Growth—Government Policies—Foreign Aid

The intricate relationship between economic growth, government policies, and foreign aid is the topic of our leading articles. The transition countries—after fifty to seventy years of mismanagement—can hardly afford to preserve wasteful resource allocation and antibusiness attitudes: the price is economic stagnation and increased poverty. Broadly based reform policies, in contrast, boost growth and foreign investment. An analysis of Freedom House's latest country rankings indirectly confirms these conclusions, emphasizing that democracy and economic reform are closely related. The relationship between foreign aid and reform is the subject of the last article in the block. While aid cannot "buy" economic policies, it is more effective when it is allocated to countries with good policies.

Reform_boosts_growth_and_foreign_investment

by Marcelo Selowsky and Ricardo Martin

Both the policy track record and the economic performance of the transition economies have begun to differ significantly. The Czech Republic, Hungary, Poland, and Slovenia have experienced both sustained growth and a reduction in inflation, and are attracting significant foreign direct investment. The four countries moved early and forcefully to liberalize and privatize their economies and to depoliticize the allocation of credit. Their private sectors today account for an average of two-thirds of GDP. In other transition economies, such as Bulgaria and Romania, progress in inflation and growth has been more erratic. Privatization and banking sector reform have been slower and the quasi-fiscal deficit remains a source of inflationary pressures and crowding out of the private sector. Foreign direct investment (FDI) in these countries has grown less and so have the private sectors.

There is also variability in performance across the countries that formed part of the Soviet Union, including the Baltic economies. The Baltic countries have made as much progress with reform as the most advanced Central European reformers, and their economies are growing. Armenia, Georgia, and the Kyrgyz Republic have made significant progress in reducing inflation and liberalizing, and in 1996 they achieved GDP growth of about 5 percent. By contrast, measured output is still declining in the three largest countries in Eastern Europe—Belarus, Russia, and Ukraine. Until recently, Russia had advanced much faster in price liberalization and...
privatization, although Ukraine is now catching up. In Belarus there has been no progress in policy reform.

Output growth in the four advanced Central European countries came from improved resource allocation, both within firms and across firms and sectors. Some reallocation of resources and efficiency gains have taken place within state-owned firms, as they have had to face tight credit, competition, and improved export prospects due to the liberalization of the trade regime. Most important has been the growth of new private firms taking advantage of the assets released by state-owned enterprises being downsized or liquidated. Between 1989 and 1995 the share of the private sector in GDP doubled in Poland, quadrupled in Hungary, and increased tenfold in the Czech Republic.

As time passes, the share of growth derived from improved resource allocation will gradually diminish. Growth will be determined more by physical and human capital accumulation. Domestic investment rates and the ability of countries to attract foreign direct investment (with embodied technical change) will become the main source of growth.

We estimated the empirical association between improved domestic policies and growth, making a special effort to test the dynamics of policies (that is, whether they operate with a lag). The progress in policy reforms was measured by the Liberalization Index ("From Plan to Market: Patterns of Transition," Policy Research Working Paper 1564, World Bank, 1996) calculated by de Melo, Denizer, and Gelb. Measured GDP growth was adjusted to take into account the underreporting of private sector output (but we also report the results using unadjusted GDP).

Our results show that good domestic policies boost economic growth and foreign direct investment. The impact of policies on growth is highly significant in both Central Europe and in the CIS and the Baltic countries, but dynamic impact differs depending on initial conditions. More specifically:

- **Policy reforms significantly affect output growth over an extended period (three years).** The hypothesis that there is no effect or that it is entirely immediate can be strongly rejected. The complete transformation to a fully liberalized economy is associated with a 21 percent increase in GDP in the countries of both Central Europe and the CIS, as well as in the Baltics (18 to 20 percent with unadjusted growth).

