The Effects of Government Decentralization During Transition: Evidence from Enterprise-State Relations in Mongolia

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Abstract: A team of American economists examines the effects of governmental decentralization in Mongolia, using data, gathered in mid-1996, from 251 large privatized enterprises that have either local or central government ownership or are completely private. Focusing on enterprise-state relations, the authors investigate governmental involvement in corporate bodies, soft budgets, subsidies, state purchases, lobbying, and dispute resolution, and present evidence on how such relations vary with ownership and level of government. Discussion and analysis cover the effects of devolution of state supervisory power on enterprise-state relations in light of the differing constraints and incentives facing local and national politicians. *Journal of Economic Literature* Classification Numbers: P11, P21, O53, H70. 11 tables, 27 references.

INTRODUCTION

Decentralizing decision-making power away from the central government is the essence of the transition process. For the decentralization of the enterprise sector, the academic literature has emphasized mass privatization, which places decision-making power in the hands of private entities and individuals.[2] Less noticed in that academic literature but of prime concern to reformers and advisers in many countries is the devolution of governmental functions to localities, accompanied by the increasing autonomy of localities from the center.[3] This paper examines some consequences of governmental decentralization in Mongolia by reflecting on the results of that decentralization in the context of a mass privatization program. By so doing, we are able to compare effects of privatization to those of governmental decentralization.

The particular area of behavior on which this paper focuses is the relationship between enterprise and state, examining how this relationship varies with enterprise ownership and

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[2]See, for example World Bank (1996) and Boycko, Shleifer, and Vishny (1995).

[3]The importance of decentralization of government has been stressed by those studying the Chinese economy, in which privatization has not been an option until recently. These scholars identify many of the same parallels between privatization and governmental decentralization that are the subject of this paper (see, for example, Qian and Roland, 1996a).

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with level of government.[4] The paper examines *inter alia* governmental involvement in corporate governance bodies, the extent of soft budgets and of subsidies, and commercial relations between state and enterprise. The paper also presents information on the behavior of enterprises when such behavior involves direct interaction with government, such as in lobbying or in seeking the resolution of disputes.

A changing relationship between state and enterprise is a central element in reform of the enterprise sector in any former socialist country. It also is an element of change that might be expected to become evident fairly soon after the implementation of reforms. Thus, observing enterprise-state relations is important both in and of itself and as an early indicator of other developments that might have a longer gestation period.

The paper primarily provides description, pulling together various strands of information on differences between central and local government behavior toward private and partially private enterprises. The purpose is to present an overall picture, rather than pursuing a multivariate analysis of causal underpinnings. Nevertheless, in providing description, we are able to show clearly that enterprise-state relations differ according to whether the central or the local government is the agent of the state, suggesting that devolution of state power produces changes in enterprise-state relations that are similar to those of privatization itself.

Our results come from one country, Mongolia, and therefore we make no claims to generality. Rather, the purpose is to add one data point to the stock of information on transition processes. Such a data point, coming from one of the poorer, more isolated, transition countries, has real value since there is still a dearth of evidence on the enterprise sectors of countries outside Central and Eastern Europe and Russia.

Mongolia's *de facto* political status as the "sixteenth republic" of the former Soviet Union (FSU) ensured that it had the economic conditions, the ensemble of institutions, and the economic structure of a poorer ex-Soviet republic. But its *de jure* independence meant that it began reforms earlier than did comparable countries. Mongolia also pursued reforms more vigorously than did other comparable countries.[5] Its privatization scheme was relatively successful in channeling a large number of enterprises through a consistent process in a short time. In the section that follows, we present the background information on Mongolia that is necessary to place the evidence of subsequent sections in context.

To collect the evidence used in this study, we surveyed in mid-1996 251 large privatized enterprises in Mongolia, well over half of those enterprises that had passed from 1991 to 1995 through the mass privatization program for large enterprises. The survey covered all privatized enterprises in the national capital, Ulaanbaatar, plus those in the regional centers of 8 of the remaining 21 administrative districts of the country. We collected both qualitative information, from general directors using a survey containing close-ended questions, and quantitative accounting information.[6] Unless otherwise noted, the data presented in this paper's tables are derived from this survey.

[4] The paper does not present evidence on enterprise behavior in the marketplace simply for reasons of space, since presentation of that evidence would involve many considerations that are beyond the scope of this paper. Such evidence is the subject of ongoing research.

[5] With the possible exception of the Kyrgyz Republic.

[6] The response rate for the survey was above 99 percent. The accounting information was collected from a smaller set of enterprises than was the qualitative information (the difference did not exceed 10 percent). The relatively more cumbersome logistical requirements for collecting detailed accounting information led to a research design with a smaller number of enterprises for this part of the survey.

The presentation of results begins in the third section with a discussion of the size and distribution of retained state ownership, delineating the role of central and local governments in post-privatization ownership. The following section examines the composition of enterprise governance bodies and the presence of central and local government officials on these bodies. We found the local government to be more active than the central government on this aspect of corporate governance.

Next, we portray how enterprises lobby the political system to pursue their goals, showing that the devolution of state functions causes a break in the old links between enterprises and ministries and leads to the use of new lobbying routes that are more consonant with a decentralized, democratic politico-economic system. Hence, devolution has effects similar to those of privatization. This is a conclusion that is echoed in the section that follows, the sixth, where we focus on subsidies and soft budgets. Those enterprises whose state ownership share is administered by the central government perceive their budget constraints to be much softer than do enterprises under the tutelage of local governments

The two subsequent sections examine the state's involvement in transactional processes, as customer for the enterprises' products and as arbiter of disputes between enterprises. Both of these activities could possibly be efficiency enhancing in a transition environment in which market and legal infrastructure is highly underdeveloped, although there must remain ambiguity on government motives in these spheres. We find local government more active in these areas than is central government, with the central government more narrowly focused on the subset of enterprises that have a residual state share administered by the central government itself. These results, and the ones presented in other sections, suggest that state ownership is of more consequence when it is held by the central government than when held by local governments.[7]

The ninth section concludes the paper by comparing the results with theoretical predictions that might follow given the important differences between central and local government. Foremost among these differences is the fact that the central government has more budgetary flexibility than do local governments. Moreover, local governments face domestic inter-jurisdictional competition, which the center does not. Thus, the budget constraint of a local government is harder than that of the central government, leading to two important predictions. First, local governments are more likely to be oriented toward policies that are social-welfare enhancing or, at least, they will find social-welfare-reducing policies less attractive. Second, state ownership is likely to be less important when it is administered at the local level than when it is exercised at the center Both predictions are consistent with the data that are presented in this paper.

