Firm Performance, Conflict Prevention, Capital Flight—World Bank Researchers on New Territories

Interview with Paul Collier and David Dollar

In the following interview with Transition editor Richard Hirschler, Development Research Director Paul Collier and Development Research Group Manager David Dollar talk about three ongoing research programs: surveying and comparing enterprise performance across countries, understanding and helping to prevent ethnic and civil conflicts, and identifying the causes of and preventing capital flight. The findings could be highly relevant for transition economies.

Q. What are the major new thrusts of the research department that might also involve the transition economies?

A. One major new initiative is to collect internationally comparable data on firm performance. Manufacturing has reached a global scale, and it is no longer sensible to think only within the context of a national market. Countries must determine if their manufacturing sectors are internationally competitive. By having a comparable standardized survey, with detailed information on costs and performance, we will be able to benchmark a country's manufacturing sector against international competition. That can help to determine to what extent and why cost structures are out of line. The Bank has surveyed firms in several countries in East Asia and Africa, and we will extend this project to the transition countries. The Bank has already carried out surveys on how enterprises in the transition economies of Europe and Central Asia have been affected by corruption and by government regulations.

Announcement

We are pleased to announce that the Bank of Finland’s Institute for Economies in Transition (BOFIT) has joined forces with Transition and will contribute to both its financing and its editorial content. BOFIT is headed by Professor Pekka Sutela. Its primary mission is to monitor and provide economic analysis of developments in economies in transition, particularly Russia and the Baltic states. It undertakes research and analysis of economic policy, trade, and integration. Current topics include economic developments and economic policy—stabilization policies in particular—in Russia and the Baltic states; banking and finance in Russia and the Baltic states; the European Union’s eastward integration; external economic relations of Russia and the Baltic states; and privatization and corporate behavior in Russia and the Baltic states. The institute’s regular publications—Baltic Economies: The Quarter in Review; Russian Economy: The Month in Review; and Review of Economies in Transition—are available on the Internet (see below). The institute also publishes scholarly books and participates in a number of national-level seminars and international forums.

Q. Who will benefit from this research—the member countries themselves or multinationals that will be able to invest their capital in the most lucrative enterprises?

A. The information will be beneficial to all interested parties. First and foremost we will provide feedback to government, but we will also share it with chambers of commerce and manufacturers' associations. Our data will show how enterprise performance in a particular country compares with enterprise performance elsewhere in the world. The data will analyze both weak spots and strengths. Earlier polls often relied on the opinions of the polled enterprises. We are linking that information to hard evidence on actual costs and performance. This gives us a much firmer basis for analysis. The survey is thus distinctive because it allows performance to be compared internationally, it is comprehensive, and it is quantitative.

Q. Policymakers can also make good use of these microeconomic data.

A. Definitely. The surveys provide a basis for monitoring and evaluating changes in firm-level accomplishments. This information could be important for countries, including many transition economies, that are in an early stage of global market penetration and reform.

Q. Would Russian enterprises be included in the survey?

A. We are ready to extend our survey to the Russian Federation and to Poland, followed by other transition economies, assuming that the project attracts the interest and support of the host government and gains endorsement and backing within the vice-presidency of the World Bank responsible for lending and nonlending operations in Eastern Europe and Central Asia.

Q. Who will finance these surveys?

A. We need some contribution, in the form of staffing, from the country in which we undertake these surveys. It is common knowledge that if host authorities have a stake in the success of a joint project, they are more eager to participate and make commitments. In most countries government agencies are entrusted to collect firm-level information. So ideally we could work with these agencies. In some countries private firms conduct these surveys, but we could work out arrangements with them as well. Assuming the research committee endorses the program, the World Bank will finance a significant part of this project. Our research department will contribute significant resources. We have already hired several new professionals with expertise in this area. In East Asia we are supporting a training program in which government officials are being taught to analyze the first round of data. In the Bank, country economists and other staff can use the same information to write economic reports and private sector assessments.

Q. What are the other new research areas?

A. An important field is the study of civil conflict, crime, and violence. We are trying to understand the causes of these phenomena in order to help develop policies to prevent them. We are also looking at the factors that sustain conflicts once they have started. Understanding these factors can facilitate resolution of the conflicts and postconflict reconstruction in those battered economies. The main work is just starting. We held a conference in February, with representatives from around the world, and we are building up an international research team to study the process.

Q. Unfortunately, many transition economies—including several successor states of the former Yugoslavia—
via and several countries in Central Asia, such as Tajikistan, Uzbekistan, and Armenia—are suffering from the effects of past and present conflicts. There are also open or suppressed hostilities toward minorities.

A. We are studying both open and latent conflicts. One key research finding so far is that policies that effectively prevent conflicts are very different from policies that resolve conflicts after they have occurred. In our research we have also included crime and violence, because in some countries you have the potential for overt civil war while in other cases you have "only" the mounting problems of crime and violence. It is important to explore the common sources, if any.

Q. It must be a huge research area. Crime and violence can be connected to corruption, as it is unfolding in Russia.

A. We’ll just go through a few of the findings. We can distinguish four major causes of conflict:

1. Poverty. Governments and donors can do a lot to prevent conflicts by reducing poverty. In fact, poverty reduction is the single most effective measure of conflict prevention.

2. Lack of political rights. Moving to a full democracy is equivalent to something like 50 years of growth, so it is quite a powerful effect.

3. Possession of natural resources. Many conflicts are in effect a fight for control over natural resources, which should be interpreted rather broadly to include drugs. The nature of these resources may affect the way things develop. Corruption seems a more practical way of extracting extra rents from, say, oil revenues, while civil war is a more feasible alternative if the stake is wealth from opium, cocaine, diamonds, or gold. If a country is rich in natural resources but still burdened by a lot of poverty and its people are deprived of their political rights, that country has a lot to worry about.

4. Ethnic and religious diversity. The common perception that ethnic and religious diversity contributes to civil strife is untrue: the greater the degree of religious diversity, the safer the society. That is also true with ethnic diversity. Twenty ethnic groups, for example, can live and interact very well. But it is also true that just two or three ethnic groups within a society can make each other a lot of trouble, and the risk of open conflict increases. So diversity is a source of safety, except where you have just two groups in the society.

Q. What other research projects is in the foreground?

A. We are trying to analyze the major causes of capital flight and identify ways to prevent it. We have estimated the stock of private wealth in a number of economies, looked at what proportion of that private wealth is held outside the country, and tried to determine what affects that proportion. Countries differ widely in terms of the amount of private wealth that is held abroad, and there are fairly consistent patterns as to what drives capital outflows. This is a serious problem in Africa and the Middle East, where around 40 percent of private wealth is held outside these regions. Of course, large capital outflows are also a huge problem in many transition countries, primarily Russia. Repatriating that wealth would have dramatic effects on raising capital stocks and boosting investment.

Capital outflows are driven by a combination of misaligned exchange rates, distorted relative prices, high investment risk, and high indebtedness. So if a country is heavily in debt, is seen as highly risky, has distorted relative prices and an overvalued exchange rate, private wealth is going to move outside the country. Each of these factors is pertinent for many transition economies. A number of them have unfavorable risk ratings. Some have accumulated very high levels of indebtedness. What can a country do about it? The easiest area of policy intervention is to eliminate relative price distortions and to set the exchange rate right. The risk rating is much harder to influence. It is possible to do so, however, if governments are consistent in their policies, abstain from sudden policy reversals, and adopt liberalized trade regimes through binding commitments with the World Trade Organization, for example. Countries with good economic policy are perceived to be less risky. Thus potential investors can be persuaded that there is no need to seek outside refuge for their wealth. Adopting such policies could eventually slow capital flight significantly.

A related topic is the effect of foreign aid on private foreign capital flows. Foreign aid reduces the perception of risk. Where appropriate economic policies are in place, foreign aid has a particularly strong effect on risk ratings. As a consequence, foreign aid "crowds in" foreign direct investment, helping to reverse capital flight. In contrast, when countries have highly distorted policies, official aid does not impede capital flight.
Time to Rethink Privatization in Transition Economies?

by John Nellis

Almost everywhere in the world, including Central Europe, privatization has succeeded to improve firm performance. Nevertheless, early and albeit fragmentary evidence from Armenia, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, Mongolia, the Russian Federation, and Ukraine so far shows that:
- The association between private ownership and restructuring (changes positioning the firm to survive and thrive in competitive markets) is weak or nonexistent.
- Firms that are partially owned by the state perform better than privatized companies.
- Few differences are discernible between the performance of state-owned and private firms.
- Clear performance improvements are evident only in the few firms that have been sold to foreign investors.

Faced with these sobering results, many policymakers and observers, particularly in the smaller or more geographically isolated transition economies, have begun to question the wisdom of rapid mass privatization. Several factors have made them question this policy:
- First, the failure of privatization to improve performance in Russia has convinced many decisionmakers that privatization is unlikely to succeed in their countries, where the quality of industrial assets and the business environment is as bad or worse than in Russia.
- Second, recognition has become widespread that the administrative and legal mechanisms needed to transform rapacious grasping into tolerable and productive acquisitiveness are almost entirely lacking.
- Third, policymakers in the former Soviet republics recognize that many aspects of their economies are still under the influence if not the control of Russian supply, transport, energy, and sometimes criminal networks.
- Fourth, several countries that tried mass privatization schemes, such as Kazakhstan, Mongolia, Moldova, and Albania, have concluded that they gained little from the effort. In those countries, divesting ownership to inexperienced investors has not led to effective governance of firm managers, many of whom failed to implement change and remain largely unaccountable for their actions.

What Went Wrong?

Critics place part of the blame on the international financial institutions, since they required governments of transition economies to privatize rapidly and extensively before competitive policies and institutional safeguards—recognized as important but thought to be secondary—were put in place. These institutions believed that the immediate need was to rapidly create a constituency of property owners. Private ownership by itself, they believed, would provide sufficient incentives to shareholders to monitor managerial behavior and push firms to good performance.

But capitalism is revealed to require much more than private ownership. It functions because of the widespread acceptance and enforcement of fundamental rules and safeguards that make the outcomes of exchange secure, transparent, and predictable. Where such rules, safeguards, and institutions are absent—fairness, equity, and firm performance suffer. In an institutional vacuum none of the players in a privatized firm—workers, managers, creditors, investment fund shareholders, civil servants managing the state's residual share—is interested in or capable of maintaining the long-run health of the assets. In such circumstances, privatization is more likely to lead to stagnation and decapitalization than to improved financial results and enhanced efficiency.

Should Privatized Firms Be Renationalized?

Some observers thus have suggested that further privatization be postponed until competitive forces and an enabling institutional or governmental framework are in place. Others have even called for the renationalization of divested firms, which would or could be "reprivatized" at some later date.
Despite its *prima facie* (obvious) appeal, renationalization of privatized enterprises would be a desperate measure, with a high likelihood of failure, particularly in those institutionally weak settings where the idea has been most strongly endorsed. To successfully renationalize (and then reprivatize) previously state-owned firms, the state would have to select some or all of the most egregiously mismanaged enterprises, put them back in its portfolio, manage them while there, and eventually sell them in a responsible manner. Unlike the sales transacted the first time, these reprivatizations would have to be conducted in an open, transparent manner. Standard, internationally accepted valuation procedures would have to be adopted, and internationally recognized, financial and transaction advisors would have to be involved. All relevant information would need to be disclosed to bidders, and bidding would have to be open to all interested parties. No restrictions (such as maintaining the same line of business or retaining a certain number of employees) could be placed on the management of the business after the sale.

The problems with such a plan are obvious: how many transition governments outside (or even within) Central and Eastern Europe could reasonably be expected to undertake this process and handle it well? How many have the capacity to prevent asset stripping in state-owned companies, or the technical and political capability to divest firms according to this set of procedures? Regrettably few. The irony is that a country with the skills and will to run state-owned firms in an effective and efficient manner is usually the very same country that can privatize successfully. Conversely, the forces and conditions that lead governments to botch privatization also hinder efficient management of state-owned enterprises.

The slightly less drastic argument runs as follows: in institutionally weak and politically fractured transition economies, long removed from or never fully integrated into the Western commercial tradition, the government should halt privatization of the remaining portfolio. Instead, it should shift efforts to strengthening market-supporting institutions (mainly public but some private as well), with the goal of channeling present “wild East” commercial activity into socially productive and acceptable modes. Discipline and competition should be imposed on and in the remaining public enterprises, accompanied or followed by staged, incremental shifts in ownership patterns, in a more or less evolutionary manner, “Chinese-style.”

Once again, the idea has a *prima facie* appeal. But once again, the solution assumes the existence of an effective state mechanism and institutional framework. Where such a framework does not exist, the options—unsuccesful privatization or maintenance of inefficient enterprises in the hands of a weak and venal state—are bleak. The medium- to long-term solution is to build up the government’s administrative, policymaking, and enforcement capacities. Exactly how this can be done and what the role of external assistance is in this process remains unclear, however.

Can anything be done in the shorter term? Several transition governments have tried to compensate for managerial and institutional deficiencies and lack of political consensus by contracting out much or all of the privatization process to private agents and advisors. Estonia, Poland, Bulgaria, Armenia, and Uzbekistan have tried or are contemplating this approach. Although proved successful in Estonia, this method is far from being a universal or speedy solution (as the Poles can attest). And the effectiveness of the effort still depends heavily on the capacity of the government.

As a consequence, reformer elements in the transition governments and the international assistance community—international financial institutions, the European Community, bilateral donors—abandon speed as the priority. They shift their efforts to a necessarily slower form of case-by-case or tender privatization, a more cautious, more evolutionary, more government-led path of ownership transfer.

**What Should Policymakers Do Now?**

Yes, it is time to rethink privatization; but only in those transition settings where history, geography and politics have channeled seemingly laudable economic policy into less than optimal outcomes. In Russia and elsewhere, both reformers and external advisors, aid-providers promised too much of privatization. Reformers seemed at first to view ownership change as a sufficient condition to bring about a new liberal order. Judgement of external advisors and aid providers—less forgivably—may have been clouded by hopes for fast and relatively simple solutions.