- **Countries of the CIS-Baltic States and Central Europe differ significantly in their output response to policy changes.** A particular difference is in the immediate impact of reforms, which is negative in countries of the CIS-Baltic States and positive in Central Europe. This means that liberalization has an up-front "investment cost"
in the CIS-Baltic countries. This may reflect their more adverse initial conditions: a higher initial share of negative value added and military output, artificially located industries, and the lack of a legal framework supporting markets and private property. All these make resource reallocation more difficult. However, it does not change the general proposition that fast stabilization, liberalization, and privatization bring benefits earlier.

**Russia scenarios.** We simulated Russia’s future output growth under two alternative reform scenarios (figure 1). In the first scenario, the Liberalization index does not improve beyond its 1995 level. In the second, reforms accelerate quickly so that by 1999 Russia reaches current liberalization levels for the Czech Republic and Hungary. Under stagnant reform, positive growth is reached in 1997, leveling out at a level of about 2 percent a year. Accelerating reforms postpones the bottoming out of output for another year, but then output grows quickly, reaching about 7 percent (4 percent with unadjusted growth) in 2001. The figure clearly shows the extra years of low growth, that is, the “investment” under the reform acceleration scenario.

Obviously, the high level of growth to which the recovery converges under the accelerated reform case is a short-term or “transition” convergence. To be sustained, it must be validated by enough capital accumulation and productivity growth, the long-run sources of growth.

The flows of foreign direct investment can give a useful indication of future output growth, as they reflect the desire to invest in the country. We used the fact that there is now a reasonable amount of data to test their link to policy improvements. Our results show that full liberalization “is worth” 1.8 percent of GDP in additional foreign investment during the same year, and 6.8 percent over the long run. The data also imply that there is a minimum threshold of reforms needed to attract foreign investors.

The existence of a delayed response implies that the speed of reforms is significant. Figure 2 compares the predicted levels of foreign direct investment for two countries eventually reaching full liberalization. “Fast” reformers reach that level in three years, while for “slow” reformers, it takes seven years. As a result, cumulative foreign investment in the slow reformer is only half that in the fast reformer, with annual flows still 25 percent below its counterpart even by the end of the reform period.

**Implications for foreign assistance.** The high return to policy reform implies that foreign assistance must be strictly conditional on policy progress but also largely untied, to maximize consumption smoothing in the interim, particularly in the CIS-Baltic countries where better policies may have a temporary negative impact. There are some limits in trying to accelerate output recovery through targeted interventions that provide direct credit to the private sector, finance infrastructure projects, or speed up legal reforms ahead of progress on the policy front. Such interventions first require a minimum amount of progress in stabilization, liberalization, and privatization so as to first develop a demand for credit, a demand for infrastructure services, and a demand for the rule of law.

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**Being Up To Date**

"Who has been covered by the report of the Minister of Welfare?"

From the Hungarian daily Népszabadság.
Nations in Transit 1997 Freedom House Rankings
by Boris Shor

More than half a decade has passed since the sweeping political and economic events of 1989 and 1990 in the countries of Central and Eastern Europe and the former Soviet Union. The latest Freedom House survey—Nations in Transit 1997—seeks to benchmark the progress of democratic and market reforms in the region. In so doing, it helps to provide conclusive evidence to resolve several of the more contentious debates in postsocialist economic reform and, more generally, developmental policy. Some major findings from the report:

- **Alternative: to reform or not to reform.** Following the fall of communism, the pace of reforms designed to marketize economies was one of the most contentious issues in each postsocialist state as well as among Western observers. Radicals advocated rapid, comprehensive reforms to sweep away the brittle structures of the old system and make the changes irreversible. Gradualists argued that this "big bang" strategy would be counterproductive as the reform process itself would impose such horrible costs on the citizenry that populists would be swept back into power.

In the end, however, the debate remained academic. The experience of seven years has shown that what carried the day was less the plausibility of these alternative strategies than the reality of raw political power.

