inequality.

<sup>25</sup> Data on Russia as a whole show substantial changes in inequality during this period, although due to lack of data we cannot trace it on the regional level.

access to the global labor market, while market for less skilled occupations is local. Clearly, there are many more occupations in Moscow for which the labor market is global, which may add to an increase in inequality of incomes in Moscow.

The results in this section are in line with the cross-country findings of Dollar and Kraay (2001), who demonstrate that in globalizer countries growth rates have increased and poverty rates have decreased in the last 20 years, while non-globalizers have experienced a decline in growth rates.<sup>26</sup> The effect of globalization on income distribution is uncertain, with some countries becoming more equal and others less so. As the previous section suggests, low geographical and/or professional mobility can at least partially explain the increase in inequality in globalizer countries.

## **Does geography matter? Problems of landlocked countries.**

While experience of the CIS countries shows that good institutions and proper functioning of the government are vital to economic growth, it also suggests that when institutions are more or less effective, then access to international markets may speed up and the lack of it - slow down growth. Experience of two landlocked countries – Armenia and Kyrgystan – is particularly remarkable in this respect.

Armenia is one of the poorest countries of the CIS now. Its initial transition experience was particularly unfortunate. Shortly before the beginning of transition, Armenia suffered from an earthquake, which devastated some parts of the country. At the beginning of transition Armenia was involved in a military conflict with neighboring Azerbaijan. In 1994 an armistice was reached, but the border between the two countries is still closed for trade, and officially there is no trade between Armenia and Azerbaijan. Another country, with which Armenia has closed border is Turkey, the most developed country in the region. Tensions between the two countries date back to the massacre of Armenians by Turks in 1915. There is some trade between the two countries, but it goes via Georgia. Armenia is a landlocked country and is uses Georgian port Poti for maritime services.

Armenia's major trade partners are Russia, other CIS countries combined and the EU. Importance of the first two has been decreasing in the last 10 years, while the volume of trade between Armenia and the EU has been on the increase. Armenia does not share a border with any of its major trade partners and has to pay sizable fees to Georgia for carrying goods via its territory.

The structure of Armenian GDP has changed dramatically in the last 10-15 years. As most other CIS countries, Armenia was highly industrialized before transition, but most of its industrial firms used imported inputs and often produced intermediate inputs for firms located in other FSU countries. The breakup of the Soviet Union, the military conflict and blockade by neighboring countries have led to a complete destruction of Armenia's industry. The share of industrial

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<sup>26</sup> Of course, a reverse causality explanation - that faster growing economies can integrate into the world economy more successfully, and to attract more FDI, cannot be excluded. However, even in this case, good institutions are necessary preconditions for both growth and FDI.

production in GDP has declined substantially, while the share of agriculture has increased. In recent years, Armenia has started to develop new sub-industries, mainly the diamond industry, which currently produces one third of Armenian exports (EBRD 2002, Manasyan and Jrbahsyan, 2002).

Armenia is one of the fastest growing CIS countries. It started to grow in 1994, with its annual growth exceeding 5% for 7 years out of 8 (to 2002). Despite the high growth rates, Armenia remains one of the poorest and the most unequal countries in the region. In 2001, the poverty rate exceeded 50%, the Gini coefficient for income was equal to 0.54, and the Gini coefficient for consumption was equal to 0.38 (Iradian and Minassian, 2002). Most observers consider a bad investment climate and widespread corruption to be the most serious obstacles to growth and inequality alleviation. Normalization of trade regimes with neighboring countries would also be an important step in this direction. According to Polyakov (2001), opening of Armenian-Turkish and Azerbaijani borders would allow Armenia to double its exports, to decrease its trade deficit by a third and to increase its GDP by 30%. Opening of trade with Turkey and Azerbaijan would help to diversify Armenian exports (Iradian and Minassian, 2002), thereby providing prerequisites for a more equal growth.

Armenia now has one of the most liberal trade regimes among CIS countries and is preparing for WTO accession. If, however, the conflict with the neighboring countries fails to be resolved, the Armenia may reap only limited benefits from the WTO, as Kyrgyzstan's experience suggests.