**Share of GDP derived from private sources**

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<td>Poland</td>
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<td>Slovakia</td>
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*This is almost exclusively agricultural production (Slay 1993).* 

Note: Czechoslovakia dissolved in 1993 and was replaced by Slovakia and the Czech Republic.

Sources: Patterson 1993; European Bank for Reconstruction and Development 1994, 1997; Bureau of Economic Analysis.
But the admission of error should not be overdone. When it can be carried out correctly, privatization is clearly the right course of action. In most of Central and Eastern Europe and the Baltic States, privatization has proven its usefulness. Difficulties that privatization had to face in institutionally-weak settings were not clear at the outset of transition—and those who claim they have long perceived this did not come forward with a clear alternative strategy.

One must continually ask, what was and is the alternative to privatization? Is it not clear that Russia would be better off today had it not undertaken the mass privatization program of 1992–94? Several other institutionally-weak transition economies—Belarus, Bulgaria, Romania, and Ukraine, for example—that eschewed, delayed, or approached privatization more cautiously, have little to show for it (though in no case, of course, is privatization or its absence, what explains the “whole story”). States that delay privatization usually find that enterprises make irresistible claims on nonexistent resources, threatening the whole of the reform process.

Where, then, does this leave policymakers? What policy prescriptions can be drawn from this experience?

- Privatization is generally the preferred course of action. But the institutional underpinnings of capitalism must be in place if privatization is to be effective and socially acceptable in the short term. Where they are present, privatization should proceed.
- If these underpinnings are not in place but the government is effectively working to create or reinforce them, it may make sense to delay privatization until this effort bears fruit. Hungary and Poland offer cases in point.
- Where the government is unwilling to or incapable of creating the necessary institutional framework, the long-term course of action is to support measures enhancing will and capacity. In the short term, case-by-case and tender privatization as well as reprivatization should proceed, in cooperation with the international assistance community, in the hope of producing success stories that will lead by example.

John Nellis is a senior manager in the Private Sector Development Department. He has worked extensively on the restructuring and privatization of state-owned enterprises in the Russian Federation, Morocco, Kenya, Estonia, Moldova, Egypt, and Vietnam. This article is based on a presentation he gave at the IMF Conference “A Decade of Transition: Achievements and Challenges,” held in Washington D.C. in February 1999. A longer version of the presentation will be published in the June issue of the IMF Quarterly, Finance and Development.

Organized Crime and Corruption Are Alive and Well in Ukraine
by Louise I. Shelley

Crime and corruption have increased dramatically in Ukraine over the past five years. As elsewhere in the former Soviet Union, the endemic corruption of the Soviet period has been replaced in Ukraine by organized crime and rampant corruption. Both threaten the country’s stability, undermine its transition to a market economy, deter foreign and domestic investment, and accelerate capital flight.

The effect on the economy has been severe. After nearly six years of independence, total foreign investment in Ukraine is a paltry $1.4 billion, and some $15–$20 billion is believed to have left the country illegally, at least partly in response to corruption and organized crime. Many major multinational corporations have decided not to do business in Ukraine, the second most populous country in Europe. In the spring of 1997, for example, several U.S. companies that had considered investing a total of $1 billion in Ukraine changed their minds, indicating that the business environment there is too risky. Motorola also decided not to invest in the country after losing its bid to develop a mobile phone network to the Kyiv Star company, a Ukrainian firm with close ties to the government.

Drug traffickers, as well as other domestic and foreign crime groups, launder money through casinos, exchange bureaus, and the banks. And banks provide criminal groups with information about businesses’ profitability and assets, which they use to extort money from them. Criminals and public officials often collude in this effort. Criminals, for example, extort money from businesses by threatening to sell the information they illegally obtain from banks to the tax police. Tax officials are sometimes
Public officials in Ukraine are poorly paid and face many opportunities to benefit from their positions. Business activities are regulated by as many as 32 laws, about 30 presidential decrees, and more than 80 resolutions; 32 ministries and departments have the right to issue licenses for various activities. This bureaucratic labyrinth creates vast opportunities for corruption. At the same time, taxes are high, creating incentives for businesses to pay off officials rather than pay taxes. A number of parliamentary deputies oppose tax cuts for fear that they will tempt many private firms out of the shadow economy, thus eliminating lucrative corruption-related opportunities for themselves.

The infiltration of Ukrainian legislatures by criminals became a serious problem. More than 20 members of the Parliament would be tried on criminal charges if they were stripped of their parliamentary immunity, according to Hryhory Omelchenko, a member of the Parliamentary Committee on Fighting Organized Crime and Corruption. Forty-four legislators, elected to local political bodies, also have criminal backgrounds.

The problem of corruption extends to the very highest levels of government in Ukraine. Serious accusations of embezzlement of Western aid funds have been made against the speaker of the Parliament, O.M. Tkacenko. Pavlo Lazarenko, Ukraine’s prime minister in 1996–97, reportedly made tens of millions of dollars annually through his company’s license to import natural gas and oil. [Lazarenko is suspected of having stolen $2 million in state funds and stashed some $4 million in a Swiss bank during his premiership. In February 1999 Ukraine’s Supreme Council stripped the former premier of his parliamentary immunity, and a warrant was issued for his arrest. The Editor]

**Corruption Is Perceived as Worst in the World**

A survey of enterprise managers by the Ukrainian Market Reform Education Program in June 1998 found that 96 percent of respondents attributed the stagnation and failure of privatized firms to high taxes. They also cited current tax policies as reasons for massive tax evasion and the expanding shadow economy. The survey indicated that about 70 percent of enterprises operate in the shadow economy. These companies have no protection from corruption and are open targets for bribery and other forms of extortion. Almost two-thirds of the surveyed enterprise managers regard corruption among central government officials and local civil servants as a major cause of their problems. State regulation and interference with business activities was the fourth major obstacle facing private enterprises, with 36 percent identifying it as a problem.

Ukrainian enterprises appear to be more concerned about pervasive bureaucratic corruption than enterprises in any other country surveyed, including enterprises in notoriously corrupt Indonesia. Another measure of corruption, Transparency International’s 1998 corruption perceptions index, also confirms the seriousness of the problem. That index ranked Ukraine 70th out of 85 countries. (Russia was ranked 76th.)

**What Can Be Done?**

The government has proved unable to deal with the problem effectively. According to a recent survey, only 7 percent of Ukrainians believe that the government is doing a good job at fighting organized crime. The country’s president, Leonid Kuchma, has acknowledged that the government has not created an environment that is conducive to honest businesses.

When Ukraine became an independent state it had almost no expertise in fighting crime and corruption. Its institutional capacity to improve the performance of the police and prosecutors was also limited. As a result, the country lacks adequate law enforcement and an independent judiciary with which to block the influence of organized crime. Unless Ukraine adopts the necessary criminal laws and procedures; passes civil laws that regulate markets, the banking industry, and commercial transactions; and establishes a viable tax policy, it will not be able to deal effectively with the problem of corruption.

In September 1996 President Kuchma endorsed a national anticrime program that sought to tighten criminal laws, introduce financial reforms, and increase civic education and technical assistance. The Ministry of Interior assumed a lead role in law enforcement and the president’s administration was assigned a key role in implementation. As for now, however, the crack-down on corruption and other serious financial reform measures remains in the planning phase.

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This article is based on her study “Organized Crime and Corruption in Ukraine: Impediments to the Development of a Free Market Economy,” which appeared in Demokratizatsiya—The Journal of Post-Soviet Democratization (Fall 1998).
Dancing with Anticorruption: Is Government Complicity in Corruption a Form of Economic Protectionism?

By Ivan Krastev

Seven centuries ago Dante placed those guilty of treachery in the deepest and darkest circles of Hell. Historians point to political reasons for his dislike of corruption. Bribery was deemed responsible for the failures of the Italian republics and for the success of Dante’s political enemies.

Nowadays, reports of bribery and other abuses of public office can be found not only in new editions of Dante’s Inferno but also on the front pages of newspapers and magazines. Stories of the pervasiveness of corruption in Russia, Mexico, and Nigeria—just to name a few—make for exciting reading. Italian “clean hands” and postcommunist “dirty linen” have become two of the most reodent catchphrases of the post-Cold War world.

But why has corruption become such an important topic for public debate? Behind this question lies another: How sincere are today’s postcommunist governments in their declared war on corruption?

In a paper written for the IMF, “Corruption Around the World: Causes, Consequences, Scope, and Cures,” Vito Tanzi argues that it is difficult to measure whether corruption is more widespread today than earlier, and if so, to what extent; but it is also obvious to everyone, Tanzi adds, that corruption has become a key issue for both understanding and reforming the current state of affairs (IMF Working Paper, May 1998). Corruption is widely held responsible for the failure of market reforms in countries like Russia and Bulgaria as well as for the collapse of the Asian miracle. The credibility of governments and political leaders has begun to hinge on the intensity of their commitments to fighting corruption.

The end of the Cold War, the spread of democracy, the new power of the free media, the increasing globalization of trade, and the rise of free-market economies are commonly listed among the factors that explain the emergence of a new consensus on anticorruption. In Washington, the consensus of the development community could be summarized as: “more reform means less corruption.” Not only has anticorruption become fashionable, but the terms of the debate have radically changed. At the beginning of the century, corruption was analyzed mainly in cultural and political terms; in communist circles, it was viewed as a “bourgeois legacy.”

Today, corruption is debated mainly in economic terms. Some fifty years ago, corruption was considered a reflection of the moral fallibility of human nature, while today the focus is on opportunities and incentives: anticorruption policies aim to restrict the demand and supply of acts of corruption. Some thirty years ago, economists and political scientists—Samuel Huntington among them—argued that corruption could play a positive role in the process of modernization. Today, no one assigns corruption a constructive role.

Two important sides of the issue are neglected in the present-day obsession with corruption, especially in the transition economies. First, postcommunist governments are necessarily of two minds about corruption. And, second, an anticorruption campaign is a very useful platform for attacking reformist policies and reform-minded governments. The protectionist character of present-day corruption is one of the principal reasons for the selective approach of the reformist governments in grappling with it. At the same time, reform-minded governments view anticorruption rhetoric as a dangerous instrument that may abet the rise of populist and antireformist alternatives.

Corruption as a hidden form of protectionism

Multinational companies—foreign investors in general—and international financial institutions are the driving forces in today’s global anticorruption campaign. Transparency International’s Corruption Index registers the evaluations of “cleanliness” given to specific countries by the officers of multinational corporations. In the traditional perception of bribery, the “conversion” of multinational companies from sources of corruption into fighters against corruption is a dramatic change. To illustrate the extent to which foreign capital was once seen as a source of corruption, I have only to point out that in the Bulgarian language, all French, German, and English words for doing business—Geschäft, for example—have the connotation of performing a corrupt act.

In the 1960s and 70s, foreign investors considered corruption to be a useful vehicle for opening up and modernizing the
A look at the Transparency International garment goods. This symbiosis between assets is the quintessential example of free trade; protectionism is an off-the-major reasons for the much lauded anticorruption rhetoric of this century. To know whether to give a bribe, to whom bribery, and by growth in the black market because they are plugged into existing networks and because they possess local knowledge. In other words, a corrupted business environment is much more favorable to local businesses than a transparent market. This “patriotic” side of corruption is one of the major reasons for the much lamented ineffectiveness of anticorruption campaigns and the (tacit) unwillingness of postcommunist governments to crack down seriously on corrupt practices. The protectionist nature of present-day corruption complicates the attitude of postcommunist governments toward their own official anticorruption policies. For instance, we can expect the Bulgarian government to focus its efforts on fighting the illegal import of foreign goods into the Bulgarian market rather than on fighting the illegal export of untaxed Bulgarian goods. This symbiosis between corruption and protectionism is crucial in understanding the ambiguous, half-hearted, and selective policies of the postcommunist governments.

One of the major assumptions of the present campaign against corruption is that anticorruption rhetoric and anticorruption "sensitivity" are part of the reform effort. But a review of the history of anticorruption rhetoric demonstrates that such an assumption is misleading. In Bulgaria, at the turn of the century, anticorruption rhetoric was associated with virulent hostility toward modernity and modernization. Corruption was conceptualized as the essence of modernization, as the all-corrosive force bent on destroying traditional morality and traditional community. In the 1920s and 30s, Bulgaria witnessed a heated anticorruption debate provoked by the rise in the incidents of bribery and by growth in the black market. In its essence, this debate was a part of the deep anticapitalist sentiments that had captured people’s imagination in the prewar period. In the communist period, the accusations of corruption were successfully used to attack communist reformers. In the late 1980s, anticorruption rhetoric was heavily used by communist hard-liners to attack Gorbachev’s perestroika. This brief backward glance at the anticorruption rhetoric of this century in Bulgaria serves to remind us that the new war on corruption declared by the IMF and World Bank can be counterproductive if it does not take into account the cultural and political hinterland within which this war takes place. The success of anticorruption rhetoric is endangered, in the context of postcommunist politics, because the majority of the public sees corruption as a direct result of market reforms. Public-opinion polls testify that, for the losers in the transition, privatization of state assets is the quintessential example of corruption. The success of politicians, like Alexander Lukashenka in Belarus and Alexander Lebed in Russia, illustrates that the anticorruption platform can be misused by antireform populists. In an ideological environment where there are no plausible alternatives to democracy and a free market, anticorruption rhetoric can, in a distorted way, occupy the place of a policy alternative.

Current campaigns and debates neglect this dangerous side of anticorruption rhetoric. We now hear plenty of anticorruption rhetoric and even see some modest successes in combating corruption. But the dance with anticorruption could be a dangerous one if, at the end, someone like Lukashenka takes the floor.