Those countries that in the early post-transition years were without significant antireform interest groups (their nomenklatura was either swept away or—as bankers and entrepreneurs—became major beneficiaries of the new regimes) were able to adopt a standard reform strategy and became "consolidated market democracies". Those countries that retained the nomenklatura or had significant antireform factions chose the gradual route. In practice, the relevant economy—and gets over the transition costs as quickly as possible. Countries with more or less similar endowments of assets and liabilities (both human and natural) have achieved differing results because of their different policy choices over time following independence. Belarus used to enjoy one of the highest standards of living in the Soviet Union. After seven years of go-slow economic reforms, however, the population has become one of the poorest in the region.

On the other hand, Armenia and Georgia, after a devastating 75 percent drop in GDP over the 1990-94 period, introduced macroeconomic and structural reforms, combined with privatization, stabilized their economies while bringing down inflation, and achieved significant growth in 1996. Armenia's GDP, which dropped 25.3 percent on average from 1991 to 1993, turned around and has averaged 6 percent annual growth since. (This is despite closed borders with natural trading partners Azerbaijan and Turkey and continuing problems in obtaining a stable energy supply.) This turnaround is coincident with the introduction of IMF-supported economic reforms in 1993. And in both countries the private sector, albeit largely informal, is booming.

- **Over the long term, deep structural reforms should include the institution of secure property rights and a judiciary, strong enough to protect these rights.** Restructuring of the state sector requires some excruciatingly difficult political choices about closures, layoffs, foreign investment, privatization of strategic industries, and reductions in subsidies. Even the consolidated market economies in the region have not

continued on page 6
What's Behind the Freedom House Ratings and Deliberations

Each of the twenty-five country reports is divided into seven major categories. The Political Process section deals with elections and referenda, party configuration, conditions for political competition, and popular participation in elections. The Civil Society section highlights the degree to which volunteerism, trade unionism, and professional associations exist, and whether civic organizations are influential. Press freedom, public access to a variety of information sources, and the independence of those sources from undue government or other influences are covered in the Independent Media section. The Rule of Law section considers judicial and constitutional matters, as well as the legal and de facto status of ethnic minorities.

Government decentralization, independence and responsibilities of local and regional governments, and legislative and executive transparency are discussed in the section on Governance and Public Administration. The Privatization section details legislative and actual states of privatization in each country. The Economy section reviews the development of institutions that form the foundation of a modern capitalist economy—property rights, macroeconomic balance, an independent central bank, and the ability of people to engage in business. (Sources for the data include international lending institutions, U.S. and nongovernmental organizations, U.S. and regional independent media, and the governments of the countries ranked.)

In order to make data more easily comparable within and among countries, Freedom House rated each of the seven sections (political process, civil society, independent media, rule of law, governance and public administration, privatization, and economy) for each of the twenty-five countries. This was done on a 1-7 scale, with 1 representing the highest and 7 the lowest degree of achievement in each area. Freedom House weighed both governmental and nongovernmental factors aiding or hindering a country's achievement in each area.

The ratings process involved three main steps:

First, the authors of the individual essays created preliminary ratings for the categories for each of their countries.

Second, a meeting of the Nations in Transit Academic Oversight Board was convened in New York in January 1997. This board was chaired by Alexander Motyl, Associate Director of the Harriman Institute at Columbia University, and was composed of the following experts: Jozef van Brabant, Principal Economic Affairs Officer, United Nations; Richard Ericson, Professor of Economics, Columbia University; Wolfgang Danspecgkruher, Director, Liechtenstein Program on Self-Determination, Princeton University; and, Charles Gati, School of Advanced International Studies, Johns Hopkins University. At this meeting, using the preliminary consultant ratings as source material, ratings were established by consensus following discussion and debate.

Finally, a Ratings Committee of Freedom House staff reviewed the ratings for consistency serving on this committee were Freedom House President Adrian Karatnycky, Central and Eastern European area expert George Zanycky, and Nations in Transit coordinator Boris Shor.