MONGOLIAN REFORMS AND GOVERNMENTAL STRUCTURE[8]

In 1990, a peaceful revolution in Mongolia led to sweeping reforms. On the political side, the movement to democracy was swift and apparently irreversible. After an election in mid-1990, a broad coalition government was formed in which the old communist party,

[7]This empirical observation resonates with the theories of Shleifer and Vishny (1994), which suggest that state ownership matters less when government budget constraints are tighter

[8]This section provides only the information necessary for an understanding of the general context in which the paper's results should be placed For additional detail, interested readers should see Boone (1994) on stabilization, Murrell, Dunn, and Korsun (1996) on price liberalization, and Korsun and Murrell (1995) on privatization

the Mongolian People's Revolutionary Party (MPRP), was dominant. The economics portfolio was held by a member of one of the new parties, the National Progress Party, which had been formed by a group of young economists who were convinced that the country needed truly radical reforms. Therefore, the first two years of democracy saw strong economic reform.

An election in 1992 gave the MPRP an overwhelming majority in parliament. The new parties left the coalition and the MPRP governed alone for the next four years. During this time, economic reforms proceeded at a less rapid pace, but the general direction of reform was clear. So, too, was the cementing of political reforms, which was underscored by the election of a non-MPRP president in 1993 and the surprise election victory in 1996 of the Democratic Union, a coalition of new parties. The data presented in this paper cover the time period before the 1996 election.

Economic reform proceeded continuously throughout the period 1991-1996, although not without many setbacks along the way. Formal liberalization of the economy was announced quite early, but actual liberalization proceeded more slowly, because of the effects of lingering interventions. By the end of 1993, despite the failure of initial attempts at stabilization, runaway inflation was a danger no longer. Nevertheless, since that time successive governments have struggled to maintain fiscal balance and monetary control, inflation remaining above 50 percent in 1995 and 1996. Growth resumed in mid-1993, after a relatively mild (for transition countries) fall in GDP of 20 percent. Concurrent with the fall in GDP was a catastrophic decline in living standards as a result of the withdrawal of Soviet aid, which during the 1980s had been as high as 30 percent of Mongolian GDP (IMF, 1996).

The centerpiece of the early economic reforms was privatization, which occurred in three different programs—for small enterprises, for large enterprises, and in agriculture. The focus here is on the large enterprises that passed through the privatization program, beginning with the first formal large-enterprise privatization in March 1992. Over the next four years, 483 large enterprises were privatized in the voucher, mass-privatization program: 55 percent in 1992, 30 percent in 1993, 12 in 1994, and 3 in 1995.

Enterprises had little scope for decision-making in the privatization process, as all large enterprises went through the same method of privatization. First, a privatization plan was prepared, detailing the assets of the enterprise. Approval of that plan resulted in corporatization. Then control shifted into the hands of the general director, the workers, and central or local privatization commissions, the latter serving as putative representatives of future shareholders. Enterprise shares were then scheduled for sale on the stock exchange—not for cash, but for the vouchers that previously had been issued to every citizen. Markets, in which vouchers were exchanged for shares, determined the allocation of enterprise shares among individuals. Enterprise employees could buy shares in their own companies and this was a very popular option. The secondary trading of shares officially began only in August 1995, 10 months before our data was collected.

Within each enterprise's privatization plan, the government announced the proportion of that enterprise that would remain state property. Of enterprises passing through the mass privatization process, 45 percent emerged with lingering state ownership. The state ownership share averaged 20.4 percent in the sample of enterprises studied in this paper. For those enterprises in the sample that have some "non-zero" residual state ownership, the mean state ownership share was 46.5 percent.

Residual ownership gives to the state the same formal rights to participate in corporate governance as is possessed by a normal shareholder. In Mongolia, the exercise of these state-owned shareholder rights in any company is assigned either to the central government or to the pertinent local government. It is this division of stewardship between local and central government that provides the observations that drive this paper. The paper examines enterprise-state relations for three groups of enterprises: those fully privatized, those in which the residual state share is administered by the central government, and those in which the residual share is administered by a local government.

Mongolia is a unitary state.[9] Twenty-two administrative units form the second level of the political-administrative hierarchy immediately below the central government (21 aimags, or provinces, and the capital city.) Local representative assemblies are elected, and local executives, the governors, are appointed by the central government for four-year terms on the nomination of the local assemblies. The authority of local governments is heavily circumscribed by the central government, but the scope for decision making at the local level has increased substantially since 1990.

Borrowing authority and the use of the most important tax instruments are reserved for central government. Localities do have the use of personal income taxes, fees for the use of natural resources, real estate taxes, and a variety of lesser taxes, but tax rates and policy are set by the central government. In 1995, local revenues were 22.6 percent of total government revenues, and an additional 12.1 percent of total government revenues were transferred from the center to localities. The governors are responsible for decisions on the allocation of the local budget and exercise a considerable degree of flexibility in those decisions. They also are responsible for administering the state-ownership share in those enterprises assigned to their locality's stewardship.

Many aspects of the division of authority between center and locality are in flux. The formal structure of government certainly echoes its origins in a highly centralized communist state, but local governments are relatively strong and effective, perhaps reflecting the imperatives of governance in a vast, sparsely populated country (UNDP, 1994). Localities have more discretion than indicated by the highly centralized structure of the state, as a result of the decreased willingness and declining capacity of the central government to exercise the degree of control that it formally possesses. With the formal rules incompletely specified, sometimes contradictory, and undergoing rapid change, the degree of discretion held and exercised by any particular local government is highly dependent on the personal skills and relationships of the governor.