Transition experience of Kyrgyzstan differs a lot from that of Armenia. Located in the area rife with military conflicts, Kyrgyzstan has managed to escape one. Kyrgyzstan is one of the fastest reformers among the CIS countries, and was the first CIS country to become a member of the WTO back in 1998. Nevertheless, entry to the WTO has not led to a substantial increase in international trade. In fact, Kyrgyz exports to neighboring Kazakhstan, for example, have even decreased by 50% since 1998 (EBRD, 2002). The problem is that until recently no Kyrgyzstan's neighbor was a WTO member. Although Kyrgyzstan, Kazakhstan, and Uzbekistan are members of the Customs Union, the last two often impose prohibitive tariffs or other barriers to Kyrgyz export or transit of goods. The only WTO member bordering Kyrgyzstan is China. However, there is no transport infrastructure on the Chinese-Kyrgyz border. What is more, Kyrgyzstan shares a border with Northern China, which is much less developed than the South.

According to some observers, WTO accession has not led to an increase of FDI inflows to the country mainly because of its bad geographical position, with no access to the sea or a common border with major trading partners (Mogilevsky, 2002). In fact, in 2001 Kyrgyzstan was the worst performing transition economy. Other factors, such as corruption and bad corporate governance, may also play a role, although it is clear that the small domestic market and high costs of export may limit inflows of FDI to the country. Accession of Kazakhstan and Russia to WTO, along with establishment of transport infrastructure over the Chinese border may help to improve the situation.



## **Conclusions and suggestions for further research.**

This paper shows that quality of institutions is an important factor affecting the results of globalization in transition countries. Countries with strong government institutions, i.e. CEE countries and China, have benefited from globalization. The CIS countries, in most of which governments were weak after the beginning of transition, have globalized “passively”. While the share of trade in GDP has increased in such countries, bad institutions prevent development of advanced industries, leading to a bias in economy toward over-representation of the natural resource extraction sectors. Globalization may also increase inequality: it increases the wedge between incomes in importing and exporting sectors, or between skilled labor, which can compete on the global market, and unskilled labor, which can only compete on the local labor market. In many cases, however, such an effect of globalization on economy is mainly due to bad institutions. For example, it is true that globalization increases income inequality between import substituting and exporting sectors. However, it is because of poor contract enforcement that production of complex goods has failed to become an exporting sector in all CIS countries. Additionally, poor labor mobility, largely caused by malfunctioning of the labor market and of the social security system, leads to the lack of reallocation of labor between exporting and import-substituting sectors.

As regards opening of capital markets, in countries with bad institutions it mainly provides more opportunities for capital flight, and in some cases may also attract unstable foreign portfolio investment. Russia is the only example of a transition economy, which was able to attract a large inflow of portfolio investment at some point. At the same time, countries with bad institutions, which do not guarantee property rights protection, fail to attract FDI, one of the major vehicles of positive effects of globalization in successful countries.

While there is large literature on causes of output decline and growth in transition economies, the issues of income inequality and poverty have been studied insufficiently, and there have been almost no studies of the effects of globalization, trade and capital account liberalization, on poverty and inequality. The greatest problem is the lack of data, particularly data comparable across countries and over time. One of the most interesting issues to study in this respect is interaction between institutional factors and globalization. Labor market institutions are particularly interesting to study. In the era of globalization, labor market institutions and the social security system perform two roles: they promote labor mobility across sectors and occupations, and decrease income insecurity. In developed countries, there is a popular belief that globalization destroys social security systems. The experience of transition countries, au contraire, shows that countries, where the social security system works better, i.e. countries of the CEE, have managed to restructure faster and to reap more benefits of globalization. So a comparative study of the effects of labor market policies on adjustment caused by globalization would help to both better understand the effects of globalization, and to reform labor market institutions.

A more general issue of interaction between institutions and effects of trade policies also remains insufficiently studied. Recently, a couple of papers have appeared showing how bad institutions affect importers and exporters (Anderson and Marcouiller 2001, Berkowitz et al 2002). In application to CIS countries it would be interesting to find out what particular features of institutions in these countries prevent them from developing their economies and increasing integration into the world economy, and what effect it has on their poverty and inequality.

One more issue, which needs to be studied, is the effect of capital account liberalization on income inequality. The effect of this measure is unclear. On the one hand, opening of capital account may dis-proportionally increase possibilities for the rich to diversify their income. At the same time, it is easier for rich people to overcome capital control limitations. Comparison of the experience of Uzbekistan, which has multiple exchange rates and capital control, with the situation in neighboring countries can give a useful insight in this respect.<sup>27</sup>

To conclude, I would like to say that I do not claim that globalization is bad for welfare of countries with bad institutions. In fact, it can partially compensate population of such countries for government problems: capital flight is a way to escape some taxes decreasing welfare, and low tariffs is a way to minimize corruption of customs officials. However, it appears from the experience of the CIS countries that strong institutions, and particularly strong commitment of the government to securing a good investment climate, are needed for globalization to positively affect development of transition and developing economies.