Table 2 The Freedom House Rankings: A Breakdown

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<th>Civil society</th>
<th>Independent media</th>
<th>Rule of law</th>
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a. GPA=Government and Public Administration.
Good Policies are Needed to Make Aid Effective
by Craig Burnside and David Dollar

In our recent paper, "Aid, Policies, and Growth," we concluded that over the period 1970-93, aid has promoted economic growth in those developing countries that pursued good fiscal, monetary, and trade policies. Our data set covered a wide range of developing countries from Africa, Asia, Latin America, and the Middle East, but did not include any of the transition countries that have changed from a command to a market system within the past decade. We have to ask, what is the relevance of our findings to the transition economies?

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Sources: Aid is defined as ODA (Official Development Assistance) grants plus lending minus repayments from OECD sources. GDP (measured in US$) and population are from the World Development Indicators CD-ROM. The figures in the aid column are averages for 1994-96. The figures in the GDP per capita column are for 1995. Growth is the annual growth rate of GDP from 1993 through 1995. Openness is measured by the Sachs and Warner dummy variable (1 indicates open, 0 indicates closed), and is measured as of 1996. Inflation (CPI) and the budget surplus are 1994 figures from the IFS database. Liberalization is an index of liberalization (maximum liberalization is 1, minimum is 0), updated for 1995, and is described in de Melo, Denizer and Gelb "From Plan to Market: Patterns of Transition," PRWP 1564, World Bank, 1996.

Table 2 Aid and Macroeconomic Indicators, by Openness

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Our findings were as follows:

- Aid is not a determinant of policies pursued by the recipient countries’ government. Aid could not “buy” good policy.
- In determining aid flows, recipient governments’ policies are not the most important factor. More important factors are evident in the following trends:
  - Lower-income countries, other things being equal, receive larger aid flows.
- We also found a statistically significant tendency for good policy to be “rewarded” by aid, but this effect is swamped by the political variables, leaving no overall correlation between aid and policy.

Is Aid Investment?—Excerpts from a Washington Post Article

Two economists from the World Bank, Craig Burnside and David Dollar, have concluded in a study that the billions of dollars in foreign aid showered on poor countries since 1970 has produced no net impact on the overall economic performance of the Third World, nor on the economic policies of the recipient countries. [Their] findings show that aid has generated substantial benefits only in countries with “good” economic policies such as open trade and balanced government budgets. In countries with “bad” policies, such as high trade barriers and big budget deficits, aid has produced “no positive impact,” and in countries with average policies, the impact of aid has been so minimal as to be statistically indistinguishable from zero. “Where aid happened to coincide with good policies, it had a strong positive effect on growth,” the authors write. “Otherwise, it seems to have been dissipated in unproductive government consumption.”

What’s most significant about the study is its finding that aid has failed to affect poor countries’ choice of policies, “for good or for ill.” Ever since the early 1980s the World Bank and its sister institution, the International Monetary Fund, have sought to use aid as an incentive to get officials in developing nations to reduce inflationary government spending, end wasteful subsidies, and curb burdensome bureaucracy. The idea is to induce politically painful “structural adjustment” that makes a country’s economy more hospitable for business investment, which should in turn foster job growth and rising living standards. There are countries such as Ghana in which one can argue that aid has supported policy reform,” the authors write. “For each Ghana, however, there is a Zambia, in which policy deteriorated continuously from 1970 until 1993, while aid receipts rose continuously.”

What is needed, the study’s authors and other bank officials say, is a shift in approach. Burnside has acknowledged that the study implicitly supports the argument for a “tough love” stance in which aid agencies would cut off aid much more readily than they do now to countries that fail to reform, while channeling more resources to good performers. And the number of good performers is rapidly increasing, according to Burnside and Dollar, who deem it ironic that many rich countries are reducing their aid budgets just as countries such as Ethiopia, India, Mali, Viet Nam, and Uganda are adopting market-liberalizing reforms. Since these reforms should increase the chances that aid would generate economic benefits, “the climate for effective aid is improving,” the authors write.