CENTRAL AND LOCAL OWNERSHIP IN THE PRIVATIZED SECTOR

Before presenting results, it is necessary to address certain issues of terminology. We shall use the term "centrally owned enterprise" to indicate an enterprise that has positive residual state ownership and whose state ownership is administered by an arm of the central government. The designation "locally owned" is defined in the same way, except that state ownership is administered by a branch of the local government. The terms are introduced for parsimony only and do not reflect *de jure* ownership rights, which have remained ill-defined throughout the reform era: retained enterprise shares have been simply classified as state-owned without any formal designation of which state agency is

[9]On the subject matter of the ensuing paragraphs, see Enkhbat (1993), Government of Mongolia (1993), Government of Mongolia (1995), and State Statistical Office of Mongolia (1996)

Table 1. Distribution of Residual State Ownership in Privatized Mongolian Enterprises in 1996

	All enterprises		Centrally owned enterprises		Locally owned enterprises	
Percentage state ownership	Number in sample	Percentage share	Number in sample	Percentage share	Number in sample	Percentage share
0	140	56.2	—	—	—	—
1-19	6	2.4	2	3.9	4	6.9
20-29	8	3.2	2	3.9	6	10.3
30-39	11	4.4	6	11.8	5	8.6
40-49	6	2.4	2	3.9	4	6.9
50-59	66	26.5	32	62.7	34	58.6
60-69	6	2.4	1	2.0	5	8.6
70-79	0	0.0	0	0.0	0	0.0
80-89	3	1.2	3	5.9	0	0.0
90-99	3	1.2	3	5.9	0	0.0

the legal owner.[10] The terms centrally owned and locally owned, however, do accurately reflect *de facto* usage rights, which have become cemented through time in informal arrangements.

State ownership averages 20.4 percent across our sample of enterprises: 56 percent have no state ownership, 13 percent of enterprises have state minority ownership, and 31 percent have state majority ownership.[11] Table 1 presents information on the distribution of central and local ownership according to the proportion of each enterprise that is owned by the state.[12] The distribution of ownership held by the central and the local governments is rather similar, each showing a distinctive peak at 51 percent, suggesting a deliberate attempt to keep some enterprises under the control of the state. On the basis of unweighted means, the center and the localities each own approximately 10 percent of the privatized sector.

Once the size of enterprises is taken into account, central and local shares appear to be of quite different orders of significance. Table 2 makes this point clear by presenting weighted means for percentage state ownership, using a variety of measures of enterprise size as weights.[13]

During privatization, two different enterprise valuations were generated, one based on the book value of net assets and the other reflecting the relative valuations that Mongolian citizens placed on enterprises when using vouchers to buy shares. The second and third

[10]The Law on State and Local Property of 1996 marks a beginning in clearing up the legal ambiguity, but nonetheless leaves many issues unclear

[11]Residual state ownership after mass privatization is quite common (see Pistor and Turkewitz, 1996, Brom and Orenstein, 1994, Earle et al , 1993)

[12]The distribution of state ownership shares is roughly similar to that found by Pistor and Turkewitz (1996, p 197) after the first wave of privatization in the Czech Republic Russia has less residual state ownership, with estimates for that country falling within the 10-13 percent range (Dolgopyatova, 1995, p 10, Shleifer and Vasiliev, 1996, p 72)

[13]Table 2 omits data on one enterprise that is very large when compared to all others and has a quite large central ownership share Its inclusion would tend to obscure the general picture presented in the table The information in the table is derived from data from the Mongolian Stock Exchange, the Government of Mongolia General Privatization Commission, and from selected issues of *Ardyn Erh* covering a five-year period commencing in 1991

Table 2. Proportion of Mongolia's Privatized Sector Owned by the State, 1992-1996

	Weighted means of percentage	
Weight used in calculation of size	Central ownership	Local ownership
Unweighted	9 9	10 2
Book value[a]	26 9	5 4
Stock-market valuation of voucher denominated auctions	24.7	4 6
Employment[a]	7.8	7 3
Book value in 1994	25.4	4 5
Stock market valuation in secondary trading[b]	14.6	4 8

[a]At time of privatization
[b]Using average price in the first 10 months

rows of Table 2 report the size of central and local ownership based on these valuations. The weighted means indicate that the economic significance of the centrally owned enterprises dwarfs that of local ones. However, a quite different picture emerges from an examination of size based on levels of employment at the time of privatization. As the fourth row of Table 2 indicates, levels of central and local ownership of the privatized sector are roughly comparable if one assesses enterprise size by levels of employment.

The secondary trading of enterprise shares for cash began in 1995. In preparation, accounting data on the book values of enterprises in 1994 were circulated widely in the media.[14] The importance of the governmental holdings based on these values appears in the fifth row of Table 2. There is a small decline from analogous values at the time of privatization, which is larger in proportional terms for the locally owned enterprises

There were much greater changes in investors' valuations of the relative worth of enterprises with residual state ownership. Between the initial public offering and the first ten months of re-trading, the stock-market value of the central government's holdings fell from 25 percent of the privatized sector to 15 percent.[15] For locally owned enterprises, the change is in the reverse direction, but small. The magnitude of the change in the valuation of the centrally owned share suggests that the share prices reflect more than the underlying value of the enterprises, in fact incorporating investors' evaluations of the significance of the presence of different types of owners.[16] The data presented in subsequent sections of this paper suggest reasons why investors might view centrally and locally owned enterprises very differently.