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<sup>27</sup> In this paper I do not discuss the role of increased mobility of global capital on inequality and poverty in CIS countries. Since the inflow of foreign portfolio investment to these countries has been small so far, these effects are not large. It is well known, for example, that 1998 financial crises lead only to a short-lived recession in Russia and other CIS countries, followed by 4 years of high growth.

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**Table 1: EBRD Trade and foreign exchange system index (2002)**

Armenia	4
Azerbaijan	4-
Belarus	2+
Georgia	4+
Kazakhstan	3+
Kyrgyz Republic	4
Moldova	4+
Russia	3
Tajikistan	3+
Turkmenistan	1
Ukraine	3
Uzbekistan	2-

Where:

1. Widespread import and/or export controls or very limited access to foreign exchange
  2. Some liberalization of import and/or export controls; almost full current account convertibility in principle but with a foreign exchange regime that is not fully transpired (possible multiple foreign exchange rates)
  3. Removal of almost all quantitative and administrative import and export restrictions; almost full current account convertibility
  4. Removal of all quantitative and administrative import and export restrictions (apart from agriculture) and all significant export tariffs; insignificant direct involvement in export and imports by ministries and state-owned trading companies; no major non-uniformity of customs duties for non-agricultural goods and services; full current account convertibility.
- 4+ Standarts and performance norms of advanced industrial economies: removal of most tariff barriers; membership in WTO.

*Source: EBRD (2002)*

**Table 2: Trade to GDP ratio, and Tariff Rates in CIS countries, and Countries-Globalizers**

	Average Trade/GDP (Percent)	Weighted Average Tariff Rate
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	1970s	1975s	1980s	1985s	1990s	1995s	1985s	1990s	1995s
ARGENTINA	0.113	0.132	0.164	0.155	0.237	0.329	27.5	13.9	11
BANGLADESH	0.103	0.118	0.138	0.14	0.186	0.267	92.7	54.3	26
BRAZIL	0.111	0.107	0.103	0.105	0.135	0.179	45.8	21	11.5
CHINA	0.125	0.141	0.267	0.285	0.301	0.342	38.8	39.9	20.9
COLOMBIA	0.338	0.309	0.334	0.331	0.45	0.589	29.4	16.6	12.2
COSTA RICA	0.745	0.771	0.713	0.82	1.083	1.281	19.5	12.6	11.2
DOMINICAN REP.	0.387	0.315	0.413	0.403	0.563	0.923		17.8	16.2
HAITI	0.322	0.43	0.477	0.508	0.67	0.989	11.6		10
HUNGARY	0.409	0.471	0.484	0.527	0.576	0.74	18	9.9	14.8
INDIA	0.127	0.137	0.159	0.163	0.17	0.221	99.4	61.9	38.3
IVORY COAST	0.544	0.527	0.704	0.675	0.68	0.764	26.3	23.8	20.7
JAMAICA	0.8	0.759	0.765	1.066	1.092	1.259	18.4	19.6	10.9
JORDAN		0.942	1.182	1.04	1.622	1.662	16.3	15.8	16
MALAYSIA	0.893	0.917	1.068	1.208	1.739	2.198	14.9	14.3	8.9
MALI	0.286	0.299	0.428	0.513	0.516	0.513			18.8
MEXICO	0.17	0.177	0.212	0.232	0.335	0.499	16.7	12.8	12.8
NEPAL	0.165	0.254	0.31	0.322	0.42	0.603	21.8	16.1	11
NICARAGUA	0.491	0.529	0.656	0.51	0.685	0.851	22.1	12.7	10.7
PARAGUAY	0.282	0.321	0.32	0.378	0.773	0.994	10.9	13.1	9.3
PHILIPPINES	0.405	0.416	0.522	0.562	0.755	1.061	27.8	24.5	17.2
RWANDA	0.191	0.229	0.264	0.295	0.465	0.374	33	38.4	
THAILAND	0.474	0.471	0.498	0.591	0.846	0.946	41	36.6	23.1
URUGUAY	0.355	0.426	0.473	0.5	0.664	0.843	33.7	18.9	9.6
ZIMBABWE		0.438	0.442	0.448	0.594	0.771	9.2	17.2	21.5
			1985	1990	1995	1999	1993	1996	2000
RUSSIA**			15.1*	53.3	37.4	36.8			
Armenia				81.336	86.115	70.669			
Azerbaijan					85.835	84.453			
Belarus				90.405	104.769	126.508			
Georgia					67.864	73.007			
Kazakhstan					71.091	85.315			
Kyrgyz Republic				78.754	71.826	99.2			5.15 (01)
Moldova					130.343	114.823			
Russian Federation				36.106	52.009	74.453	7.3	10.9	9.1
Tajikistan						131.846			
Turkmenistan					71.071	103.533			
Ukraine				56.363	97.229	104.426			
Uzbekistan				76.635	74.566	37.893			