Ivan Krastev is the director of the Centre for Liberal Strategies, Sofia, and a fellow at the Collegium Budapest, Institute for Advanced Studies. This article is a reprint of the original piece, published in the East European Constitutional Review, Vol.7, No.3., Summer 1998, p.56., Internet website: http://www.law.nyu.edu/eecr/
World Bank Finds New Ways to Diagnose Corruption Symptoms
by Daniel Kaufmann, Sanjay Pradhan, and Randi Ryterman

Over the past year the World Bank has helped Albania, Georgia, and Latvia measure corruption and design strategies to combat it and improve governance. All three countries are now refining and implementing these strategies.

Using Surveys to Measure Corruption

Until recently, systematically measuring corruption in government institutions and assessing its economic and social costs was considered impossible. Data consisted only of general measurements of public and expert perceptions of aggregate corruption in a country. Recent research, however, has analyzed cross-country perceptions of corruption and compared them with institutional and other correlates. This work has shed light on the causes and consequences of corruption (by showing, for example, that corruption is higher in countries that repress civil liberties).

The newest method of measuring corruption is to survey the parties to corruption—including household members, enterprise managers, and public officials—and ask them about the costs and private returns of paying bribes to obtain public services, special privileges, and government jobs. When approached with appropriate survey instruments and interviewing techniques, respondents are willing to discuss agency-specific corruption with remarkable candor.

What Do Survey Data Reveal?

Detailed surveys of corruption were conducted in Albania, Georgia, and Latvia. Preliminary results provide a disturbing picture of systemic and deeply institutionalized corruption that reduces public welfare and taxes private sector activity. The portrait that emerges is different in each country. In Georgia, for example, the most common form of corruption is embezzlement of public funds. In Albania and Latvia the most common form is theft of state property. Bribery in procurement is common in all three countries.

Institutional causes of corruption also differ across the three countries, suggesting different priorities for reform. In Albania a weak judiciary is one of the main causes of corruption; regulatory failures are less important. Regulatory failures are more serious in Georgia and Latvia, both in terms of excessive regulations and the discretion granted to regulators enforcing them.

The survey data can help establish priorities for reform in each of these areas. For example, detailed statistics were collected on the bribes paid by enterprises to regulators in different agencies. This information can be used to determine which agencies are receiving the largest share of side payments (see figure on this page).

Several important findings emerge from these survey data. First, corruption is costly for firms, and they would be willing to pay higher taxes if it were eliminated (see table on next page). In Albania and Latvia bribes account for 7 percent of revenue in firms that admit to paying them. In Georgia bribes account for 15 percent of firms’ revenue. Lost fiscal revenues are high in all three countries, especially in Georgia.

Corruption has serious implications for public finance in other ways as well. A large number of small bribes are paid to officials to avoid paying taxes, customs duties, and other liabilities to the state, reducing fiscal revenues. Moreover, other
Composition of Corruption in Georgia

<table>
<thead>
<tr>
<th>Type of Corruption</th>
<th>Albania (percent)</th>
<th>Georgia (percent)</th>
<th>Latvia (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contact with road police</td>
<td>53</td>
<td>71</td>
<td>30</td>
</tr>
<tr>
<td>Building permits</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>State banking services</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lease of state-owned commercial real estate</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Registration of ownership of physical or real property</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Phone line installation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Enterprise registration</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Water and electricity</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Weights and measurements inspection</td>
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<td></td>
<td></td>
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<tr>
<td>Fire and sanitary inspections</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inspection by tax or financial authorities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

Based on a World Bank - GORBI survey of 350 enterprises in May 1998.

Tax Revenues Lost as a Result of Corruption in Albania, Georgia, and Latvia (percent)

<table>
<thead>
<tr>
<th>Measure</th>
<th>Albania</th>
<th>Georgia</th>
<th>Latvia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enterprises willing to pay higher taxes if corruption were eliminated</td>
<td>53</td>
<td>71</td>
<td>30</td>
</tr>
<tr>
<td>Additional taxes those enterprises would be willing to pay if corruption were eliminated (as percent of total revenue)</td>
<td>11</td>
<td>22</td>
<td>15</td>
</tr>
<tr>
<td>Additional taxes all enterprises would be willing to pay if corruption were eliminated (as percent of total revenue)</td>
<td>6</td>
<td>16</td>
<td>4</td>
</tr>
</tbody>
</table>

Source: 1998 World Bank survey of 483 enterprise managers in Latvia (Latvia Facts), 350 managers in Georgia (GORBI), and 356 managers in Albania (ACER).

Second, corruption disproportionately harms the poor. In Georgia 14 percent of households admit to paying bribes; in Latvia the figure is 12 percent. Although richer households are more likely to pay bribes, the burden of corruption (measured as the fraction of income paid in bribes) is much greater for poorer households.

Third, bureaucrats pay for lucrative positions. In Albania, Georgia, and Latvia, the price of obtaining “high-rent” positions is well known among public officials and the general public, suggesting that corruption is deeply institutionalized (see figure above). Higher prices are paid for jobs in agencies and activities that households and enterprises report as being the most corrupt, suggesting that corrupt officials rationally “invest” when buying public offices.

The pattern of corruption differs across the three countries. Ministerial positions are purchased more often in Latvia than in Albania and Georgia, for example, and lower-level positions are purchased less often. These findings suggest that grand corruption may be more of a problem in Latvia, while petty corruption is more serious in Albania and Georgia.

Fighting Corruption

Anticorruption programs in Albania, Georgia, and Latvia share several common features. All three countries sought assistance from the World Bank in designing reforms to improve governance; all three are committed to open and transparent policymaking, including collecting detailed data on corruption and sponsoring public workshops to discuss the data and the policy agenda. All three countries initiated policy processes that should culminate in anticorruption programs for public administration reform, including civil service, public finance, and judiciary and regulatory reform.

Daniel Kaufmann is Division Manager, Regulatory Reform and Private Enterprise, Economic Development Institute. Sanjay Pradhan is Sector Leader, Europe and Central Asia. Randi Ryterman is Senior Public Sector Management Specialist, Europe and Central Asia. This article is adapted from “New Frontiers in Diagnosing and Combating Corruption,” PREM Notes No. 7, 1998.

Corrupt Bureaucrat

From Vitaliy Kartamyshev’s collection.
Why has rapid privatization of state enterprises in some Eastern European countries and the former Soviet Union failed to bring about dramatically higher performance? Why have China and Poland grown much more rapidly than many other countries, even though they have not been aggressive in privatizing? If private ownership is so clearly dominant, why has state control of enterprises been such a common phenomenon historically, not only in the formerly socialist economies but in many Western countries as well? If state control is inefficient, why did the U.S. government maintain extensive control over military production, rely on the draft rather than price incentives to recruit soldiers, and ration resources for the military during World War II?

The apparent paradox may reflect the fact that private enterprises may be socially inefficient when they face large price distortions, whether from high tax rates or explicit price controls. These distortions generate efficiency losses roughly proportional to the square of the implicit tax rate. In contrast, the efficiency loss from state ownership should be largely independent of these implicit tax rates, since managers can be compensated based on true productivity rather than after-tax profits. The efficiency loss from state enterprises may thus be less than that from private ownership when price distortions become large enough.

Historically, there seems to have been a close association between state ownership and high tax rates. During World War II, effective tax rates rose in order to finance the war. The increase would have been even more dramatic if price incentives had been used more heavily. If the former Communist regimes had relied on private ownership, tax rates would have been extremely high in order to induce the desired shift in resources toward heavy industry.

States have considerable flexibility in terms of the ways in which they can relinquish control over the economy. China, for example, freed output prices quickly, while liberalizing wage rates and interest rates more slowly. Output decisions were decentralized, state enterprises were not allowed to lay off their workers, credit was rationed, and state enterprises were given incentives to re-invest their retained profits. More recently, remaining price distortions have been largely eliminated and labor and capital decisions have been almost entirely decentralized. State-owned firms are now being rapidly privatized.

Other countries that have engaged in privatization in recent years have seen sharp drops in tax and nontax distortions. When privatization has occurred without a substantial reduction in tax rates, as in Russia, efficiency costs of the high tax rates have been obvious, raising questions about the internal consistency of this set of policies.

Roger Gordon and David Li are professors of Economics at the University of Michigan. Chong-En Bai is a professor of Economics at Boston College. All three are Research Fellows of the Davidson Institute. Their study "Efficiency Losses From Tax Distortions vs. Government Control," forthcoming in European Economic Review.

Recent working papers of the William Davidson Institute:
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Kinoshita, Yuko. Technology Spillovers through Foreign Direct Investment. WP 221, January 1999.
Taxation and Government Incentives—Eastern Europe versus China
by Roger H. Gordon and David D. Li

During the transition period, governments in Eastern Europe and the former Soviet Union officially supported the entry of new private firms. In practice, however, the state often hindered the process (by denying bank credit or access to office space to new firms, for example, or providing loans to state firms that would never repay them). In contrast, officials in China (at least at the local level) have been strongly supportive of new entrants, and these new entrants have been the key source of economic growth in China.

The main reason for the sharp differences in the behavior of officials in the two regions is their differing sources of government revenue. Local tax revenue in China comes almost entirely from profits taxes and other fees on new entrants. In contrast, in Eastern Europe and at the national level in China, profits and payroll taxes on the old state enterprises represent a disproportionate share of tax revenue. Since officials in both regions draw on public funds for their personal use, they have a strong financial incentive to use their power to try to increase future tax revenue. At the local level in China, they could do this by raising the profits of new entrants, and officials have clearly pursued these incentives very aggressively and creatively. In Eastern Europe, in contrast, to increase future tax revenue officials needed to raise the profits of the old state enterprises. This gave officials an incentive to suppress competition from both new entrants and imports and to induce existing firms to collude on price. Many aspects of government behavior seem consistent with these incentives.

The key alternative explanation for the obstructive behavior of Eastern European officials has been the pressure they face from voters, whose current welfare may be closely tied to that of the old state firms. The success of political parties linked to the former Communist party provides supporting evidence for this alternative explanation. Once elected, officials face strong financial incentives to aid existing state firms, particularly firms in industries that are in the best position to use bribes to influence government behavior. Even fully informed voters who care only about overall efficiency may still prefer to vote for parties whose ideology supports state-owned firms.

If the source of tax revenue has important effects on the behavior of government officials—as the experience in China and Eastern Europe would suggest—the behavior of officials should change when the source of tax revenue changes. In particular, the recent shift in China toward the shared use of a value-added tax by the national as well as local governments should give the national government a new interest in nonstate firms. It should also reduce the conflicts of interest between national and local governments, which have been intense in the past. While value-added taxes have also been introduced in most of the other transition economies, collecting revenue from new private firms remains difficult in most of these countries, where cash transactions are significant. As a result, in most cases financial incentives on officials still favor the old state firms. The Chinese have apparently avoided these distorted incentives in part by developing a nonstate firm with close enough ties to local governments to facilitate the collection of tax revenue.

Ironically, the model suggests that the best way to induce officials to be supportive of new private firms is to raise the effective tax rate on these firms. Previous research has focused on the fact that such taxes will discourage private investment in these firms. By encouraging public support and investment, however, these taxes may aid rather than hinder the rate of growth of the private sector. Certainly, past work has ignored entirely the role of the tax system in influencing the incentives faced by government officials.

Roger H. Gordon and David D. Li are professors of economics at the University of Michigan and research fellows at the William Davidson Institute. An earlier version of this article appeared as William Davidson Institute Working Paper No. 56.

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Enterprise Reform in Vietnam: The Response of New Private and State Firms

Two working papers reviewed by Jed Friedman

Vietnam has achieved high rates of growth since the implementation of Doi Moi ("renovation" in Vietnamese), a spate of market-oriented reforms adopted in the late 1980s. Enterprise reform, an important strand of Doi Moi, reorganized the state sector, permitted new private firms, and actively encouraged foreign investment in productive units. Output from firms of all three major ownership types—state firms, new private firms, and partly or wholly owned foreign firms—increased throughout the past decade. Although many interesting questions were raised by this dynamic period, few studies have explored the impact of Doi Moi on firm behavior and performance. Two recent papers focus on this topic. McMillan and Woodruff (1998) examine the types of networks that develop among both new firms and recently privatized cooperatives. Malesky and others (1998) review state sector reform and attempt to determine the degree of implementation of reform of state enterprises at the firm level.

How Do Interfirm Relationships Affect Trade in Vietnam?

McMillan and Woodruff (1998) use a survey of Vietnamese private firms to examine interfirm relationships and the role interfirm networks play in facilitating trade. Trading relations in Vietnam are shaped by two market frictions—the difficulty of locating trading partners and the absence of formal third-party enforcement of contracts. To some degree these frictions offset each other. The high search costs found in Vietnamese markets impel firms to cooperate. Simultaneous transactions in goods and credit introduce a possible substitute for the legal system because, if the customer is in some way locked into the relationship, the supplier can cut off trade in goods if the debt is not repaid. The authors seek to understand how these informal relationships work, what the determinants of successful cooperation are, and whether the reliance on informal contracting entails any costs.

They find that strong bilateral relationships exist between many firms. These relationships are embedded in two types of networks: one based on pre-existing ties of family or friendship, the other on communication among manufacturers of similar kinds of goods. Private firms use both of these networks, to investigate potential trading partners before dealing with them and then to monitor them once they start to transact. The punishment for nonpayment of a debt can be bilateral (the creditor refuses to continue to deal with the debtor) or communal (other firms are told of the bad debt and blacklist the debtor).

McMillan and Woodruff measure the amount of trade credit the firm grants to the partner as an indicator of a firm’s trust in its trading partner. They find that the cost of finding alternative trading partners facilitates trade credit. Search costs are undoubtedly higher in Vietnam’s transition economy, which lacks information-generating market infrastructure, than in industrial economies. Moreover, interfirm credit is needed more in Vietnam than in industrial economies because firms have less access to banks. Such credit is necessarily informal, because the legal system offers little protection to creditors. Reputation is also an important factor. When a firm has access to information about the customer from its other trading partners or (to a lesser degree) from family members, it is more likely to extend trade credit to a potential customer. Firms are also more likely to receive trade credit if they receive a bank loan. This may reflect the inefficiency of Vietnam’s banking system and the inability of creditors to invoke the law. The knowledge that a customer received a bank loan may give a seller some assurance that trade credit will be repaid.