Indeed, officials at the bank and other aid agencies contend that they are better positioned than ever to make development assistance work well. In part that’s because, following the collapse of the Berlin Wall, they are no longer constrained by Cold War considerations that once required them to shovel money to poorly run regimes in order to help contain communism. “The Bank putting this research out and stimulating a healthy debate is really a sign of the changed times,” said Mark Malloch Brown, the World Bank’s Vice President for External Affairs. “Development assistance is going to be treated more as an investment by the international community, and you’ll invest only where you see a return—a developmental return. The old, pre-1989 soft speak, that development assistance should go even to countries which don’t have strongly reforming economies, is going to get blown away.”

- Aid had a statistically significant impact on growth, but only when the policies of the recipient government were unusually good compared with the average in our sample. The impact of aid was greater in poor countries relative to its impact in middle-income countries in our sample.

- In an era of declining aid disbursements, donors need to improve the allocation of aid by targeting, to a greater degree, recipients with good economic policies. This will increase the likelihood that aid is effective in achieving its goals.

**Observations on the Transition Economies**

Statistics for a group of economies in transition from a command to a market system are presented in table 1, page 6. Some caveats: the GDP figures are not adjusted to purchasing power parity. As a result, sharp movements in real exchange rates can exaggerate the patterns in the data, which shows up especially in growth rates. Also, the data have not been arranged chronologically; some of the policy variables, for example, are measured only at the end of the period for which we have measured aid flows. Despite these flaws, as well as the unavailability of important data for many of the countries in our sample, some conclusions can be drawn:

- **Lower-income transition economies tend to get more aid.** The correlation between per capita GDP in 1995 and average aid/GDP in 1994-96 is -0.52. On the other hand, the correlation between per capita GDP and per capita aid is just -0.09. (Part of the difference is explained by the relationship between per capita income and reform. The higher-income countries have reformed more.) This implies—consistent with our paper—that a main goal of donors is poverty reduction.

- **Per capita aid is highly correlated with better policy.** Given the findings of our study, we would conclude that donors targeted their aid to transition economies with good government policies, rather than that policies were a reaction to aid flows. Aid per capita was higher in open countries (table 2, page 7). Other policy variables—inflation and the budget balance—seem to be closely correlated with openness, and therefore also with aid per capita. The correlation between per capita aid and (a) openness is 0.26, (b) inflation is -0.33, (c) budget surplus is 0.32, and (d) liberalization index is 0.57.

Craig Burnside is Economist and David Dollar is Head of the Macroeconomic and Growth Division, Policy Research Department, the World Bank.

**The EBRD Increases Activity**

**Interview with EBRD's Chief Economist Nicholas Stern**

by Richard Hirschler

*The European Bank for Reconstruction and Development (EBRD) is not ''abandoning'' Central Europe, though it is pushing the frontier of its lending and investment activities farther east. It wants to increase the share of equity investment and preserve the two-thirds proportion of the private sector in its total commitment. EBRD Chief Economist Nicholas Stern was interviewed by Transition editor Richard Hirschler following the organization's annual meeting in London. (The next annual meeting is scheduled for May 11-12, in Kiev, Ukraine.)*

**Q. What will be the topic of the next EBRD Transition Report?**

**A.** The next Transition Report will be on restructuring and growth. It's clear that enterprise restructuring is under way throughout the region. But it has a long way to go, even in such "transitionally advanced" countries as the Czech Republic, Hungary, and Poland. While market experience can now enable investors to assess the likely costs and benefits of enterprise restructuring fairly well, it is still a risky venture. Although some blue chip companies can borrow at low interest rates, for three to four years, long-term capital—either as equity or loans—is still not readily available for everybody. So restructuring will remain an important issue and we want to analyze its relationship to the growth prospects of the region. We want to learn more about the sources of growth to better understand the prospects of the individual countries and predict the likely development of their investment markets. Macroeconomic stabilization and the first stage of structural reform generated some growth, but the growth potential in the CIS countries, not to mention Hungary and others, is certainly higher than we have seen so far. This is an area that we have to investigate more closely. How much of the growth is simple recovery, how much is the result of productivity increase, and how much is coming through reallocation across sectors and through growth in new sectors? Once we assess potential sources of growth more clearly we will be able to assess the economic prospects and investment potential of the individual countries. We also want to analyze more carefully the time lag between investment and growth. Since the EBRD finances investment, we are trying to understand more profoundly the determinants of investment opportunities and the influence of investment on growth.
Q. What are other major features of the EBRD’s research program?