\* USSR; source "Narodnoe Khozyaystvo SSSR v 1989 Godu"

\*\* trade with non-CIS countries only

Source: Dollar, Kraay (2001), World Bank, National Statistic Offices.

**Table 2.1: CIS Export Share**

CIS share in Total Export	1989*	1994	1996*	1997	1998	1999	2000	2001
Armenia	72	73.3	44		36.8			
Azerbaijan	45	42.1	47		38.3			
Belarus	59		75	78.9	70.5	73.3	64.6	61.4
Georgia	68	76.4	65		55.7			
Kazakhstan	75		59	45.9	39.9	26.7	26.2	
Kyrgyzstan	81		78					
Moldova	83		77	69.6	67.9	55.4	58.6	
Russia	30		24					

Tadjikistan	52	45				
Turkmenistan	67	52				
Ukraine	58	46	39.2	41.2	28.1	30.9
Uzbekistan	46	54		26.0	30.4	35.9

\*trade with FSU countries

Source Djankov, Freund, Disintegration and Trade Flows: Evidence from the Former Soviet Union

Official trade statistics

**Table 2.2: CIS Import Share**

CIS import share	1994	1995	1996	1997	1998	1999	2000	2001
Armenia	52.2				25.5			
Azerbaijan	62.5				37.6			
Belarus				64.3	64.9	76.6	74.1	67.3
Georgia	80.7				30.2			
Kazakhstan				54.2	47.4	43.3	54.6	
Kyrgyzstan								
Moldova		67.7	60.9	51.6	43.0	38.7	31.9	
Russia								
Tadjikistan								
Turkmenistan								
Ukraine			63.5	57.7	53.8	56.9	57.6	
Uzbekistan					27.8	26.0	34.8	

Source: official trade statistics of respective countries

**Table 3: FDI in % of GDP in globalizer and CIS countries**

	FDI avg 80s	FDI avg 90s		FDI avg 80s	FDI avg 90s
Argentina	0.7%	2.4%	Nicaragua	0.0%	4.4%
Bangladesh	0.0%	0.1%	Pakistan	0.3%	0.8%
Benin	0.1%	0.8%	Paraguay	0.3%	1.4%
Brazil	0.7%	1.5%	Peru	0.1%	2.9%
Burkina Faso	0.1%	0.5%	Philippines	0.6%	1.6%
Cameroon	1.2%	0.1%	Rwanda	1.0%	0.2%
Central Af.Rep.	0.6%	0.2%	Thailand	1.0%	2.4%
China	0.5%	4.0%	Uganda	0.0%	1.7%
Colombia	1.3%	2.0%	Uruguay	0.5%	0.6%
Costa Rica	1.4%	2.9%	Venezuela	0.2%	2.2%
Dominica	2.6%	8.6%	Zambia	1.7%	3.4%
Dominican Rep.	1.0%	2.7%	Zimbabwe	-0.1%	1.3%
Ecuador	0.5%	2.5%		1994-1999	
Egypt	2.7%	1.2%	RUSSIA*		0.5%
Ethiopia	0.0%	0.7%	Armenia		4.0%
Haiti	0.4%	0.2%	Azerbaijan		16.2%
Hungary	0.0%	4.1%	Belarus		0.8%
India	0.0%	0.4%	Georgia**		3.5%
Indonesia	0.4%	0.9%	Kazakhstan		5.8%
Ivory Coast	0.0%	0.0%	Kyrgyz Republic		3.3%
Jamaica	0.2%	3.6%	Moldova		2.7%
Jordan	0.9%	1.2%	Russian Federation		0.3%
Kenya	0.4%	0.2%	Tajikistan**		1.1%
Malaysia	3.2%	4.7%	Turkmenistan		3.6%
Mali	0.2%	1.1%	Ukraine		1.0%
Mexico	1.0%	2.0%	Uzbekistan		0.5%