Given differences in relative size of the capital stock of centrally versus locally owned enterprises, it is not surprising to find sectoral differences in the composition of holdings.[17] The central government's ownership is more concentrated in heavy industry, whereas local governments have a larger stake in the agricultural products sector and in

[14]Some enterprises submitted data for 1993 only, this paper uses the inflation-adjusted 1993 values for these enterprises

[15]This was due only to changes in relative valuations the state did not sell any of its residual ownership in privatized enterprises at this stage

[16]It should be noted that the voucher and the secondary-trading valuations represent the assessments of different mixes of the population During privatization, all Mongolian citizens made investment decisions with their vouchers, each citizen having an equal amount of voucher purchasing power In subsequent trading, buyers used cash, the primary buyers were insiders attempting to increase their stake in their own enterprises and large outsider-investors hoping to obtain controlling blocks of shares

[17]Korsun and Murrell (1996) have investigated the determinants of state ownership based on a smaller set of enterprises

wholesale trade, a large proportion of the latter being concerned with the procurement and distribution of agricultural raw materials and processed agricultural products.

There also is a geographical difference in the composition of local and central holdings. Whereas 60 percent of the centrally owned enterprises are located in the capital city, Ulaanbaator, only 36 percent of the locally owned enterprises are located there. In Mongolia, as elsewhere in other small former-socialist countries, there is a common assumption that reformers are concentrated in the capital cities and economic life is very different elsewhere. Although this may be true in general terms, it is worth stating at the outset that this cannot explain the results of this study, for two reasons. First, crudely stated, the results for local-government holdings appear to be more reformist in character than do those for the centrally owned enterprises. Second, the results for the capital-city local government do not differ systematically from those for the provincial local governments.[18]

FORMAL ELEMENTS OF CORPORATE GOVERNANCE

A simple way of ascertaining whether state ownership has any meaning is to ask enterprise management how often it meets with the specific authority that exercises the state's ownership rights. For both central and locally owned enterprises, 65 percent of enterprise directors met with this authority at least once a month to discuss enterprise affairs.[19] This is quite a high level of frequency for centrally owned enterprises in view of the sometimes formidable difficulties of such meetings in this poor, but vast, country.[20]

The Partnership and Company Law of Mongolia of 1995 gives shareholders the power to select two boards. The "Board of Representatives" is analogous to a U.S. board of directors. For many enterprises, these boards came into existence well after privatization, because the first company law, the Economic Entities Law of 1991, did not mandate their formation. Their existence was mandated only in July 1993, after amendments were passed to the Economic Entities Law. In a large proportion of enterprises, these boards are active participants in enterprise decision making on such matters as investment policy, the distribution of profits, and the setting of managerial compensation.[21]

The "Auditing Board" has deeper and murkier roots in the process of transition. It is the institutional successor of the only board originally mandated for privatized enterprises in the Economic Entities Law, formerly named the "Control Council." The Control Councils were a curious mélange of monitoring units of the old centralized administrative system and a German-type supervisory board, a group of outsiders elected by shareholders to monitor company operations. According to the 1995 Law, the declared functions of the auditing boards now are much closer to those of an auditor. But there is still some rather broad language; for example, the auditing boards are to "supervise the activities of the management of the company."[22] The influence of these boards on company decision making seems to be much less than that of the boards of representatives, although it is significant in some activities, such as the distribution of profits. This suggests

[18]For this reason, and for brevity's sake, the results are not reported separately for the capital city and for provincial governments.

[19]Thus, in contrast to the conclusions of Aghion et al. (1994, p. 1328) and Fan and Schaffer (1993, p. 5) on other transition countries, the state in Mongolia does not appear to be an absentee owner.

[20]Mongolia is 3.7 times the size of California, but has a population (2.1 million) that is similar to that of Arkansas.

[21]The latter influence was reported by general directors in response to our survey questions.

[22]Article 54, Clause 1, part 1 of the Partnership and Company Law of Mongolia of 1995.

Table 3. Size of State Representation on Corporate Boards in Mongolia in 1996

Set of enterprises	Board of representatives (percentage membership)[a]		Board of auditors (percentage membership)[a]	
	Local government officials	Central government officials	Local government officials	Central government officials
All	8.5	4 6	16 8	11 5
No state ownership	0.9	0.7	7 3	8.7
Centrally owned	8.9	18.1	20 5	23.2
Locally owned	26.5	2 0	36 4	7.7

[a]Means over sets of enterprises

that the auditing boards retain a role that is somewhat more encompassing than simply auditing company books.

Tables 3 and 4 present data on board membership. Table 3 focuses on the size of the governmental presence, examining the percentage of board seats occupied by government officials, while Table 4 examines the simple presence of government, that is, whether or not there are government officials on a board at all.[23] Both tables provide clear evidence that the state's ownership interest is represented. Nevertheless, 28 percent of centrally owned enterprises do not have central government officials on either of the boards, whereas 12 percent of locally owned enterprises do not have a local government official on either of the boards. Moreover, in completely private enterprises, 14 percent have at least one central government official on one of the boards and 15 percent have at least one local government official.

There are small differences in the patterns of central and local government representation in the enterprises with residual state ownership.[24] Overall, the local governments are more active in securing representation on the two boards, judged in terms of the measures

Table 4. State Representation on Corporate Boards of Mongolian Enterprises in 1996

Set of enterprises	Percentage with local government representation			Percentage with central government representation		
	Board of representatives	Board of auditors	One or both boards	Board of representatives	Board of auditors	One or both boards
All	30	27	39	17	17	27
No state ownership	4	14	15	4	12	14
Centrally owned	38	36	30	64	32	72
Locally owned	84	50	88	9	18	21

[23]The survey question was phrased so that the responses represent government officials acting in an official capacity

[24]There are no differences between the amounts of local and central representation on the boards of wholly privatized enterprises

Table 5. Importance of Lobbying Contacts in Mongolia, 1996

Set of enterprises	Type[a]	Importance of contact (percentage of enterprises)		
		Very important	Important	Not important
All	Ministries	12.4	53.4	34.1
	BA/LG	18.1	51.4	30.5
No state ownership	Ministries	9.3	47.1	43.6
	BA/LG	25.0	52.9	22.1
Centrally owned	Ministries	19.6	64.7	15.7
	BA/LG	7.8	43.1	49.0
Locally owned	Ministries	13.8	58.6	27.6
	BA/LG	10.3	55.2	34.5

[a]BA/LG = Business associations or formal lobby groups

presented in both Tables 3 and 4. The central government's representation is more narrowly confined to centrally owned enterprises. No doubt these differences can be partially explained by geography—local governments are located near locally owned enterprises, but sometimes there are great distances between the center and its enterprises.[25]

LOBBYING

Lobbying represents the opposite side of the coin from government representation on boards, enterprises reaching out to affect policy. The survey asked enterprise directors the following question: "When this enterprise wishes to make its opinion on a government policy or law known to the government, how important are the following methods....," then listed six different varieties of lobbying to elicit the reactions of respondents. Of these six, the lobbying route most indicative of the continuation of past ties is contact between the enterprise and the officials of a parent or former parent ministry.[26] The route most representative of the new market democracy is the use of a business association or formal lobbying group. The data on the use of these two lobbying options are presented in Table 5.