A. The department is primarily strategic and operational, but we are also conducting some research. We are trying to learn more about ownership trends in the transition economies and their influence on governance. In another project, we will evaluate the availability of financing in these economies, examining both direct investment and the lending capacities of the financial institutions. With respect to the approaching enlargement of the European Union, a third project will examine, through a survey, the competitiveness of Central and East European enterprises, the challenges they are facing, and their expected response to accession. We are also doing research on how we could support most effectively small and medium-size enterprises.

Q. Will these projects be concluded in the current financial year?

A. No. We will be getting results on all of them during the current year, but they will probably continue into 1998.

Q. And how will the results be communicated to the interested public?

A. Through our working paper series, and also through our Journal, Economics of Transition. Part of the findings will be integrated in the Transition Reports, and some researchers will publish their studies in the various journals.

Q. During the annual meeting, there were some hints that the EBRD’s lending and equity investment activity will move farther east, to Ukraine, Russia, the Central Asian countries. Most Central European economies will be declared “success stories,” that is, “graduated” to private capital. In this sense they will not need more EBRD money. The Economist also asked why the EBRD is still lending in countries that now have easy access to international capital markets?

A. In fact, over the next couple of years we plan to boost our annual lending and investment capacity to around $3 billion across the region, compared with some $2.6 billion in commitments to borrower countries in the past financial year. True, within this increased activity, our commitments to countries farther east will rise faster. But in the next two years Central and Eastern Europe can expect further EBRD support targeting enterprise restructuring, investment in the environment and energy sector, efficiency in infrastructure in general, privatization of utilities, and strengthening of the financial institutions. We will basically commit our resources in those areas where private investors need encouragement, where without our assurances they would hesitate to commit their long-term capital, and also where we can be useful providing advice, for example, on the way public utilities should be commercialized. As long as we have something to bring to the table, and that would be more than just money, we will be present in this region.

Q. Analysts warn the EBRD that “farther east” it will face more difficult environments: the economies are more unstable, the state sector is still overwhelming, and private companies are small and weak—and that therefore the Bank’s loan and equity portfolio could worsen. This could mean that the Bank would not be able to preserve its “golden rule”—to commit at least two-thirds of new investment to the private sector.

A. Some of these concerns are understandable, but I’m still convinced that there are plenty of sound opportunities “farther East.” We will participate only in sound projects that have the potential to stand on their own feet. We have to be convinced that a project will pay back from its own revenues. I do not foresee any problem in repeating the performance of last year when the private sector received 66 percent of our commitments.

Q. Has the EBRD assessed the success rate of its projects?

A. We evaluate a project in detail only after completion. Public sector projects have quite a long life time, more than five years, and the Bank is only six years old. Although we started lending from the beginning, it is the last four years that have seen the strongest activity. So we are only now actually accumulating sufficient data to be able to draw lessons of experience. By the way, I am always a little skeptical about the words “successful” and “not successful”—you have to consider a number of different dimensions. Some of our loans are bound to go bad. If none went bad then probably we would not be doing our job. We would not be taking enough risks. It is hard to cover the loan risks in terms of the interest spreads. Therefore, having a direct stake in the company, and thus sharing in the upside, could serve us better.