Nepal	0.0%	0.2%** - average for 1996-1999
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Source: Dollar and Kraay (2001), EBRD (2002)

**Table 4: Gini coefficient in CIS countries**

	1992	1999
Armenia	28.0	45.7(1996)
Azerbaijan	31.7	31.1
Belarus	24.2	28.3(1998)
Georgia**	31.3	57.6(1997)
Kazakhstan	29.1	35.4(1996)
Kyrgyz Republic	31.2	40.5
Moldova	26.4	46.6(1997)
Russian Federation	26.4	48.7(1998)
Tajikistan**	31.8	
Turkmenistan	31.6	40.8(1998)
Ukraine	24.8	31.3(1997)
Uzbekistan	30.6	33(1994)

Source: UNDP

**Table 5: Poverty Rate in CIS Countries**

	year	Population in Poverty, %	Living on 1\$ a day, %
Armenia	96 / 98 / 01	54.7 / 53.7 / 50.9	
Azerbaijan	1995	44.7	1995 <2
Belarus	97/98/99/00/01	32.1 / 33 / 46.7 / 41.9 / 28.9	
Georgia	1997	11.9 ???	
Kazakhstan	2000	31.8	1996 1.5
Kyrgyzstan	1999	55.3	
Moldova	1999	53.4	
Russia			
Tajikistan	1999	83	
Turkmenistan	1994	48	1998 12.1
Ukraine	1996	30	
Uzbekistan	1996	22.0	1993 3.3

Source: Worldbank, [www.economic-trends.org](http://www.economic-trends.org)

**Table 6: Legislated and Collected Tariff Rates in Russia**

CEFIR calculations	1996	1997	1998	1999	2000
Weighted average legislated tariff rates (all countries)	14%	14%	12%	8%	
Collected tariff rates (collected tariffs/import)	4%	7%	7%	5%	
IMEI calculations	1996	1997	1998	1999	2000
Weighted average legislated tariff rates (non-CIS countries)	15%	14%	15%	12%	13%
Collected tariff rates (collected tariffs/import)	9%	12%	8%	9%	9%



**Table 7: FDI, Trade volume, and GRP growth rates in regions-globalizers and non-globalizers.**

region	Cumulative FDI, 1995-99	FDI per capita, cum. 1995-1999	Trade/GRP 2000	Average growth rate, 1997-99	GRP growth rate, 1999
<b>Globalizers:</b>					
Moscow city	9807567	1147.6	0.75	3.7	6.9
Moscow oblast	2046579	318.0	0.61	3.7	5.2
Krasnodar krai	1846136	369.3	0.29	1.8	16.6
Sakhalin oblast	1682294	2846.5	0.39	4.7	19.1
St. Petersburg city	1160353	250.7	0.70	-0.2	6.2
Leningrad oblast	732281	441.4	1.21	1.5	13.7
Novosibirsk oblast	569896	208.7	0.27	-2.0	4.7
Tyumen oblast	514291	158.0	0.76	0.1	1.9
Samara oblast	496643	151.5	0.75	0.1	2.5
Sverdlovsk oblast	382738	83.7	0.57	-3.1	1.8
Volgograd oblast	298970	112.5	0.43	-2.6	1.2
Primorskii krai	260183	120.7	0.40	0.0	6.5
Kaluga oblast	256978	240.4	0.23	-3.3	1.5
Chelyabinsk oblast	245633	67.3	0.51	-1.6	8.3
Magadan oblast	212186	906.8	0.10	-8.3	-3.0
Khabarovsk krai	188860	126.2	0.59	2.5	9.2
Nizhny Novgorod oblast	186976	51.5	0.32	0.4	3.4
Oryol oblast	179862	201.9	0.23	3.4	1.2
Tatarstan republic	175287	46.4	0.47	0.1	7.6
Orenburg oblast	147274	66.6	0.66	0.3	9.0
Komi republic	131138	116.5	0.49	-2.0	-3.7
Vladimir oblast	129424	81.4	0.20	0.9	7.1
Stavropol krai	125456	47.3	0.18	-1.8	4.1
Tula oblast	120705	70.3	0.51	-3.4	-0.3
Novgorod oblast	103353	143.5	0.45	3.1	6.5
Average	880042	335.0	0.48	-0.1	5.5
<b>Non-Globalizers</b>					
Tambov oblast	14605	11.6	0.08	3.2	9.1
Bryansk oblast	13468	9.5	0.23	-2.8	-4.1
Kamchatka oblast	12600	32.8	0.23	-5.8	-7.0
Tver oblast	11888	7.5	0.20	-0.5	4.9
Kemerovo oblast	10351	3.5	0.61	-1.2	8.3
Amur oblast	10344	10.4	0.08	-5.2	3.9
Kirov oblast	10055	6.4	0.31	-1.5	4.7
Ivanovo oblast	9871	8.2	0.41	-4.1	5.0
Dagestan republic	9021	4.2	0.21	-1.8	1.8
Kostroma oblast	9018	11.7	0.14	0.6	5.5
Smolensk oblast	8393	7.5	0.49	5.6	25.5
Chuvash republic	8109	6.0	0.13	-4.5	0.7
Penza oblast	7368	4.9	0.09	0.6	12.1
Kabardino-Balkar	3794	4.8	0.04	2.4	9.0