Not surprisingly, contacts with ministries are more important for centrally owned enterprises than for locally owned enterprises, indicating that old ties have tended to be preserved to a greater degree when ownership is kept within the central government than when it passes to localities. Conversely, enterprises with local ownership tend to use independent lobby groups more than do the enterprises with central ownership, suggesting that the breakdown of ties with the center leads to greater use of the new democratic channels of access to government. This result holds even more strongly for locally owned enterprises located in the capital city, suggesting that geographical proximity (or lack of same) is not the reason for these patterns in the data.

[25]But this explanation does not provide the full picture. When repeating the analysis in Tables 3 and 4 for only those enterprises in the capital city, the same pattern emerges—the local government is more active.

[26]All privatized enterprises were the scions of some central ministry.

Table 6. Proportion of Mongolian Enterprises Receiving Subsidies in 1995

Set of enterprises	Subsidies from (percentage). Local governments	Central government
All	6.4	6.0
No state ownership	5.0	2.1
Centrally owned	7.8	17.6
Locally owned	8.6	5.2

A rough summary of the lobbying data would place the lobbying relations of locally owned enterprises halfway between those of centrally owned enterprises and those of completely privatized ones. This characterization, concerning how enterprise-state relations vary with level of government, recurs throughout this paper.

SUBSIDIES AND SOFT BUDGETS

A prime goal of reform is the hardening of enterprise budget constraints, which can occur both by changing the incentives of politicians as they interact with enterprises and by changing the constraints facing politicians, particularly governmental budget constraints.[27] Changes in the levels of state ownership can alter political incentives (Kornai, 1992b; Shleifer and Vishny, 1994). The governmental budget constraint hardens as enterprise-state interactions devolve to lower levels. In Mongolia there is no doubt that local governments have much harder budgets and less flexibility than does the central government, both because discretion in financing decisions is more limited at the local level and because the center does not face the inter-jurisdictional competition that is present at the local level.

To examine possible sources of soft budget constraints, the survey asked whether enterprises had received subsidies in the previous fiscal year either in the form of direct financial assistance or in terms of funds or loans for investment.[28] Table 6 summarizes this information, listing the percentage of enterprises that had received at least one subsidy from either the central or the local government. Although the number of enterprises aided by each level of government is similar, the distribution is quite different. The central government focuses its subsidies on centrally owned enterprises, whereas the local subsidies are more evenly spread. As a result, centrally owned enterprises are more likely to be recipients of subsidies than are enterprises with other forms of ownership.

Basic accounting data provide a complementary view. As Table 7 shows, tax arrears are a significant source of implicit state aid for Mongolian enterprises. Further insights into the results presented in the table derive from two facts. First, the collection and use of the corporate income tax for most enterprises is in the hands of the local authorities except in the case of a significant proportion of very large and/or centrally owned enterprises. Second, corporate income tax arrears are negatively correlated with current

[27]We have omitted a discussion of the changing incentives of managers as they interact with politicians, which of course lead indirectly to changes in the incentives of politicians. For a clear discussion of these points, see Shleifer and Vishny (1994).

[28]Government loans are viewed as subsidies, since these usually involve low interest rates and uncertain repayment.

Table 7. Enterprise Subsidies through the Mongolian Tax System in 1995

Set of enterprises	Effective percentage of corporate income tax for enterprises earning positive profit	Percentage of enterprises		
		Earning positive profits that were assessed corporate income tax	Owing more than one year's worth of corporate income tax	Owing more than one year's worth of social insurance liabilities
All	28.4	82.9	22.5	15.9
No state ownership	25.4	77.6	25.0	16.0
Centrally owned	30.2	88.1	14.9	12.8
Locally owned	33.0	89.4	23.6	18.5

profitability. Then note from Table 7 that locally owned enterprises have higher effective tax rates than other enterprises and that locally owned enterprises have higher than average tax arrears. These facts suggest that implementation of tax policy by the local government might have more of a redistributional component than does central government implementation. In an environment where enterprises are not mobile and where governments have only blunt tools to effect redistribution, such policy by local government might represent a relatively efficient means of redistribution.

Table 8 examines data on interactions with commercial banks. Although commercial banks in Mongolia are independent entities (some with government ownership), the central government holds considerable sway over these banks. The banking sector has been continually in a parlous state and the banks have frequently relied on central bank funding and government deposits, as well as the nonenforcement of prudential requirements. Thus, the data in Table 8 are indicative of central government influence. Centrally owned enterprises seem to have been granted some concession on loan rates, although with inflation running at approximately 3.5 percent a month, the interest rates are at high real levels. Fewer centrally owned enterprises are overdue on their loans, indicating that no consistent picture emerges on subsidies through the banking system. Nevertheless, the overall picture emerging from Table 8 is that interactions between locally owned enterprises and commercial banks are more similar to those interactions for fully privatized enterprises than for those of centrally owned enterprises.