These informal devices are effective in allowing deals to be made in the absence of a legal system, but informal contractual enforcement comes with efficiency costs. Exclusion is the corollary of ongoing relationships. Continuing to deal with customary trading partner may mean refusing to deal with new entrants. In fact, according to McMillan and Woodruff, firms sometimes forgo better deals from outsiders.

Small firms appear to use networks differently from large firms. Small firms and slow-growing firms rely on family networks; large firms and fast-growing firms do not. This evidence suggests that to be successful, rather than just to survive, a firm must somehow break out of its reliance on family-based links. Interfirm networks remain significant even for large firms, however, in that they use other firms in the industry as sources of information about new suppliers. Perhaps a network of firms in the same industry, being an open network in the sense of allowing entry and exit, does not limit a firm’s success in the way that a family-based network does.
How Have Reforms Changed Behavior by State Enterprises in Vietnam?

Malesky and others (1998) focus on the implementation of enterprise reform at the firm level and how these reforms have changed the behavior of state enterprises. The state sector in Vietnam has traditionally accounted for a very small portion of GDP compared with that in Eastern Europe, the former Soviet Union, or China. In 1996 Vietnam’s state sector produced only 29 percent of GDP, mostly through manufacturing and other industries. Nevertheless, the indebtedness of the state sector may present severe problems in Vietnam’s future. Total debt by state enterprises is worth about $30 billion—20 percent more than the entire turnover of the state sector and equal to the country’s total GNP in 1997. This situation underscores the need for Vietnamese government officials to push ahead with reform of state enterprises. Initial reform of state enterprises included the liquidation or merger of many small and unprofitable companies (5,000 of 12,000 state enterprises were eliminated in 1989) as well as the combination of many surviving state enterprises into larger business groups or conglomerates. Other reform programs have yet to witness equally dramatic results. Despite well-designed reform laws (governing the introduction of corporate governance plans, enterprise autonomy, better accounting standards and internal management practices, and more competition), implementation has been lax.

Malesky and others surveyed top and mid-level managers and a nonrandom sample of state enterprise managers and employees. They identified six key steps essential for successful reform:

- **Grant enterprises autonomy and eliminate bureaucratic centralism.**
- **Introduce both foreign and domestic competition.**
- **Allow prices to reflect market scarcity.**
- **Create management boards and re-structuring the management hierarchy.**
- **Adopt new management techniques.**
- **Impose hard budget constraints.**

These reforms have substantially reduced. The liquidation of 5,000 of 12,000 firms sent a signal that firms will be allowed to fail. Managerial interviews revealed that cost control and financial performance are now the most important priorities of operations management. However, several managers still believe that the government will bail their firms out if necessary and hence adopt unrealistic strategies for expansion. Establishing a credible hard budget constraint is thus still a priority for Vietnamese policymakers.

- **Competition.** Reformers in Vietnam hope to eradicate longstanding monopoly control and prices through an influx of foreign and domestic competition. Competition can be fostered by dismantling import or investment licenses, output quotas, control over prices, and other interventions that give certain firms advantages over others. Managerial responses illustrate that they are facing competition from both foreign and domestic suppliers. This competition has led state enterprises to engage in customer-focused decisionmaking. A competitive labor market for skilled staff and managers has developed. Conglomeration has counteracted competition by giving monopoly power to certain state corporations, although in some state corporations member companies may still be competing against each other or their parent corporation.

- **Prices.** State enterprises need to set prices that reflect market scarcity and the true costs of production. Toward that end firms appear to be paying market prices for inputs, perhaps partly due to prefabrication. Firms recognize a need for the competitive pricing of outputs, although they are often unhappy with the results. The record on wage compensation is mixed. Many firms have estab-
lished complex wage scales based on worker productivity; others have been unable to eliminate seniority-based pay scales that do not account for productivity. Some state enterprises have had difficulty receiving ministry approval for promotions of their employees.

- **Management reform.** Reforms adopted in Vietnam envision a new and independent management board replacing the relevant governing people's committee or ministry. In fact, management boards have been left untouched or only slightly changed. Most members are still appointed by the ministries. Lower-level management reform has been slow and incremental but has made strides. In many firms departments have been reduced, management layers eliminated, and reporting policies streamlined. The number of internal administrative divisions should be reduced and a coordinated hierarchy introduced that gives more responsibility and accountability to lower-level managers.

- **New management techniques.** If other reforms are achieved, management can begin to act independently and focus on improving productivity by adopting modern management techniques. The authors focus on four such techniques: promoting a shared vision, encouraging innovation, promoting internal and external employee education programs, and streamlining internal processes. Adoption of these techniques has met with varied success. While some firms have attempted to encourage innovation by rewarding creative problem solving, most managers did not consider it vital. Top managers are more concerned than lower-level managers about stimulating creative energies. Although managers claim they want to keep employees on the cutting edge of knowledge, they are more likely to use internal than external training programs. External education is reserved only for higher-level managers out of fear that beneficiaries of expensive training would leave the enterprise for more lucrative jobs.

In spite of the uneven adoption of reform programs, state firms have been able to achieve high levels of growth. State en-

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**Conference Announcements of the Davidson Institute**

**International Conference on Transition Economics,**
July 22–25, 1999, Beijing, China

Organized by: The William Davidson Institute. In commemoration of the 20th Anniversary of the start of China's economic reforms. The conference will be cosponsored by the Ford Foundation, CEPR, and the World Bank. The local organizing and hosting institution is Tsinghua University. Its dean, China's Premier Zhu Rongji, will be the patron of the conference. The conference will have two days of academic proceedings and one day of policy-oriented presentations and discussions. The policy day, featuring high-level policymakers and academics, will focus on China's economic record in comparison to that of the Commonwealth of Independent States and Central and Eastern Europe. The academic conference will be based on theoretical and empirical papers in all areas of transition. These papers will be presented by selected Davidson and CEPR research fellows, as well as invited Chinese and other academics.

**Foreign Investment Conference**
June 17–20, 1999, Ann Arbor, Michigan, United States

Organized by: Davidson Institute Area Director Bernard Yeung. This conference will focus on the impact of foreign investment in transition economies in the past, present, and future and take into consideration the influence of foreign investment on emerging markets' growth. Presenters will consider the impacts capital markets and labor markets and the social transformation have on public policy debates.

**Corporate Governance Conference**
September 23–25, 1999, Ann Arbor, Michigan, United States

Organized by: Davidson Institute Area Directors Merritt Fox and Michael Heller. To date, sophisticated work on corporate governance has focused on advanced market economies. In the post-socialist context, high-quality corporate finance and institutional economics scholars have usually done little more than convey the received theory to transition policymakers. The unique contribution of the conferences and edited volume will be to focus on the reverse concern: what, if anything, do the reform experiences of transition countries teach about corporate governance theory generally? Corporate governance scholars will present the principal papers; discussants will include scholars of transition economics and corporate governance.

**Conference on Accounting**
October 14–16, 1999, Ann Arbor, Michigan, United States

Organized by: Davidson Institute Area Director for Accounting William Lanen.

Information for the Accounting conference will be announced shortly.

For more information on these conferences, please contact Ms. Sharon Nakpairat, Research Manager, tel. (734) 936-0041, email: sharonch@umich.edu.
Streamlining Corporate Governance in China’s State Enterprises

by Chi Fulin

China started to corporatize its state enterprises in the early 1990s in an effort to establish a modern enterprise system. So far more than 800 enterprises have been converted into public companies, listed on the stock exchange. Other enterprises have been turned into joint-stock companies or limited liability companies.

Although significant progress toward corporatizing state enterprises has been made in the past several years, some serious problems remain. Enterprises are organized irrationally, and the state bureaucracy regularly intervenes in their operations. Despite the reform’s emphasis on decentralizing power, “insider” administrative appointees are able to exert control over enterprises. Illegal or unregulated operations drain the assets of state enterprises. These obstacles impede the development of effective corporate government at a critical juncture in China’s economic transition.

The Business of Reform Remains Unfinished

Despite corporatization, some enterprises have been unwilling to undertake any real change in their governance structures and still adhere to the old management and operational systems. In about 20 percent of listed companies, the same person serves as both chair of the board of directors and general manager. In many transformed enterprises government departments continue to select the chair and general manager, thus effectively precluding any independent role for them. This arrangement suggests that reform of the property ownership system in state enterprises is still unfinished.

The state controls more than 50 percent of the shares of publicly listed (joint stock) companies (70-80 percent in some enterprises). With such an ownership structure and in an environment in which government administrators are hardly distinguishable from enterprise operators, companies find it difficult to free themselves from the binding constraints of government departments, and their boards of directors are not able to perform their duties. Ownership structure should therefore be diversified as soon as possible.

The state should give up its majority interest in state enterprises in the competitive sectors, which is both unnecessary and inefficient. Corporate governance based on state ownership can hardly be effective. Even large state enterprises need a properly diversified ownership structure. Collectives and individual entrepreneurs, not the state, should take over ownership of these enterprises. The state should also withdraw its assets altogether from small and medium-sized enterprises in the competitive sectors. This would boost their operations and facilitate their corporatization.

Bureaucratic Control Must Be Eliminated

Poorly regulated corporatization and the intensification of administrative control
The appointment of top management by government departments should be abandoned as soon as possible. For enterprises that have undergone systemic reform, top management should be selected by the board of directors. At the same time, supportive personnel system reform should be pursued.

- Profits should be adequately allocated to genuine entrepreneurs who invest in state enterprises and transform them into profitable enterprises. Entrepreneurs are these enterprises' most precious and scarce resource. They should be able to retain a high percentage of their enterprises' shares; in some small enterprises, they should be allowed to become the largest shareholder. China should also deal with the strange but common phenomenon of "age 58-59." It refers to the traditional preretirement practice in which managers of state enterprises try to grab as much they can, sometimes through unscrupulous means, before leaving the firm.

- Enterprise employees—both workers and managers—should be able to become enterprise owners. Shareholding by management can create strong incentives for developing a participatory mechanism and effective corporate governance.

**The Company Law Needs to Be Amended**

The Company Law was issued in 1994. Implementing the law has proved difficult. Violation of the law and loose law enforcement are common, and some companies routinely run illegal operations. The law itself has several loopholes and needs amending to keep pace with the progress of the reform.

The Company Law should be amended to improve corporatization. Also, implementing regulations need to be drafted as soon as possible. The amendments should focus on such issues as how to enable shareholder meetings to function as the highest decisionmaking body of the enterprise, improve the structure as well as the code of conduct of the board of directors, strengthen the function of the supervisory board, and regulate managerial control. Enforcement of the law must be strengthened, with listed joint-stock companies used as the first "testing grounds" for checking the effectiveness of enforcement.

**The Government Should Pull Back from State Enterprises**

Solving various problems encountered in establishing effective corporate governance also involves reform of government administration. It is difficult to develop effective corporate governance without efficient management of state assets, removal of state assets from the competitive sectors, and true autonomy of enterprises and diversification of the ownership structure.

A law regulating management of state assets should be drafted and issued as soon as possible. Management of state assets should not mean that different government departments take charge of the enterprises; that would eliminate the role of the board of directors. The law would help both the government and enterprises to perform their respective roles, and it would facilitate the market-oriented management of state assets.

The strategic restructuring of the state economy should be accelerated. State-owned assets should be withdrawn from the competitive sectors as soon as possible. By doing so the government can concentrate on providing services in the public domain (including health and education). The separation of government administration from enterprise operations would provide favorable conditions for investment in state-owned assets, safeguarding the rights and interests of both the state as a shareholder and investors, who are ready to bolster these companies with their ideas and resources.

Chi Fulin is Executive Director of the Haikou-based China Institute for Reform and Development (CIRD), in Hainan Province. An earlier version of this article appeared in the Far Eastern Economic Review (February 19, 1999).

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**Trimming the State Sector: Big Bang Chinese Style?**

Call it a Big Bang, Chinese-style. No one knows exactly how many companies have been sold so far. But it has been the largest transfer of industrial property since Mao Zedong nationalized Chinese industry in the 1950s. The State Economic and Trade Commission (SETC) estimates that as of November, 1998, Liaoning Province, in the northeast, formerly a bastion of state industry and conservative thinking, had shed 60 percent of its small and medium-sized state companies. Results were even more dramatic in the coastal and southern provinces, where almost all state enterprises had been sold.

In the mid-1990s China had about 300,000 state companies, engaged in manufacturing, trade, retailing, finance, and services. By the middle of the next decade, only a much smaller core of "strategic" industries—such as communications, power, and heavy industries, such as steel and oil—are likely to remain entirely in state hands. Capital that had been monopolized...
by inefficient state companies will be freed for more productive uses. The reforms are likely to establish a firmer foundation for long-term growth.

Nothing better illustrates the new attitude than a draft constitutional amendment, expected to win legislative approval in March 1999, that endorses the private sector as an important part of the economy. Fan Gang, director of the National Economic Research Institute, is skeptical that state companies can be turned around through internal restructuring and mergers, but he notes that these measures could make companies more attractive for future sale, something he believes cannot be ruled out. "The government's willingness to make changes has itself changed," he says. "Five years ago, officials wanted to hold everything; now they only want to hold big companies." Even the definition of which companies are large has been altered so that fewer fall into the must-hold category, he notes.

According to Ji Xiaonan, a senior official at SETC, companies must have more than 500 million yuan worth of both sales and assets to count as large, suggesting that heavily capitalized companies may become saleable if their sales performance slips badly. In the past, about 5,000 companies were considered large. It is not clear how many will meet the new definition.

Since 1993 more than 6,000 state companies of all sizes have been reorganized as shareholding companies. Although the state usually remains the major shareholder, mergers and acquisitions are quietly increasing the private stake in many of these firms. In apparent recognition of that fact, the government is preparing to allow companies with as little as 51 percent state ownership to list on the two domestic stock markets. Previously, only companies with 75 percent state ownership were allowed to list. Other reform moves are aimed at changing the environment in which state companies operate. For example, last year the government demoted the last of the industrial ministries that once told companies what to produce, turning them into bureaus of the SETC with a long-term planning function. It also banned government and party offices from running businesses, which often led to conflicts of interest. It approved a law to curb stock market fraud so that the markets can more effectively channel capital to well-performing companies. And it decided to let Guangdong International Trust & Investment Corp. go bankrupt, signaling a new willingness to let the market discipline badly managed state companies.