republic					
Buryat republic	3786	3.7	0.18	1.4	8.0
Karachaevo-Cherkess republic	3469	8.0	0.05	-1.7	-2.8
Ulyanovsk oblast	3180	2.2	0.19	0.0	6.0
Adygeya republic	2616	5.9	0.05	-2.4	5.4
Mari-El republic	2176	2.9	0.11	-0.8	0.2
Tuva republic	2155	7.0	0.43	0.6	6.6
Kalmyk republic	1641	5.2	0.77	-3.9	-6.0
Khakasia republic	1563	2.7	0.92	-3.1	-0.8
Chita oblast	1447	1.2	0.15	-3.7	9.8
Kurgan oblast	1101	1.0	0.36	-0.2	3.0
Evrei autonomous oblast	979	5.0	0.12	-7.3	5.1
Altai republic	117	0.6	0.85	-3.2	4.5
North Osetiya republic	0	0.0	0.32	2.9	12.0
Chukotka autonomous okrug	0	0.0	0.02	-13.2	-7.6
Average	5826	6.2	0.28	-1.8	4.4

Source: Goskomstat

**Table 8: Poverty and Inequality Changes in Regions-Globalizers and Non-Globalizers**

region	poverty rate 1995	poverty rate 1999	Change in poverty rate 1995-99, compared to Russian average change	Cini 1995	Gini 2000	Change in Gini coefficient 1995-99, compared to Russian average change	5 to 1 income quintile ratio 1995	5 to 1 income quintile ratio 2000
<b>Globalizers</b>								
Moscow city	19.1	23.3	-6.88289	0.52	0.56	0.032688	19.7	27.8
Moskow oblast	31.2	27.6	-14.6829	0.26	0.30	0.034688	4.0	5.3
Krasnodar krai	32.4	35.3	-8.18289	0.35	0.36	-0.00291	7.3	7.6
Sakhalin oblast	24.6	36.5	0.81711	0.22	0.29	0.057888	3.3	5.0
St. Petersburg city	20	33.2	2.11711	0.35	0.32	-0.04531	7.3	5.9
Leningrad oblast	29.1	51.5	11.31711	0.25	0.26	-0.00651	4.0	4.1
Novosibirsk oblast	39.8	61.1	10.21711	0.29	0.31	0.004688	5.0	5.6
Tyumen oblast	19.2	17.8	-12.4829	0.41	0.42	-0.00011	10.5	11.5
Samara oblast	21.2	23.4	-8.88289	0.30	0.39	0.079088	5.2	9.2
Sverdlovsk oblast	29.5	35.6	-4.98289	0.30	0.31	-0.00451	5.3	5.6
Volgograd oblast	33.2	58.1	13.81711	0.26	0.28	0.003488	4.3	4.7
Primorskii krai	31.8	39.8	-3.08289	0.26	0.29	0.019488	4.2	5.1
Kaluga oblast	26.6	47	9.31711	0.35	0.29	-0.07531	7.3	4.9
Chelyabinsk oblast	27.9	32	-6.98289	0.31	0.32	-0.00531	5.6	5.8
Magadan oblast	24.6	46.3	10.61711	0.35	0.27	-0.09051	7.1	4.4
Khabarovsk krai	29.4	28.2	-12.2829	0.28	0.31	0.024288	4.6	5.6
Nizhny Novgorod oblast	22	38	4.91711	0.29	0.31	0.008288	5.0	5.7
Oryol oblast	22.7	35.9	2.11711	0.35	0.33	-0.03771	7.3	6.2