Table 8. Loans Paid, Interest Rates, and Extent of Overdue Payments by Mongolian Enterprises, 1995

Set of enterprises	Percentage with current loans	Average monthly interest paid on loans from commercial banks	Percentage with overdue loans from commercial banks
All	33.6	6.1	9.4
No state ownership	36.7	6.3	10.8
Centrally owned	27.1	5.3	4.2
Locally owned	32.7	6.2	10.9

Table 9. Perceptions of Soft Budget Constraints in Mongolia, 1996

Set of enterprises	Percentage					Means of enterprise responses
	0	1-4	5	6-8	9-10	
All	73	12	6	4	3	1.23
No state ownership	81	13	1	2	3	0 75
Centrally owned	52	16	14	10	8	2 56
Locally owned	72	10	9	9	0	1 26

The existence of subsidies is not synonymous with soft budgets, because subsidies might be unrelated to enterprise performance (Kornai, 1992a, p. 10). Similarly, the absence of explicit subsidies does not imply hard budget constraints, because assistance can be channeled in ways other than direct financial subsidies. Thus, we asked enterprises the following question, designed to elicit their expectation of the likelihood of state aid if their enterprise came upon hard times:

> Suppose that unfortunate market conditions resulted in a sudden drop in your enterprise's revenues, so that you might have to lay off workers. How likely is it that the government (either national or local) would help your enterprise out, so that it would not be forced by its financial situation to lay off workers? Please indicate your expectation of the likely government reaction by choosing a point on a scale from 0 to 10—a "0" means you that think that the government would do absolutely nothing to help out and a "10" means that you think that the government would completely make up for the decline in revenues in some way, and a "5" means the government would make up half the decline in revenues.[29]

A summary of the enterprises' responses appears in Table 9. Although 27 percent of all enterprises expect some form of help when they are in distress, 48 percent of centrally owned enterprises expected such help. The locally owned enterprises were much closer to the fully privatized enterprises in their responses, with 28 percent of locally owned enterprises expecting some form of state aid; 19 percent of privatized enterprises have such expectations. By changing scale, one can interpret the answers to the above question in terms of the "degree of softness" of budget constraints. For example (see last column of Table 9), the mean score of the responses of centrally owned enterprises is 2.56, indicating that these enterprises believe that 25.6 percent of lost revenues would be made up by government. The equivalent figure is half as much for locally owned enterprises, and less than one-third as much for fully privatized enterprises.

[29]The question used "unfortunate market conditions" as the cause of the enterprise's problems, rather than any wording that could have been taken to imply that the enterprise was responsible for its plight, to remove any ethical content from the answers Similarly, we focused on employment as the objective of the government aid, to reduce the negative connotations associated with admitting the receipt of such aid Employment maintenance also is a likely goal of governments in transition environments

Table 10. Sales to Mongolian Government in 1995 (percent of total)

Set of enterprises	Average sales with government involvement[a]			
	Mandated by central government	Negotiated by central government	Mandated by local government	Negotiated by local government
All	3.8	5.3	3.3	5.5
No state ownership	2.6	4.9	2.4	3.3
Centrally owned	6.3	7.4	4.0	7.4
Locally owned	4.3	4.3	5.0	9.3

[a]As buyer or intermediary

THE STATE AS CUSTOMER

In examining the role of the state as a customer, the survey attempted to discern which state purchases were on a commercial basis and which involved compulsion, since the implications of these two forms of enterprise-state interactions are very different. Enterprise managers therefore were asked which sales to the government were freely negotiated and which were mandated, identifying the arm of government that was the buyer.[30] The results appear in Table 10. Mandatory purchases by the central government are slightly higher than those of the local government, with the difference primarily reflecting the comparatively high figure for central government purchases from centrally owned enterprises. In contrast, the mandatory purchases of the local government tend to be spread much more evenly across the different types of enterprises.

THE STATE AS MEDIATOR

Under the old system, contract enforcement and the arbitration of interenterprise disputes was the responsibility of the administrative system. Now, enterprises are removed from that system, but the economy lacks the legal institutions and informal contract enforcement and dispute-resolution mechanisms that are common in market economies. There is wide scope for costly transactional failures.[31] For better or worse, local and central administrations have the power to step into this breach, providing dispute-resolution services.

Our survey asked respondents to assess the usefulness over the two previous years of a variety of mechanisms employed by enterprises to resolve disputes with their customers or suppliers Table 11 summarizes their responses, contrasting the use of the courts and of the two levels of government with the private-sector alternatives. Local government is much more heavily involved in these dispute-resolution activities than is the central government. Moreover, the activities of the local government are more evenly spread over all types of enterprises than are those of the central government, whose activities are heavily concentrated in those enterprises with central ownership. Since the answers to the survey

[30]The questions sought information on government involvement, whether or not the government was the ultimate consumer

[31]See Hendley et al (1997) for a description of such problems in Russia

Table 11. Use of Methods of Dispute Resolution[a] by Mongolian Enterprises in 1996

Set of enterprises	Percentage reporting use of: Intervention of local government	Intervention of central government	Courts	Private methods[b]
All	35	17	61	23
No state ownership	26	11	61	24
Centrally owned	52	44	70	31
Locally owned	43	10	53	15

[a]Disputes with customers or suppliers
[b]Arbitration, security firms, etc

question reflected the usefulness of these dispute-resolution activities, Table 11 suggests that local governments have played a more useful role in filling this institutional gap, and one that is more evenhanded across enterprises of different ownership types.

CONCLUSION: THE EFFECTS OF DECENTRALIZATION

If one were to employ the standard elements of economic theory to make predictions about the differing behavior of central and local governments toward the enterprise sector, then the analysis would begin by identifying the differing incentives and constraints of officials and politicians within the two levels of government. A very important difference between the two levels of government is the tightness of fiscal constraints, with the local governments having only small room for maneuver, whereas the central government has a considerable degree of flexibility in deciding the size and allocation of its budget. In addition, the local governments face inter-jurisdictional competition, perhaps not in terms of existing enterprises moving from one location to another, but certainly in terms of shifts in the inter-regional share of national markets and in attracting new enterprises.[32]

With such differences between the two levels of government, one would predict that local governments would face stronger pressures to pursue social welfare-enhancing policies than would the central government. Oates and Schwab (1988) have shown that inter-jurisdictional competition between local governments tends to weed out inefficient tax-spending policies. Their results imply that such competition would reduce inefficient interventions. Qian and Roland (1996b) have demonstrated that governmental decentralization leads to the imposition of harder budget constraints by governments on enterprises. The central government, with more fiscal discretion, would tend to be more active in pursuing noneconomic, political goals than would local governments (Brennan and Buchanan, 1980).