Privatization shifts the problems off government shoulders, but it does not automatically solve them. The new owners often face heavy debts and glutted markets. For most companies, the main change is sudden financial discipline, as banks hold private companies to standards of risk that they waive for state enterprises. For very large companies, privatization may not be feasible. China's private sector lacks the capital to buy very large companies, even at firesale prices, says Dai Yuanchen, a senior economist at the Chinese Academy of Social Sciences. "If the state sector was sold all at once to society, who could buy it?" he asks. "Who would want it?" Some cities have been unable to unload their worst small companies, even for free.

As an owner, the Chinese state has been amazingly forgiving of bad performance. Premier Zhu Rongji wants to change this and has sent teams of senior officials around the country to audit large companies. The government is also creating a network of asset management bureaus under the Ministry of Finance to exercise ownership rights and responsibilities. So far the bureaus seem ineffectual in elbowing aside local officials, who are accustomed to intervening in company affairs. The power to appoint managers at large companies remains with the central personnel department and provincial governments, further complicating chains of command.

The government hopes that restructuring state companies into fewer, larger conglomerates will make oversight easier. But officials are also studying other options. As early as 1995 the SETC asked the World Bank to organize a conference to examine other countries' methods for managing state assets and enforcing corporate governance. The chief recommendation: China should make its state companies as much like private ones as possible, with separate legal identities, commercially oriented managers, transparent operations, and minimal political interference. Even then, economists said, the sector will be a drag on growth unless it is kept small.

Some of China's most influential economists, such as Li Yining, have long been making such arguments. As vice chairman of the national legislature's finance committee, Li is helping draft a law on management of state assets. "My personal view is you can't have the government represent the assets," he says. He envisions a state investment company that manages a portfolio of transferable holdings, shifting funds either to chase higher profits or bolster favored industries for development.

"China should make its state companies as much like private ones as possible."

Excerpted from Kathy Wilhelm's article "Out Of Business" published in the Far Eastern Economic Review, Hong Kong, on February 19.
Reader's Forum

The Crisis in Russia Must Not Be Ignored
by Michael D. Intriligator

An event of immense historical significance, with profound implications for the world, is being largely ignored. It is the catastrophic economic and political situation in Russia, which poses long-term dangers to both Russia itself and to the world at large and represents probably the greatest threat to global security today. While the problems of Kosovo are important, those of Russia are a thousand times more important. But they are getting very little attention.

What had been a crisis situation in the Russian economy has become a true catastrophe as a result of the desperate moves taken by the Russian government on August 17, 1998. Those measures included devaluation of the ruble, default on foreign debt, and freezing of bank accounts.

The subsequent replacement of the government by a new one headed by Yevgeny Primakov possibly signals the beginning of a new set of policies that will reverse the collapse of the economy. Primakov certainly deserves our support and help, as his government may represent the last for democracy in Russia. But reversing the disaster of the Russian economy will be extremely difficult at best.

The Russian economy is in a state of collapse. A few wealthy bankers are largely in control, criminalization is extensive, and most transactions are handled by barter or are not paid for at all. All other systems that are part of a modern state—health, education, the environment—are failing. The Russians themselves are beginning to lose hope in their own future and are turning to new leaders. Many of these new leaders would return to authoritarian rule, whether communist or fascist, typically combined with ultranationalism and militarism. Russia, a country with enormous stockpiles of nuclear and chemical weapons, is at the brink, and it could return to militarism and authoritarian rule.

Complacency on this issue is truly remarkable. During the Cold War era the West had a total fixation on the Soviet Union and its potential military threat, especially its nuclear weapons. Now many tend to regard this problem as "solved" with the dissolution of the Soviet Union, the end of the Warsaw Pact, and their transition from socialist to market economies. The problem of the future of Russia is, however, by no means solved, and we ignore it at our peril. Russia's future evolution could totally undermine global security. Indeed, the present situation is remarkably similar to the one that prevailed between the World Wars. Depending on what happens in Russia, the current period may represent the lull between "Cold War I" and "Cold War II."

Several possible scenarios could have substantial impacts on Russia and the rest of the world. One scenario would be the advent of a new authoritarian regime—in effect a new Stalin. This result could come about through the democratic election of an extremist president who would take advantage of the 1993 constitution, which grants the president sweeping powers. It could also happen following a putsch, similar to that of August 1991, or a coup, which would repeat earlier Russian history. The result would be to turn the current epoch into nothing more than an interlude between two authoritarian regimes, similar to the brief periods of democracy that Russia experienced in 1917 and Iran experienced in 1979.

Another scenario would be the breakup of Russia into smaller states or the continued collapse of legal authority, leading to chaos and anarchy, with criminal gangs taking over whole regions of the country. There are other scenarios, few if any of which bode well for global security. Virtually all involve potential dangers in Europe, Asia, and other regions of the world. Several involve the possibility of another Cold War or even the use of nuclear or chemical weapons, whether by intent or by accident in a chaotic situation.

In his 1938 book, *While England Slept*, Winston Churchill criticized Britain for focusing on domestic issues and ignoring the threat from Nazi Germany that erupted in war the following year. There are striking similarities between Russia today and the Weimar republic that preceded Hitler's ascension to power in 1933—loss of empire and status, economic collapse, destruction of the middle class. The question has often been raised as to how the German people, a highly civilized and educated people, could have democratically installed Hitler. Of the various answers that have been proposed, perhaps the best is the simplest: desperate people will do desperate things. The same could happen in Russia, with comparably disastrous results. Just as Britain "slept" in the 1930s, the United States may be "sleeping" today, focusing on domestic issues and ignoring the problems of Russia. It is time for us to wake up and to help Russia overcome its problems.

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In Russia There Is a Real Economy—and Virtual Market
by Boris Petkov

Russia's abrupt shift from a centralized state plan, in which all information within the economic system was integrated, to an overly liberalized and underdeveloped market system was ill advised. Still, prospects for recovery from the financial (and economic) crisis of mid-August, though bleak, are not nonexistent. Russia is still a large market with great potential demand. The country can stabilize its economy. The question is how to accomplish the change (social transformation) with minimum cost in human and capital terms.

There are different views and explanations of the causes of the crisis in Russia. The main problem is usually seen as the lack of efficiency and competitiveness. Confusing and misleading comments concerning value creation and destruction in the real economy then follow. Those comments oversimplify the matter and leave it unexplained. The meaning of "value-subtraction" is only relative; it is valid only for exchange purposes. This is to say that a particular productive activity does not yield profit. However, the product (commodities) that lost market value during the process of production has its utility intact for the consumer. No doubt those goods are not up to the contemporary standard of quality and efficiency in use, but they are the ones effectively demanded at that stage of economic development. The majority of the people cannot afford the better brands (mostly imported), no matter what their preferences are.

It is important to note that the consumer choice effect is overstated at best under normal economic conditions and becomes irrelevant for any practical purposes in a crisis. Better policy and more coherent management (or at least less mismanagement) could certainly have helped to prevent much of the loss of output and employment. When people's lives are affected, each fraction of a percentage point decline in output matters significantly.

What, then, should the authorities really do? Revitalizing the economy under the burden of debt, capital flight, and the world at the brink of recession (commodity prices and basic goods prices falling) is a difficult task. However, the rebuilding has to begin by using the available capital, not by creatively destroying it. A strong regulatory system must be created before privatizing (too late perhaps for this measure). The importance of building up a proper financial system cannot be overemphasized. It is urgently needed to facilitate transactions, provide credit, and attract deposits. The lack of liquidity within the economic system has to be overcome. This task is made more difficult if investors believe that the financial markets are constantly in equilibrium.

The central bank of Russia has an important role to play. It should aim at reducing speculation and liquidity preference in particular. The difficulty of the situation calls as well for the establishment of limits on short-term open positions of the banking sector.

Currently, commercial banks engage in speculative activities, such as the purchase of currency forwards. Those activities essentially consist of redistributing the IMF loans and domestic savings to hedge funds investors and themselves. The loser of last resort is, of course, the Russian taxpayer. Little if anything is invested in production. Commercial banks focus their operations on short-term lending and are hesitant to extend long-term investment credits. Admittedly, cutting interest rates is tricky, since in the absence of capital controls, funds leave the country as foreign exchange outflow when the central bank increases liquidity. Introducing controls would have a much more positive effect than the conventional defense of increasing interest rates, which retards economic activity.

The government has to decide along what lines the country's industry will develop. The structure has to be broad enough to allow for technological changes and gradual renewal of capital stock. It should also reflect the fact that under normal conditions the Russian economy is much closer to the self-sufficient than to the open-economy model. Its external sector is relatively small relative to its output. Stabilization of investment demand should be pursued, and a policy of increasing investment spending should be implemented.

It is unlikely that the development of Russia's financial markets will come to a halt. However, if the capital market is to achieve depth and volume, regulation has to be tightened and the rights and responsibilities of the participants clarified. Only after those measures are implemented will it become possible for the real economy sector to overcome the severe liquidity crunch and start growing.

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Accounting in Russia was very well developed before the 1917 revolution and reflected Western European developments in this area. Since the revolution, accounting has been marked by the struggle between the Byzantine and Western traditions. The Byzantine tradition, which reached its peak during the reign of Stalin, emphasizes the control function of accounting. The Western tradition focuses on accounting as a decisionmaking tool.

Accounting in the Soviet Union

In the Soviet Union accounting was considered a means of safeguarding socialist property and of meeting the goals of state plans. Accordingly, the authorities exerted strict control and monitoring over firms' business activities and financial performance. Enterprises were monitored on how well they managed their assets, used the factors of production, and complied with norms regulating the amount and composition of current assets. Control also extended to the production of goods and services, the cost of production, and financial profit and its use.

Beginning in 1985, when Gorbachev announced the transition from a centrally planned economy to a market-oriented one, accounting became subject to change once more. These changes, which came from above, were inconsistent, evasive, and prone to error.

A New Accounting System Emerges

The unified Soviet system of accounting that had been developed over many decades began to disintegrate as soon as the Soviet Union broke apart. As early as 1991 crucial accounting changes were made. These changes included tighter adherence to international accounting norms, publication of a new national chart of accounts, and passage of a requirement that companies issue new financial statements, similar to those used in industrial countries. At the same time, preparations were underway for radical changes in accounting and auditing regulation and methodology. In 1992 the government approved by decree the principle normative documentation "Regulation on Accounting and Reporting in the Russian Federation," which essentially created a new Russian accounting system.

Most of the work of transforming the accounting system in Russia is being done by the Ministry of Finance, with the assistance of international institutions, including the World Bank, the United Nations, the European Union, and the major international accounting firms.
legislature is considering a multilevel system of accounting:

- The highest level would be the Law on Accounting and Auditing, which would be adopted as one of the basic laws of Russia.
- The second level would comprise mandatory regulations concerning the conceptual framework of accounting.
- The third level would include accounting standards (normative documents). By the end of 1998 a series of national accounting standards had been put into operation.
- The fourth level would comprise guidelines, manuals, and instructions to help practitioners.

The Soviet constitution mandated that a single accounting and statistical system be adopted, under the direction of the government. Accounting in Russia is still regulated by different governmental bodies, and a variety of accounting methods can be used in practice. The level of centralization has been declining, however, and a well-shaped system of accounting regulation has been created.

The New Phenomenon of Auditing

Auditing—that is, an independent accountant's review of a company's financial statements to ensure that they were prepared in compliance with generally accepted accounting principles—is new to Russia and the former Soviet Union. Throughout Russian history, the pervasive power of the state and the limited existence of private ownership hampered the emergence of an auditing profession. The notion of an independent controller was completely alien.

The situation has gradually changed since 1987. The first step was the creation of the Articles of Association (Char tes) for cooperatives. In 1987 the first basic regulations for joint venture operations were issued. Auditing for joint ventures was to conform to Western (international) practice in that audits were to be performed by independent Soviet auditors (commercial auditing organizations) for a fee.

In the past three years Russia's Ministry of Finance has been working closely with the World Bank to improve auditing. Once approved by the government the Basic Concept of Auditing will cover regulation in all major areas, including preparation and application of auditing standards, quality control of auditing work, and responsibility of auditors. All regulations will be in accordance with international auditing postulates and standards.

A good system of auditing still has some way to go in Russia. Deficiencies include the following:

- The public still is not clear about the role of auditing or who auditors are.
- Even some enterprise managers think auditors are tax inspectors.
- The large number of accountants (before perestroika there were about 3 million accountants in the Soviet Union, and the number increased after that) and the low level of their qualifications retards efforts to improve auditing.
- Professional bodies of accountants and auditors are not as active as they should be.

Soviet and Russian accounting methodology has traditionally focused solely on financial accounting (that is, reporting financial information to interested external parties, such as the Gosplan and ministries). Although cost accounting and cost analysis have been practiced extensively, mostly by enterprise adminis trators, management accounting (providing internal financial reports to assist management in making decisions) has been largely unknown until very recently. Activity-based costing (which allocates costs back to particular activities or events, reducing the risk of inaccuracies and errors that are prevalent in the traditional costing methods) barely exists. Cost accounting is made more difficult because of the absence of true pricing in Russia, where barter is common.

Remaining Challenges

There is reason for pessimism in the short term and optimism in the long term over the future of accounting in Russia. Russia's autocratic past together with the Communist experiment between 1917–88 have had a major impact on the frame of mind, the institutional infrastructure, the legal environment, and basic human motivational factors in Russia. It is hard to transform or adapt the Russian scene overnight; considerable patience will be needed by all parties concerned.

In the longer run, there is reason for optimism. The Russian people are highly intelligent and well-educated, and they possess sound skills. They have shown great resilience in the past, and they are well geared to modern socioeconomic norms. The basic propensities are in the right order.