Tatarstan republic	22.1	24.1	-9.08289	0.32	0.35	0.018288	5.8	6.9
Orenburg oblast	49.3	35.6	-24.7829	0.27	0.28	-0.00171	4.3	4.6
Komi republic	19.2	22.1	-8.18289	0.30	0.36	0.050288	5.1	7.5
Vladimir oblast	27.9	40.8	1.81711	0.24	0.27	0.024288	3.6	4.5
Stavropol krai	39.6	45.2	-5.48289	0.35	0.31	-0.04451	6.9	5.7
Tula oblast	16.2	31.2	3.91711	0.29	0.26	-0.03371	4.8	4.3
Novgorod oblast	22.8	24	-9.88289	0.28	0.32	0.022288	4.7	5.8
Average	27.256	35.744	-2.59489	0.31	0.32	0.001264	6.1	6.8
<b>Non-Globalizers</b>								
Tambov oblast	22	27.9	-5.18289	0.30	0.33	0.019888	5.1	6.2
Bryansk oblast	22.7	45	11.21711	0.27	0.29	0.011088	4.4	5.1
Kamchatka oblast	22.7	33.6	-0.18289	0.35	0.31	-0.04691	7.1	5.7
Tver oblast	28.6	67.4	27.71711	0.27	0.28	0.000688	4.4	4.8
Kemerovo oblast	16.1	27.9	0.71711	0.35	0.33	-0.03291	7.3	6.3
Amur oblast	37.9	44.9	-4.08289	0.40	0.30	-0.10651	9.6	5.3
Kirov oblast	32	56.6	13.51711	0.24	0.27	0.015888	3.7	4.3
Ivanovo oblast	33.7	64.9	20.11711	0.26	0.29	0.019888	4.0	4.9
Dagestan republic	71.2	63.2	-19.0829		0.34			6.8
Kostroma oblast	30.5	38.1	-3.48289	0.35	0.30	-0.06171	7.3	5.3
Smolensk oblast	19.8	27.2	-3.68289	0.29	0.31	0.009088	4.8	5.4
Chuvash republic	27.3	68.2	29.81711	0.24	0.28	0.033888	3.6	4.8
Penza oblast	30.2	68.7	27.41711	0.26	0.29	0.009888	4.3	4.8
Kabardino-Balkar republic	42.5	46.6	-6.98289	0.28	0.31	0.016288	4.7	5.6
Buryat republic	55.2	50.5	-15.7829	0.39	0.37	-0.02811	9.1	8.2
Karachaevo-Cherkess republic	45.7	64.6	7.81711	0.28	0.33	0.036288	4.7	6.3
Ulyanovsk oblast	16.3	31.4	4.01711	0.28	0.33	0.033488	4.8	6.2
Adygeya republic	46.4	54.8	-2.68289	0.32	0.32	-0.01931	6.1	5.8
Mari-El republic	43.2	69	14.71711	0.24	0.34	0.083488	3.7	6.5
Tuva republic	73.2	78.6	-5.68289	0.40	0.31	-0.10211	10.0	5.6
Kalmyk republic	60.3	78.1	6.71711	0.26	0.33	0.057488	4.3	6.5
Khakasia republic	25.3	45	8.61711	0.27	0.28	-0.00291	4.4	4.7
Chita oblast	66.5	88.8	11.21711	0.41	0.33	-0.09571	10.6	6.2
Kurgan oblast	50.4	56.5	-4.98289	0.27	0.35	0.069088	4.4	7.1
Evrei autonomous oblast		55.7			0.28			4.6
Altai republic	26.2	61	23.71711	0.33	0.28	-0.06331	6.5	4.7
North Osetiya republic	42.8	31.2	-22.6829	0.28	0.32	0.023088	4.7	5.8
Chukotka autonomous okrug		70.9			0.31			5.7
Average	38.026923	54.15357	4.340187	0.30	0.31	-0.0048	5.7	5.7

Source: Goskomstat