The results of Shleifer and Vishny (1994) are complementary to those already cited, shedding further light on the role of the government's ownership stake in an enterprise. They have demonstrated that the looser the government's fiscal constraint, the more likely will the state ownership share affect the government's posture toward the enterprise.

[32]The survey data show that locally owned enterprises are subject to stronger competitive pressures than is the average Mongolian enterprise

Therefore, state ownership will mean more at the central level than at the local level in Mongolia.

We thus have three predictions from theory: the central government will be more likely to pursue noneconomic goals; the local government will be relatively more active in areas that have a social-welfare enhancing component; and the central government will be more affected by its ownership stake in dealing with enterprises than will the local government. Each of these predictions finds echoes in the data presented in this paper. For example, the centrally owned enterprises report significantly softer budget constraints than do local enterprises. The actions of the central government are quite clearly targeted to centrally owned enterprises, whereas the actions of local governments tend to be spread more evenly across different ownership types. In the case of dispute resolution, which might well have efficiency-enhancing elements, the local governments are more than twice as active as the central governments and their activity is more evenly distributed over enterprises of all ownership types than is the activity of central government.

As a final observation on the data, quick inspection of the tables shows that the numbers summarizing enterprise-state relations for locally owned enterprises appear to lie between the corresponding numbers for centrally owned enterprises and those for the completely privatized ones. This suggests that governmental devolution produces effects on enterprise-state relations that are similar to those of privatization, although not of the same intensity.

We close with two comments on the limitations of the results presented here. First, we have not analyzed the consequences of decentralization and privatization for the market behavior of firms. That is the subject of ongoing research.

Second, relationships with enterprises represent only part of the activities of government and we have not examined a broader array of government behavior, such as expenditure on public goods, tax policy, and welfare programs. In Mongolia, because of the lingering excessive centralization of the socialist era and because of the extremely tight budget constraints resulting from the decline in resources available to the government during the transition, local government discretion on taxation and spending policies has been heavily circumscribed. It remains to be seen whether our results for enterprise-state relations are carried over into broader spheres of government activity as decentralization proceeds and increases in scope. At the very least, the results indicate that there is little basis for the very common presumption that devolution slows reforms by placing decision-making power in the hands of local officials who are assumed to be less reform-oriented than their counterparts in the center.

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Review

James H. Bater. *Russia and the Post-Soviet Scene: A Geographical Perspective* New York: John Wiley & Sons, 1996. xiv + 354 pp., figures, tables, index. $54.95 (cloth), $34.95 (paper).

Reviewed by John S. Adams[1]

In this robust, up-to-date, and readable text, James H. Bater (Professor of Geography at the University of Waterloo in Ontario, Canada) aims to provide a geographical portrait and analysis of the fast-moving and disruptive changes under way in Russia and the other successor states of the former Soviet Union. The book is a major expansion and revision of his earlier well-received work, *The Soviet Scene: A Geographical Perspective* (1989).

Just two years after the previous book appeared, the Soviet Union disintegrated and the book's subject changed. In the years since the collapse of the Soviet state, 15 new states have appeared where one existed before. Russia is preeminent among the successor states, so the discussion in the book concentrates on that country. Places and peoples have remained, but political, social, and economic transformations as dramatic and historic as those accompanying the creation of the Soviet Union unfolded in rapid succession after 1991, requiring a major revision of the 1989 presentation.

When Bater published the earlier work, he drew on two themes to organize the presentation of the geography of a vast region already undergoing fundamental transformation. First was a theme of *historical continuity and change*, arguing that an appreciation of Russia's past was imperative to an understanding of the nature of the Soviet system and the geography it produced, as well as the dramatic changes under way during the Gorbachev years at the end of the 1980s. Bater argued that more than six decades of Soviet-era development under the direction of the Communist Party could be understood and properly assessed only if there were an appreciation of Russian life before the Revolution.

The second theme around which the 1989 book was developed was that of *decision making*: who makes decisions, how are they implemented, what is the relation between theory and practice, and how do decision outcomes transform the landscape? The book was not a regional geography in any traditional sense. Rather, it was a broad but systematic survey of Soviet geography: physical environment and environmental deterioration wrought by Soviet-style economic development; demographic change, life expectancy, and conditions of public health; the nature of Soviet cities, economic and social geography, with special attention to patterns of urban development under centrally planned state socialism; and social justice and the quality of life in different parts of the country.

Bater builds this new work around the same two perspectives that served as the organizing framework for the previous work. First is that the *historical perspective* is essential if the present is to be understood. He outlines the nature of the Soviet socialist system as it evolved and operated in its later decades as well as its legacy to the Soviet successor

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states, demonstrating how the Soviet system has left both an indelible impression on the landscape and helped to shape human values. The second integrating theme is that of *political structures and decision making*. For more than seven decades the principles of Soviet-style socialism provided the dominant framework for decision making. Its underlying ideology shaped human values, and this legacy of the past will persist for a long time to come. Two other themes are developed in several of the chapters: *the role of minority and ethnic groups and territories, and environmental degradation.*

Following an introductory chapter, Chapter 2 outlines the principal features of the pre-revolutionary Russian Empire that culminated in the revolution and the Soviet system that followed. These include the pre-revolution agrarian system, the urban-industrial economy, and the main currents of social and political change in the late imperial era; the Soviet political and administrative structure that the revolution spawned; the theory and reality of Soviet social structure; the values that defined the Soviet era; and the events that led to the collapse of the Soviet system.

Chapter 3 describes the essential features of the Soviet centrally planned economy, the nature of the decision-making process, and regional development priorities. The Soviet system was able to generate high rates of growth in the early years, but as the economy modernized and diversified, central planning steadily foundered, and periodic and unpredictable shortages developed. The shadow economy emerged, and repeated efforts were launched to reform the system within a revamped socialist system.