Nonetheless, certain critical issues need to be addressed:

1. The legal infrastructure and legal reforms in all areas of economic activity need foremost attention. No society can work effectively and efficiently without such legal reforms, including commercial laws, tax laws, companies acts, corporate governance rules, and accounting and auditing regulations (acts). Such legal reforms require effective enforcement vehicles, but equally im-
portant is the basic acceptance and willing¬
ness to adhere to legal norms by all par¬
ties concerned.

2. Financial accounting and reporting need to be brought into line with international accounting standards. Greater transparency is needed. While Russia will tend to stick to its uniform charts of accounts (like France and many other countries), accounting measurement and disclosure are expected to be adapted to conform to international standards.

3. Tax reform, which is proceeding very slowly, needs to be accelerated. Too many taxes still prevail, hampering both tax adherence and collection. A more equitable tax system and procedures are warranted. Tax inspectors and administrators need to be upgraded and updated to make them more suitable for modern society. In the past their prime objective was tax collection, and they knew little about tax assessment, accounting or auditing. Tax policy and economic policy also need to be more closely linked.

4. Auditing, a new field in Russia, needs to be improved. Separate examinations for accountants and auditors should be considered.

5. Management accounting and cost management need to be used more widely. Management accounting as practiced in the West is a new area in Russia. Management accounting for planning and control is now taught at all major universities and institutions.

6. The theory and practice of corporate finance and banking need to be developed. The notion that bank accounting should involve both accounting and evaluation of investments (project and feasibility studies) is fairly new.

7. Education and training need to continue. Educational institutions in Russia have transformed themselves and now teach modern international financial management methodologies. The eagerness of students to learn new techniques is laudable. The wave of Russia’s future lies in its younger generation, who are very eager to adopt and adapt new methodologies. Accounting has become a favorite discipline at schools.

8. Professional institutions need to be strengthened. The Association of Accountants and the professional auditing bodies remain weak, as the Ministry of Finance still maintains tight controls. Professional bodies can be expected to gain greater autonomy in the years to come. They need to establish closer international links and increase the scope of their activities to include training, publications, continuing education, membership activities, and ethics codes.

The international community should continue to assist Russia (and other countries in the region) in its efforts to establish accounting procedures that are in line with international standards. Better accounting in these economies would benefit not only those countries but investors and trading partners in other countries as well.

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Attracting Capital via the Internet: PrivatizationLink Reaches Potential Investors around the World

by Birgit Braunwieser

A privatization agency official in Tajikistan completes a document on the upcoming tender for the Tajik cotton ginneries slated for divestiture. Moments later he posts the document on the Internet, where it is instantly accessible to potential investors all over the world. Supplemental information, including company descriptions, background information on the Tajik privatization program, analytical reports on progress to date, and relevant legal information, is also available on the agency’s Web site.

This outpouring of information from a region in which access to information was once extremely limited is remarkable. Even more remarkable is the fact that the Internet is being used in transition economies not only by universities and non-governmental organizations—elements of an emerging civil society that might be expected to embrace information technology—but also by the government.

State privatization agencies—which benefit from technical assistance from multilateral and bilateral donors and are generally better equipped and staffed with younger, more dynamic personnel than other government bodies—are especially keen on the Internet. In fact, privatization agencies in 23 of the 27 countries in the region report upcoming privatization transactions on-line.

These agencies have discovered that the Internet allows them to reach potential investors who would otherwise not have known about their planned divestitures. Marketing via the Internet is much less expensive than marketing through traditional channels, such as advertising in the Financial Times or the Economist and mailing out expensive materials. Disclosing detailed information at every stage of the privatization process via the Internet also helps make the privatization program more transparent. In addition, using the Internet helps familiarize privatization agencies with modern information technology and modern marketing techniques.

What Is PrivatizationLink?

Launched last June, PrivatizationLink (www.privatizationlink.com) is a joint initiative between the Multilateral Investment Guarantee Agency (MIGA) and the Private Sector Development Units of the Regions of the World Bank. The project’s initiators recognized that many privatization programs in transition economies and developing countries were unable to attract sufficient numbers of qualified bidders because resource constraints forced the agencies to cut back on their marketing efforts. As a result, many potential foreign investors were unaware of their offerings.

PrivatizationLink was designed to fill this information gap by providing investors around the world easy access to information about planned divestitures of state-owned enterprises. The project’s Web site features company profiles of enterprises slated for divestiture, including information on each enterprise’s ownership structure, workforce, and fixed assets. In addition, the site describes the divestiture plan, indicates the closing date for bids, and provides recent financial data that help investors assess the firm’s current and potential market position. Background information on national privatization programs is also provided.

The Business Directory contains useful contact information for key players in privatization, including privatization agency personnel, bankers, and advisors. The Virtual Library includes texts of privatization laws, data on transactions and revenues, links to other Web sites, bibliographical references, and the full texts of privatization studies. News & Events describes recent and upcoming privatization transactions.

The site is designed to provide potential investors with everything they need to know about privatizations in some 50 countries. Data from Web sites maintained by national privatization agencies can be accessed and searched from the privatization site. In addition, World Bank data on countries that do not have their own Web sites are accessible.

Birgit Braunwieser is PrivatizationLink content coordinator for MIGA. She can be reached at 202-473-3075 (telephone) or 202-522-2650 (fax).
Creating Business Friendly Customs Regulations in Slovakia

by Robert Paterson

By the summer of last year, customs procedures in Slovakia had become so cumbersome that foreign investors were starting to sound alarm bells about the negative impact on future investment. To its credit, the new Slovak government reacted quickly. The approach it has taken could serve as a model for other transition economies seeking to implement a more business-friendly customs regime.

Cumbersome Customs Procedures—Legacy of the Past

The problems that the Slovak customs authority has been dealing with over the past few years are not unique. At the start of the decade, as domestic trade and investment rose dramatically throughout Eastern Europe, Communist-era infrastructure and trade regulations proved woefully inadequate. As recently as 1997, 9 out of 10 multinationals operating in Central and Eastern Europe experienced customs problems, and more than half had lost revenue as a result of customs delays. Only 12 percent of multinationals believed that customs authorities understood how businesses operate.

The European Commission recently published a series of blueprints on customs reforms for countries interested in joining the EU (see Transition, June 1998). Many of the countries in the region are using those documents to try to tackle some of the problems that importers are encountering.

Under the previous administration, a customs regime developed that the U.S. Embassy described in the Slovak press as “anti-foreigner.” The issue that caused the most aggravation to foreign investors was the $1 value limit, which required that any import worth more than $1 had to be certified by customs officials. The limit represented one of the lowest customs limits in the world (the European Union value limit is 22 euros, about $28).

Other certification problems also slowed the process of importing. In order to import any product into the country, an importer had to complete a customs document, pay duties, pay the Export-Import (Exim) Bank charge of 0.05 percent of the product’s value, and issue a power of attorney giving the carrier the right to clear the shipment. Additional certificates were needed for the vast majority of commodities. Every good went through the same process, whether it was a child’s toy valued at $2 or a shipment of clothing valued at $100,000. The system was bad for business and bad for the government, which lost money collecting duties on shipments worth relatively little.

Procedures at the airport were so inefficient that DHL, the air express carrier in Slovakia, had goods flown to Vienna and then trucked to Bratislava rather than flown directly to Slovakia.

First Steps to Streamline Customs Procedures

To comply with a World Trade Organisation (WTO) requirement, Slovakia agreed to...
abolish a 3 percent import surcharge by October 1, 1998. More significant changes took place in November, when the new administration took office. The new coalition government has moved quickly to address some of the main concerns that the business community had been voicing. In fact, the director of operations at the customs authority set himself the ambitious task of making Slovak customs the most user-friendly customs authority in Europe.

The first step has been to create a friendlier environment for investors in general. In February, 1999 the Cabinet was putting the finishing touches on its Support for the Entry of Foreign Investors program. This policy mandates that any company that invests $5 million or more in Slovakia, creates jobs, and exports 60 percent of its output will be entitled to a five-year tax holiday. Research and development costs will be written off for an additional five years.

The government has also looked at the problems foreign investors face in getting goods in and out of the country once they have established operations in Slovakia. Most significantly, the $1 value limit was raised to 1,000 Slovak crowns ($26.39) in January, to bring it in line with the EU norm. The Slovak customs authority can now claim to have implemented part of the EU customs regime faster than many of its neighbours.

The changes make life considerably easier for businesses. They also allow resources to be diverted away from unproductive tasks, such as processing paperwork, toward more productive work, such as intercepting illegal shipments.

As the leading international air express carrier, DHL has been sharing some of the experiences it has gained from dealing with customs authorities in other parts of the world with the Slovak government. In conjunction with its global headquarters in Brussels, the company is looking at ways in which it can provide concrete support to the Slovak customs authority. For instance, DHL can help Slovak customs interface with the United Nations Conference for Trade and Development's (UNCTAD) Automated System for Customs Data (ASYCUDA) program, which aims to computerize and simplify customs procedures. It can also help Slovakia meet further EU requirements and simplify and speed up some of the administrative procedures currently being used.

Win-Win Situation

The changes made by the government have improved the trade flow in and out of Slovakia. The number of shipments that are on hold at any one time waiting for customs clearances is now one-sixth what it was several months ago. As a result of the changes, DHL is now considering flying directly to Bratislava, rather than transshipping goods from Vienna.

Reform takes time, and DHL is still making representations to the Slovak government about the Exim fee and the system of import certification that it believes should be cancelled or modified. The government has promised to make additional changes, and a new EU-friendly customs law should be unveiled later this year.

Trade policy is definitely heading in the right direction in Slovakia, and investors have welcomed the measures that have been implemented so far. Overall, the program of customs reforms should be a powerful weapon for Slovak government officials to use in discussions with the EU about raising Slovakia's status as an EU applicant. [See our interview with Slovakia's Deputy Prime Minister on page 29. The Editor.]

Robert Paterson is the general manager of DHL in Slovakia. DHL is the leading air express carrier in Slovakia and the largest importer into Central and Eastern Europe.

The new DHL Customs Report will be available in April. To order a free copy or pass on any comments about customs in Central and Eastern Europe, please contact Dirk Singer, at 44 171 465 7700 (telephone) or dirk-singer@msn.com (email).

Labor Dispute in Russia

"If you don't pay us our salary, we will start our hunger strike again."

From the Russian Daily Izvestiya
Milestones of Transition

Central and Eastern Europe

EBRD redesigns a program for Central European trade. The European Bank for Reconstruction and Development (EBRD) has agreed to commit 100 million euros ($116 million) to a new program that will provide a 100 percent guarantee on trade-finance deals rather than the 80 percent covered previously. The program permits the EBRD to work with local affiliates of Western banks as well as with Western or local banks. The 100 million euros will effectively be 400 million euros a year if the program is rolled over four times a year as expected.

Net private capital flows to emerging Europe will remain stable this year at around $40 billion, the Institute of International Finance (IIF) predicted in its latest report. That compares well with Latin America, where net private capital flows are forecast to fall sharply this year, from $88 billion to $54 billion. The IIF’s projections suggest that investors are learning to distinguish among emerging markets, but caveats remain: part of the $40 billion flowing to the region constitutes involuntary lending to Russia as interest arrears mount.

CIS

A number of former Soviet republics were late reacting to the crisis in Russia and now find themselves in serious economic difficulties as a result, the European Commission concluded in a report released late February. Social and political pressures also are building. Armenia, Belarus, Georgia, Kyrgyz Republic, Moldova, Tajikistan, and Ukraine have been hit hardest by the Russian turmoil, mainly because their agricultural exports to the country have been sharply curtailed.

The EU currently provides a total of 859 million euros in aid to the former Soviet republics through various programs; it is reevaluating the overall aid needs of the most affected countries.

Russia

Assets of 60 percent of 17 top Russia banks worthless. Alexander Smolensky, the chairman of the SBS-Agro group, the country’s second-largest retail bank before economic crisis erupted in Russia in August, told the Kommersant-Daily newspaper that his group was restructuring and closing 12 of its 17 banks. Making the situation harder still, the Finance Ministry is pulling billions of dollars of budget funds out of private banks. The funds will instead be parked at state-owned Sberbank and Vneshtorgbank. Billions of dollars are already being transferred away from the commercial banks and will continue to be withdrawn over the course of the year. With federal government revenues for 1999 projected at 475 billion rubles ($23 billion at current exchange rates), the loss of federal funds will put a major crimp in bank liquidity and profits. It will also, the Finance Ministry hopes, put an end to mismanagement of the funds.

Criminal probe launched into Central Bank dealings. Russia’s Central Bank is under close scrutiny following allegations that it channeled some $50 billion of hard currency reserves to a tiny, offshore company from 1993 to 1997. Former prosecutor-general Yury Skuratov outlined the corruption scandal in a letter to the Duma just before he resigned early February. Skuratov also said that the Central Bank committed numerous irregularities when it allowed Financial Management Co. (FMC), a firm registered in the Channel Island of Jersey, to handle Russia’s hard currency reserves. He said that the Central Bank had paid an undisclosed and illegal commission to FMC. Sergei Dubinin, former head of Russia’s Central Bank, admitted that Russia transferred a portion of its hard currency reserves to FMC between 1993 and 1997, but he said that the transfers, which included funds from the IMF, were an attempt to shield the money from foreign creditors.

Direct foreign investments in Russia were at $665 million in first nine months of 1998. Portfolio investments came to almost $7.0 billion, according to Russia’s Central Bank. Russia had a current account deficit of $5.6 billion at the end of September.

Kazakhstan

Kazakhstan posted a $1.7 billion trade deficit last year owing to the fall in world prices of the country’s major exports: oil, metals, and grain. Prime Minister Balgimbayev announced on 9 February. At year’s end, inflation was 1.9 percent, significantly below the 9.5 percent forecast. The average wage in Kazakhstan remained the highest among CIS countries, at the equivalent of $120–130 monthly, while the average monthly pension rose to $48. The government has paid nearly all pension arrears. Kazakhstan attracted $2.2 billion in investments in 1998, up from the 1997 level. Foreign trade in the first 11 months of 1998 fell by 7 percent. Exports fell by 15 percent, compared with 1997, and totaled $5.5 billion. Imports increased during the same period by 1 percent, totaling $7.13 billion.