Chapter 4 examines the demographic structure and population geography of Russia and the other newly independent states, tracing how historic events wield contemporary consequences for population structure. The concept of demographic momentum is used to show how wars and domestic events affected birth and death rates through the years, and will continue to wield their impact for decades to come, including shortened life expectancies and population declines in some of the post-Soviet states since 1991.

The urbanization of the Soviet population is the topic of Chapter 5. The Soviet city was to be built according to socialist principles, but the location and growth of cities and the urbanization of the population was to be tightly controlled as a component of central planning. The idea that the built environment of the city could help shape human values and direct certain aspects of human behavior played a major role in the design and development of cities. In the post-Soviet era, market reform and privatization of real estate are transforming the cities. The example of Moscow's housing market illustrates selected aspects of these contemporary changes.

In Chapter 6, the privatization of land and resource ownership in the post-Soviet states is examined. Some of the new states have significant natural resource endowments, but the challenge is not only to find and exploit them sensibly, but also to change management practices and civic attitudes that resist the idea that individuals or companies should own, buy, or sell natural resources, despite the opinion of many government officials that such a concept is central to the market reform process.

Chapter 7 explores the management and use of land for food production by reviewing the tragic, wasteful, and inefficient consequences of Soviet-era collectivization of agriculture. That the defects in the system were recognized is reflected in the toleration of the more or less market-oriented personal agricultural sector that operated throughout the Soviet period. In some post-Soviet states, progress in privatizing agriculture has moved swiftly, in others it has scarcely begun, but the ability of the states to feed themselves is mixed

Chapter 8 focuses on flux in the organization of energy production, distribution, and consumption. A review of the geography of Soviet-era energy resource policies and developments is followed by analysis of energy resource developments in the 1990s, with special emphasis on Russia, which has the richest energy base, and on Russia's relations with the other states seeking to export their energy surpluses.

Chapter 9 examines past and present relationships between industrial raw materials and markets, and shows how much of the legacy of Soviet-era industrial infrastructure (e g , specialized factories and cities as sole suppliers to the entire country), transportation infrastructure (i.e., designed to enforce mutual dependence of various regions on one another regardless of cost or efficiency considerations), and the movement of raw materials and finished products is simply a burden for post-Soviet economies trying to adapt to a market economy.

The quality of life in states making a transition from being a part of a single planned economy to independent market economies is the subject of Chapter 10. Unemployment, poverty, inflation, and the disappearance of the social safety net mean that a basic level of living is no longer guaranteed Meanwhile, political instability, civil unrest, and the threat of war have stimulated huge numbers of people to migrate. Life expectancy is in decline, and pollution threatens life and health in many regions.

The final chapter examines selected aspects of political geography confronting Russia and the post-Soviet scene. Special attention focuses on nationalism and core-periphery relations facing Russia.

Although the book retains the earlier 11-chapter format, the text has expanded by more than 50 percent. The compact single-column format has been replaced by larger pages and a double-column format that works well and provides more space for complex maps and figures, but it is space that is sometimes allocated only grudgingly to those graphics

Soviet-era data tables from the earlier text are updated to 1989, the last figures available. Post-Soviet-era data come up to 1994 or 1995. Ten new tables supplement the updated original 24, providing information on post-Soviet states—their areas and populations, food consumption, energy production, industrial production, consumer-goods production, privatization of Russian industry, and the startling upsurge of death rates by cause of death in recent years. Unfortunately, the tables are sometimes hard to read. They are printed with a dark screen background—perhaps 50 percent black. Numerals appear in a light sans serif type face that is less easily read than would be the case with darker numerals, lighter screens and a different type face. Moreover, five and six-digit numbers appear without commas, a style choice that creates an additional and unnecessary visual obstacle to quick reference and comparison of values.

The 61 maps and diagrams of the original text have been updated and redrawn, and supplemented by 44 new figures. The figures must receive mixed reviews because although some are significantly improved from the versions that appeared in the earlier text, others are less legible, or poorly designed, or hard to use. A few important maps from the earlier text are reproduced at an expanded size, making them easier to read and more useful. For example, the map of physical geography (Fig. 1.3) is at a scale about 25 percent larger and is significantly more legible. The map of vegetative zones (Fig. 1 5) has been completely redrawn and is much improved. A well-designed map of annual precipitation (Fig. 1.4), missing from the earlier text, is a welcome addition. Meanwhile, a map illustrating expansion of the Russian Empire (Fig. 2.1) appears to be about 25 percent larger than in the earlier text, but some labels on cities and physical features are still difficult to read, and their placement sometimes overlaps boundaries and dark screen patterns, rendering them partially illegible. A series of eleven pie diagrams illustrating post-Soviet states' retail trade turnover by state and non-state sector (Fig. 3.6) is vivid and visually effective, but accompanying lettering in four-point and smaller type is so small that even my good eyes strained to read accompanying data. On the other hand, a map of Moscow apartment prices per square meter by prefecture (Fig. 5.12) was effectively designed for the size at which it appears on the page and choropleth shading of the ten prefectures informs us that prices reach their highest levels ($900-1100 per square meter of useful space in the Central Prefecture and lowest in Southeast). But then vertical columns are superimposed on more than thirty municipal districts, with column height corresponding to apartment prices per square meter as a cartographic device to illustrate price variations within prefectures. The problem with this design is that the numerous parallel columns camouflage the very patterns being described. Appropriately graded circles would have been a better choice. In a few other applications, the vertical-column technique appears with better results.

Each chapter features an extensive and up-to-date bibliography. The index is extensive and useful. Also included are internet addresses for the *Virtual Library: Russian and East European Studies*, as well as for the *Russian News Navigator*, steering students and instructors to an almost-complete list of news sources on the net.

The text of this book is well written and carefully edited in a style that is interesting and accessible. Despite my grumbles about some of the maps and graphs, it is aptly illustrated. Bater is to be complimented for achieving the goals that he set out for this work. He has produced what I consider to be the best general geography text on post-Soviet Russia and the successor states. I am exceptionally pleased with this book, will adopt it in my course on "Russia and Environs," and enthusiastically recommend it to others.