Moldova

Moldovan government’s resignation underlines economic woes. While the government originally forecast GDP growth of 6 percent for 1998 (revised to
3 percent in June), it announced in December that it expected a GDP decline of fully 10 percent. That would make it the only one of the nine smaller CIS countries (that is, excluding Kazakhstan, Russia, and Ukraine) in which GDP declined last year. In a losing battle to prop up the currency, the national bank saw its international reserves fall from almost $365 million at the end of 1997 to about $150 million at the close of 1998. The leu’s nosedive has resulted in the collapse of the monthly wage from its June 1998 peak of $52. Even those low wages are often not paid (Michael Wyzan).

We appreciate the contributions of Radio Free Europe and Johnson’s Russia List.

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**Interview with Ivan Mikloš, Slovakia’s Deputy Prime Minister**

“We Are Creating a Friendly Climate for Foreign Investors”


Q. According to the new government’s evaluations, Slovakia inherited economic crisis conditions from its predecessor. Considering the impressive 5 percent GDP growth last year, isn’t that an overstatement?

A. This high economic growth is clearly unsustainable. Vladimir Meciar’s government invested heavily in the state sector, pursuing an expansionary fiscal policy. The huge fiscal deficit had to be financed through government borrowing. The budget deficit last year reached almost 20 billion koruna (about $550 million), while the government debt, excluding that of local governments and public funds, totaled 156 billion koruna ($4.3 billion), 20 percent of the GDP. Imports surged, while exports fell. As a result the current account deficit in the past three years oscillated between 8 and 11 percent of GDP, and by the end of last year foreign debt reached $12 billion. Despite the government’s spending spree, enterprise restructuring was absent. Crony-driven, nontransparent privatization proved counterproductive, and foreign investors stayed away. Slovakia’s foreign investment of about $1.6 billion is just a fraction of what neighboring countries receive—Hungary has received $20 billion in foreign direct investment. The government has to fix the problems of inefficient banks burdened by bad debt, underdeveloped capital markets, and nonfunctioning bankruptcy procedures.

Q. So what is in the government’s reform package?

A. First, we have to stabilize the economy. This year, the fiscal deficit has to be cut to 2 percent of GDP from last year’s 6 percent. It will not be easy. We have to improve tax collection, and we may have to double the base rate of the value added tax (VAT) from 6 to 12 percent, while lowering the top 25 percent rate to 15 percent, in accordance with EU norms. Excise taxes may also go up. We will increase public transport fees, freeze salaries in the public sector, and slow investments in infrastructure, including road construction.

Second, we have to accelerate microeconomic adjustment, prodding enterprises to adopt a profit orientation instead of rent-seeking. That will require stronger domestic and foreign competition, an influx of foreign capital, restructuring of state-owned banks, and strengthening of capital markets. Privatization procedures have to be reviewed: 900 large enterprises have been privatized, in several cases, under suspicious circumstances. The National Property Fund, our privatization agency, has to correct past mistakes—and, where the selling price has been too low, charge more now or take back part of the shares.

Q. It is known, for example, that 8 percent of the successful Slovnaft petrochemical company, whose shares were actively traded on the stock exchange, was sold in February 1998 for half the market price to a previously unknown company. Last April, while still a member of the opposition, you said that “the National Property Fund lost about 54 billion Slovak koruna ($1.5 billion) in the past 3 years. In 1997, the average selling price of state owned enterprises fell to 18 percent of its book-value. These data are a dem-
onstration of unlimited pilferage of state property under the Meciar government." Yet how can you renegotiate deals if the contracts were made according to the law?

A. That is exactly the point: many of these deals were made unlawfully. Our goal is to create a clean business environment—that is the only way we can earn the trust of honest foreign investors. This is the third element of our program: to attract strategic investors through incentives and by creating a friendly business climate in this country. We also have to restructure and privatize the big commercial banks and many of the still state-owned strategic companies. In a few months a 25–30 percent stake in the telecommunications company Slovenske Telekomunikacie will be sold through transparent international tender. We also have to radically reform public administration, first within the present framework and, in a second stage by strengthening municipal and local governments. Last but not least, we also have to streamline our social safety net and bring an end to misuse of the unemployment benefit—nearly half a million people are registered as being without a job, putting our unemployment rate at 16.3 percent. The health and education system needs to be reformed too.

Q. How does the World Bank fit into these ambitious plans?

A. Primarily we have reopened negotiations with the World Bank on an enterprise and financial sector adjustment loan (EFSAL) that could come in anywhere from $90 million to $400 million. Slovakia and the Bank had started to negotiate this loan two years ago and had made significant progress, but then the Meciar government suspended negotiations. Now we have to update the program, but that shouldn’t take long. We are also expecting technical assistance from the Bank in four areas: anti-corruption program, restructuring of enterprises and banks, social system reform, and public administration reform. Slovakia’s relationship with the Bank has radically changed for the better since the new government took office. We have no significant differences now and are working closely together to achieve the same goals—primarily, to ensure that Slovakia’s economic and social development qualifies the country for EU membership.

World Bank/IMF Agenda

Wolfensohn on New Development Strategy

The World Bank will place stronger emphasis on social, structural, and cultural issues in its projects, announced World Bank President James Wolfensohn during his presentation at the Bank für Arbeit und Wirtschaft (Bawag) in Vienna on February 12. The new approach will be tried out over the next 12–18 months in 12 countries, with the involvement of NGOs, religious groups, and other members of civil society. The president presented a 13-point program that lists many of the elements necessary for sustained economic development. The elements include a government free of systemic corruption; a legal framework and effective judicial system; a well-supervised financial system; an adequate social safety net; access to universal primary education, health services, and clean water; a sound environment and sufficient infrastructure; and an environment that enables citizens to preserve their culture and identity.

World Bank to Launch Flexible Financial Products

The World Bank plans to introduce new loan and hedging products for its borrowers as of September 1, 1999, following a go-ahead from the Board of Directors in mid-February. The new products will cost between 1/8 percent to 3/8 percent of the principal amount as transaction fees. Borrowers of the new LIBOR-based fixed-spread loan will be able to choose the currency of the loan and, if they want, change it at any time. Borrowers will also be able to fix, cap, or collar (combining cap and floor) the interest rate. Further, borrowers can tailor the repayment terms, adapting them to specific projects or to their country’s debt management strategy.

The freestanding hedging products—linked to existing IBRD loans—will help borrowers manage their risks related to currency, interest rate, and commodity price. Hedges will be offered on loan maturities of up to 10–12 years and will include swaps of currency, interest rates, and commodities. The IBRD will continue to offer currency pool loans and LIBOR-based, variable-spread single currency loans. The existing fixed-rate single currency loan will not be available as a new product from December 1, 1999. IBRD borrowers have chosen single currency loans almost exclusively (96 percent) since 1996.

IFC Reviews Russia’s Strategy

The International Finance Corporation (IFC) is reviewing its operations strategy in Russia. Several projects are in difficulty as a result of the August 1998 crisis. The IFC’s potential losses, however, were minor compared with most other investors and international financial institutions. The IFC deferred more than $200 million worth of investments in companies that later went bankrupt. Especially hard hit were the IFC’s investments in the financial sector. As of December 31, 1998, the IFC invested $70 million in 10 financial sector projects. Investments in industry—$137 million in eight manufacturing projects—have also been affected, as bank deposits are frozen and production in the domestic market is expected to drop in the medium term.
The IFC still hopes that most industrial investments will recover over time. The IFC’s investments in the oil-gas and mining industries—$41.8 million in three projects—are less affected because they rely heavily on exports. In the future the IFC is prepared to help restore Western investors’ confidence in Russia, support capital market institutions, and continue earlier investments wherever possible. At the end of 1998 IFC’s investment portfolio in Russia stood at $323 million, representing 27 projects.

$100 Million Loan for Kazakhstan

On February 9 the World Bank approved a $100 million loan to Kazakhstan for the reconstruction and maintenance of roads. World Bank experts estimate that only 37 percent of the country’s roads are in good condition. Since Kazakhstan joined the World Bank in 1992, the Bank has committed approximately $1.75 billion for 17 projects.

G-7 Endorses Financial Stability Forum

During its January 20 meeting in Bonn, the G-7 agreed to establish a Financial Stability Forum that will bring together finance ministries, central banks, and financial regulators to strengthen surveillance and supervision of the international financial system. The World Bank will have two representatives at the forum who will set up a small secretariat in Basle. The G-7 ministers remained openly divided over German-led plans to impose regulations or currency trading bans to curb speculative market swings. Between now and the G-7 summit scheduled for June in Cologne (Koln), Germany, the work will focus on proposals for strengthening the IMF and the interim and development committees. A first seminar devoted to exchange rate regimes, private sector involvement in crisis resolution, and to proposals for strengthening the IMF and the World Bank will convene on March 11 in Germany.

Democrats Name IMF Commission Members

The U.S. Democratic Party nominated Paul Volcker, a former chairman of the Federal Reserve, and Jeffrey Sachs, Harvard economics professor, to a commission to examine the roles of the IMF and the World Bank. The Democrats’ other three nominees are Richard Huber, chief executive of Aetna; Esteban Torres, a former Democratic representative from California; and Jerome Levinson, a Latin American expert from the Economic Policy Institute. The Republican Party so far has announced four of its six nominees: Charles Calomiris, a Columbia University professor; Edwin Fuelner, president of the Heritage Foundation; Manuel Johnson, former vice chairman of the Federal Reserve Board; and Lawrence Lindsay, a former Fed board member.

World Bank Promises Romania More Support

Romania is to get a $300 million loan from the World Bank, as the first installment of a two-phase program aimed at continuing the country’s reforms. The first-phase adjustment program will begin this spring, alongside an IMF stabilization program. Andrew Vorkink, the Bank’s director for Romania, announced the World Bank loans during a recent visit there. Five million will go toward labor redepolyment and is expected to create 22,000 new jobs, a quarter of which will be in the mining areas. Vorkink also announced plans for a $25 million technical assistance loan, which will go toward bank restructuring, improving the business environment, and privatization. Negotiations over a $40 million loan to help close loss-making mines and mitigate social costs in mining areas were under way.

The World Bank signed a $10 million loan for Romania’s Social Development Fund late January. Poor villages will be able to apply to the fund for grant money to develop infrastructure (sewerage systems, roads, and drainage), social services (shelters for the homeless and kindergartens), and income-generating activities. The $10 million loan is the first phase of an adaptable program loan, totaling $20 million, that the Bank is providing to help reduce poverty in Romania. In 1997, 30 percent of the population lived below the poverty line, up from 22 percent in 1996.

World Bank Loans to China Meet International Accounting Standards...

On February 23 the World Bank approved loans and credits to China worth $32.9 million to support efforts to modernize the country’s accounting system. The project has two components: to provide continuing professional education for certified public accountants in the accounting practices of market economies, and to support the Chinese government’s efforts to develop and promulgate internationally accepted accounting standards.

... Rebuild Communities Devastated by Floods...

With another $40 million IBRD loan and a $40 million equivalent IDA credit, approved on February 9, China will rebuild schools, roads, water systems, hospitals, and clinics to restore basic services to poor communities devastated by the recent Yangtze River floods. The repeated flooding of the Yangtze River last summer, said to be the worst in modern times, affected 79.6 million people in the provinces of Hubei, Hunan, and Jiangxi.

... Develop Anning Valley

The incomes of more than 250,000 poor families in China’s Anning Valley, a poor area of Sichuan province, would increase with the improvements in crop production, irrigation, and silk production funded through a new $90 million loan and a $30 million equivalent credit. The loans were approved on January 21.
For the Record

Trans CIS Projects: Prospects and Pitfalls
February 23, 1999, New York, N.Y., United States

Organizer: Eurasia Forum.
Speaker: Valeryi Serov, Former Deputy Prime Minister of the Russian Federation.
Information: Eurasia Group, 113 Broadway, Suite 1600, New York, NY 10010, United States, tel. 212-366-9560, fax 212-366-9699, Email: kapoor@eurasia group.net or go to www.eurasiagroup.net.

First ABCDE—Europe, 1999
June 21–23, 1999, Paris, France


Governance, Equity and Global Markets
June 21–23, 1999

Keynote address: by Lionel Jospin, Prime Minister, France, and James D. Wolfensohn, President, the World Bank. Chaired by: Joseph E. Stiglitz, World Bank, and Pierre-Alain Muet, CAE.

Marketing Strategies for Central and Eastern Europe
December 1–3, 1999, Vienna, Austria

Organizers: Kellstadt Center for Marketing Analysis and Planning, DePaul University, Chicago, Illinois, and the Department of International Business Administration, University of Economics and Business Administration, Vienna.

Forthcoming

Economic Stability in Russia and the CIS
March 8, 1999, New York, N.Y. United States

Organizer: Eurasia Forum.
Speaker: Boris Nemtsov, Former Russian Deputy Prime Minister.
Information: Eurasia Group, 113 Broadway, Suite 1600, New York, NY 10010, United States, tel. 212-366-9560, fax 212-366-9699, Email: kapoor@eurasia group.net or go to www.eurasiagroup.net.

Russian Foreign Policy and the CIS
March 9, 1999, Washington, D.C., United States

Organizer: Eurasia Forum.
Speaker: Boris Berezovsky, Executive Secretary of the CIS.
Information: Eurasia Group, 113 Broadway, Suite 1600, New York, NY 10010, United States, tel. 212-366-9560, fax 212-366-9699, Email: kapoor@eurasia group.net or go to www.eurasiagroup.net.
New Books and Working Papers

The Macroeconomics and Growth Group regrets that it is unable to provide the publications listed.

World Bank Publications

Working Papers


Removing obstacles to the smooth functioning of land rental markets and enhancing potential tenants’ endowments and bargaining power can significantly increase both the welfare of the poor and the overall efficiency of resource allocation. The authors draw policy conclusions about the transition from communal to individual and more formal land rights and the scope for redistributive land reform.

To order, contact Maria C. Fernandez, Room G8-064, tel. 202-473-0898, fax 202-522-3233, Email apoghosyan@worldbank.org. The authors may be contacted at amingat@ku-bourgogne.fr or jtan@worldbank.org.


In most countries, unequal distribution of education has a negative impact on per capita income. Economic policies that suppress market forces tend to dramatically reduce the impact of human capital on development. Reform of trade, investment, and labor policies can increase the returns from education. Using panel data from 12 Asian and Latin American countries for 1970–94, the authors investigate the relationship between education, policy reform, and economic growth.

To order, contact Tanya Shiel, Room G4-030, tel. 202-473-6317, fax 202-676-9810, Email tshiel@worldbank.org. The authors may be contacted at vthomas@worldbank.org or ywang2k@worldbank.org.


Experience in the United States and the United Kingdom suggests that pension funds and insurance companies should be promoted because they serve as a countervailing force to commercial and investment banks, stimulate financial innovation, help modernize capital markets, enhance transparency and disclosure, strengthen corporate governance, and improve financial regulation. Mutual funds, the third type of institutional investor, are unlikely to thrive without well-regulated securities markets.

To order, contact Agnes Yaptenco, Room MC3-446, tel. 202-473-8526, fax 202-522-1155, Email ayyaptenco@worldbank.org. The author may be contacted at dvittas@worldbank.org.


Enterprise survey data from 1995–97 reveal that in Georgia and Moldova, restructuring was achieved more rapidly in privatized companies that were purchased by their managers than in companies in which managers received significant ownership stakes for free. The author concludes that managers’ incentives to restructure decrease when they regard their newly acquired ownership as a windfall gain.

To order, contact Rose Vo, Room MC10-627, tel. 202-473-3722, fax 202-522-2031, Email hvvo1@worldbank.org. The author may be contacted at sdjankov@worldbank.org.

Simeon Djankov, Ownership Structure and Enterprise Restructuring in Six
Ownership by managers is more common in countries in which privatization programs favored incumbent managers (Georgia and Moldova) than in countries that mainly adopted the mass privatization approach (Kazakhstan and the Kyrgyz Republic). Foreign ownership, which is positively associated with enterprise restructuring, is also higher in countries in which the mass privatization approach was adopted. Ownership by outside local investors or the state is not significantly correlated with restructuring. The study was based on the changing pattern of ownership of 960 privatized manufacturing companies in six transition countries between 1995 and 1997.

To order, contact Rose Vo, Room MC10-627, tel. 202-473-3722, fax 202-522-2031, Email hvo1@worldbank.org. The author may be contacted at s杰nkov@worldbank.k.org.


Corruption is a major obstacle to economic development. It reduces domestic investment, discourages foreign direct investment, inflates government spending, and shifts government spending away from education, health, and infrastructure maintenance toward less efficient (more manipulable) public projects. International pressure to fight corruption is useful, and laws and law enforcement are indispensable. Most important, however, is reform of domestic institutions, primarily public administration, and a revamping of the civil service so that public sector workers are recruited and promoted based on merit and paid salaries that are competitive with those offered in the private sector.

To order, contact Cynthia Bernardo, Room MC2-501, tel. 202-473-1148, fax 202-522-1154, Email: cbemardok@worldbank.org. The author may be contacted at shang-jin_wei@harvard.edu.


A developing country may attract foreign direct investment for technology transfer that increases local firm profits or for wage premiums that benefit workers. The benefits of either may not be great enough to make such investment more attractive than exporting, however.

To order, contact Lii Tabada, Room MC3-333, telephone 202-473-6896, fax 202-522-1159, Email ltabada@worldbank.org. Kamal Saggi may be contacted at ksaggi@worldbank.org.


Occasional Papers


Luis M. Valdivieso, Macroeconomic Developments in the Baltics, Russia, and Other Countries of the Former Soviet Union, 1992–97, No. 175, 28 pp.

Other Publications


This volume is a collection of papers presented during a two-day seminar hosted by the World Bank and the European Commission in Brussels in December 1997. The seminar was attended by all ten European Union (EU) applicant countries (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia). The papers examine borrowing policies, institution building, portfolio optimization, and the implications of the Euro and EU accession for public debt management, fiscal prudence, and the borrowing strategies of Central European countries. The
papers discuss the most effective techniques for managing public liabilities (sovereign debt) and explore ways in which prudent debt management could be promoted in Central Europe by creating a regional network of experts.


To manage the environment rather than merely control pollution, policymakers must create a broad mix of incentives and pressures. Guidelines used to prepare World Bank Group projects, which are detailed in this handbook, can minimize the use of resources, protect human health, and reduce the quantity of waste requiring treatment and disposal. Such guidelines use commercially proven and cost-effective technologies, follow regulatory trends, and promote good industrial practices.


Alternative fuel resources abound in the form of agricultural and municipal waste (biomass). This report reviews the state of the art of biomass combustion and gassification systems, identifying their advantages and disadvantages. It encourages investment in these technologies to enable developing countries to better exploit their biomass resources and help close the gap between their energy needs and supply.


Each issue of this new World Bank quarterly will contain price forecasts for 46 primary commodities (for the next three years and for 2005 and 2010), detailed market reviews for 27 major commodities, and expanded sections on global and regional price indexes. Each issue will review major market developments, highlighting commodities that have shown the greatest price changes. The quarterly will be available in both print and electronic format. Full-service subscribers will receive monthly electronic updates containing the most recent monthly prices and regional indexes.

IMF Publications

To order, contact IMF Publication Services, 700 19th Street, NW, Washington, DC, 20431, United States, tel. 202-623-7430, fax 202-623-7201, Email: publications@imf.org, Internet: http://www.imf.org

Working Papers


BOFIT Publications

To order: Bank of Finland Institute for Economies in Transition (BOFIT), P.O. Box 160, FIN-00101 Helsinki, tel. 3589-183-2268, Email: bofit@bof.fi, Internet: http://www.bof.fi/bofit.

Review of Economies in Transition


Some concepts of standard fiscal federalism do not apply to transition economies as they do elsewhere. For example, normally undesirable interregional competition may actually benefit the transition process by forcing regions to alter their patterns of public spending. Practices such as in-kind transfers may carry additional benefits in a transition environment. The paper makes extensive use of observations from Russia's system of intergovernmental relations.

If the center does not know the true wealth of the regions, any redistributive transfer scheme has to be designed so that the rich regions also have incentives to reveal their true wealth. In Russia 10 regions (of a total of 89) produce about 50 percent of GDP. The 10 poorest regions rely on federal transfers for more than half their budget revenues. In other words, there is a compelling need to design a system for equalizing transfers that is both transparent and relatively efficient and able to tackle the problem of costly and incomplete information available to the federal government. This calls for a new model of intergovernmental transfers based on the tradition of optimal income taxation.

A certain degree of decentralization and loosening of fiscal control may be inevitable during Russia's transition to a market economy. Since economists know little about what happens when an economy shifts from one equilibrium to another, studying decentralization schemes may provide useful knowledge. Decentralization, after all, offers greater opportunities for implementing gradual or partial reforms, because different reform approaches can be tested on a small scale in different parts of the country.

Stock price indices in the three small Baltic stock exchanges are not even weak-form efficient (that is, past returns do not predict future returns). The Baltic exchanges are still very small, and trading there is quite thin. If some shares are traded very infrequently, then their seldom-changing prices will affect the index. This could be the main reason for the failure of weak-form efficiency. However, one cannot argue that investors could consistently benefit from the failure of weak-form efficiency, because transactions costs might make such trading strategies unattractive. A natural next step would be to test for the informational efficiency of individual stocks. Information disclosure requirements have been tightened in all the Baltic states, and it would be interesting to see whether the prices of individual stocks are even weak-form efficient.

This study found evidence that, within the Baltics, the stock exchanges of Tallinn and Riga influence each other as well as the Lithuanian stock exchange. Only the U.S. stock market seems to influence the Baltic stock exchanges from outside the Baltics, however.


China, not yet a fully open economy, has the means and resources to withstand pressures against its currency. China's exports have an import content of 50 percent, so a small devaluation would make little difference, and a large devaluation would probably trigger a new round of competitive devaluations among the region's countries, in the end leaving everyone worse off than before. Thus for the time being China is best served by maintaining a stable exchange rate, but in the longer term China may have to reconsider the wisdom of its peg to the U.S. dollar.


Other Publications


This free on-line publication covers the most recent economic developments in Estonia, Latvia and Lithuania. The January issue includes "The Effect of the Russian Crisis on the Baltic Countries." by likka Korhonen.


Free on-line publication that reports on the Russian economy, including fiscal policy and financial market developments. The January issue contains: "Will the Russian Federation Fall Apart?" by Laura Solanko.


To order, contact EERC, 3 Kochnovsky Prosed, Suite 418, 125319 Moscow, Russia, tel./fax 7-095-152-0601/0121, Email eerc@eerc.ru.


This free biannual publication, available in both Russian and English, reports find-

"It would be a big mistake to build a shopping mall to replace the kindergarden, instead let's build a Macdonald's."

From the Hungarian Daily Nepszabadsag
Investment has declined in Russia since the beginning of the 1990s. The decline is associated with political and economic instability, an excessive tax burden, and a high rate of crime. Incentives for increasing investment should include state guarantees to investors, development of investment insurance, and tax benefits that favor investment.

**Other Publications**

Petr Chadraba and Reiner Springer (eds.), *Proceedings of the Sixth Annual Conference on Marketing Strategies for Central and Eastern Europe*, December 2–4, 1998, Vienna, Austria. To order, Email Gertrude.Seidelmann@wu-wien.ac.at.


Evidence from 452 banks in 16 transition economies shows that macroeconomic instability is associated with low levels of banking activity, high interest margins, and, in some instances, high rates of profitability. Concentration in the banking sectors in many transition economies has impeded the ability of banks to mobilize savings. Smaller banks are expanding their customer loans more rapidly than larger banks. New banks and privatized banks also tend to be more profitable than state banks. One constraint on the number of new banks is the regulatory authority’s capacity to supervise them effectively. Sufficient concentration of ownership following privatization is required in order to provide effective corporate governance.


As examination of Russia’s economic crisis reveals that economic policies cannot be put in place in an institutional vacuum. Assistance to create appropriate institutions should never have been relegated to the rank of "second-generation" transition issues. Lack of satisfactory progress toward structural reform in some transition economies has often been due to severe political and resource constraints. The existence of a large number of nonviable firms is a major impediment to the successful implementation of the transformation policy agenda. Restructuring these enterprises will continue to require special efforts not only by national policymakers but also by the international community at large. (See economic indicators on next page).

**New Publications Available On-Line—Special Issues**


This free quarterly journal reports on the status and development of laws affecting not-for-profit organizations in countries around the world. The December 1998 issue includes “Registration of Associations in Central and Eastern Europe and the Newly Independent States: A Survey,” by Rachel L. Holmes, and “NGO Legislation in Georgia,” by Vasha Salamadze. To order, contact the International Center for Not-for-Profit Law, 733 15th Street, NW, Suite 420, Washington, DC 20005, United States, tel. 202-624-0766, fax 202-624-0767, Email info@icnl.org.


This free publication by MESA 10 (the Center for Economic and Social Analysis, a major economic think tank in Slovakia) reports on major developments in the Slovak economy. To order, contact the Bank of Finland Institute for Economies in Transition (BOFIT) Aleksanterinkatu 36 A Helsinki, or PO.Box 160 FIN-00101 Helsinki, tel. 358-9-183-2268, fax 358-9-183-2294, Email: bofit@bof.fi. MESA and be reached at Hviezdoslavovo nám. 17, 81102 Bratislava, Slovakia, tel. 421-7-544-35-328, 544-34-009 fax 421-7-544-32-189, Email: mesa10@internet.sk.
### Basic economic indicators of transition economies, 1996-1999

(Rates of change and shares, percent)

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP (growth rates) 1998</th>
<th>Industrial output (growth rates)</th>
<th>Inflation (per cent change, Dec./Dec.)</th>
<th>Unemployment rate (end of period, percent)</th>
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**Note:** Aggregates are UN/ECE secretariat calculations, based on previous period weights at 1992 prices. Output measures are in real terms (constant prices). Forecasts are those of national conjunctural institutes or government forecasts associated with the central budget formulation. Industrial output refers to gross output, not the contribution of industry to GDP. Inflation refers to changes in the consumer price index. Unemployment generally refers to registered unemployment at the end of the period (with the exception of the Russian Federation where it is the Goskomstat estimate according to ILO definition and Estonia where it refers to job seekers). Aggregates shown are: Eastern Europe (the 12 countries below that line), with sub-aggregates CETE-5 (central European transition economies: Czech Republic, Hungary, Poland, Slovakia, Slovenia) and SETE-7 (south European transition economies: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, The former Yugoslav Republic of Macedonia and Yugoslavia; Baltic states (Estonia, Latvia, Lithuania); CIS (12 member countries of the Commonwealth of Independent States); and total transition economies. 

**a** June 1998 over June 1997.

**b** Data reported by the Statistical Office of the Federation; these exclude the area of Republika Srpska.

**c** Bulgarian industrial output indices were recently recalculated according to a new methodology and old series reportedly have been revised back to 1991. Here and in appendix table B.4 the industrial output indices now cover gross output of all activities of industrial enterprises (and not gross output of "pure" industry, as previously published). The figure for industrial output growth in 1996 according to the new methodology (3.8 per cent) differs significantly from the figure for the rate of change of gross industrial output (-9.1 per cent) reported in the national accounts for the same year.

**d** Gross material product instead of GDP.

**e** Excluding Transnistria.

**Source:** National statistics; CIS Statistical Committee; direct communications from national statistical offices to UN/ECE secretariat (IMF and World Bank data for Albania).
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