Q. Will the EBRD shift away from co-financing toward equity investment?

A. Yes, we would like to see an increase of the equity share in our total investments—
the share now accounts for about 20 per-
cent. We never take more than 35 per-
cent of any private sector project. An
EBRD representative then can participate
at board meetings and be directly involved
in the decisionmaking process. The en-
terprise can also benefit from opening up
to the scrutiny and examination of an “out-
side” shareholder. Many enterprises can
obtain loans, but have difficulties raising
money alone on the stock exchange.
However, we want to be a partner that
does not dominate the activity.

Q. But if the equity investment is a
success, after a couple of years the
Bank sells its share and winds up its
engagement...

A. That can happen. We sold our share in
the Hungarian pharmaceutical manufac-
turer EGIS last year, and we have just
sold our stake in a Polish bank. It is a
question of timing. It doesn’t make sense
to disappear instantly as soon as the
company starts to make a profit. At the
same time, you don’t want to outstay your
welcome. After all, opening new opportu-
nities for domestic and foreign private
capital is our job.

Q. It boils down to the fact that the
EBRD has to perform a tough balanc-
ing act: trying to be profitable but also
looking out for territories where pri-
ivate business would not dare to go...

A. Exactly. We have to identify the fron-
tier in terms of the investments that are
sensible but not yet quite sound enough
for the private sector to engage in with-
out us. And we must constantly push
out the frontier.

Q. One great advantage of the EBRD
is its relatively small size; responsi-
bilities are more easily identified in a
smaller organization.

A. Personal responsibility is very important
and is a very strong principle of merchant
banking. This means that while any loan
can get into difficulty, it is the responsi-
bility of the person who made that loan
to sort it out.

Q. The World Bank is making efforts to
develop partnership programs with other
international financial institutions such
as the EBRD. What are the results so far?

A. In Russia, for example, the World Bank
is supporting reform in the bank sector,
while the EBRD is investing in specific
financial institutions. We also participate
jointly in Russian infrastructure projects.
The IFC and the EBRD are working to-
gether to strengthen regional venture funds
that invest in private enterprises. During
the annual meetings of the EBRD in April,
we organized a joint seminar with the
World Bank and the IMF on the obstacles
to economic growth. Participants included
Johannes Linn, Joe Stiglitz, and Marcelo
Selowsky from the World Bank; and Stan
Fischer and John Odling-Smee from the
IMF. As participants of a Development
Committee Task Force, we are also ex-
ploring—together with other regional
banks—how we could increase our effec-
tiveness as a group.

Comparing GDP Growth Forecasts for 1997

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Note: No EBRD projections are made for Albania due to the significant uncertainty over its developments.

Enterprises Divesting Social Assets—
The Belarus Story
by David Sewell

Firms in Belarus, like those in many former command economies, spend large sums on "social services," such as housing for employees, summer camps for their children, on-site health and dental clinics, and off-site specialized medical and dental facilities. Firms subsidize food; maintain crèches, kindergartens, and vocational schools, sport facilities, and spas; and provide local infrastructure, such as district heating, electricity, and water and sewer networks. The sums involved can be important, as Scott Thomas noted in the February 1997 issue of Transition.

Non-Wage Benefit Spending

In recent years the share of social benefits in total employee compensation has been drastically cut in Belarus; in 1995, fringe benefits amounted to 12 percent of total employee compensation. In the United States, in the same year, voluntarily provided nonwage payments by employers totaled about 10 percent of employee compensation. The composition of spending on nonwage benefits, however, is still quite different in Belarus compared with that of the OECD economies:

- Belarus firms spend primarily on housing, clinics, kindergartens, and other in-kind subsidies while the nonwage benefits spending of U.S. employers is essentially on pensions and insurance.
- Western firms "outsourcing" the provision of these benefits, for example by hiring insurance companies as providers. In Belarus, firms engage directly in a variety of activities that are well removed from their core business activities. (For example, producers of television sets and of heavy construction equipment used to run vegetable farms in order to secure a reliable supply—a practice that originated during the former command economy.)

The term "social assets," in Belarus, simply means fringe benefits that are part of the wage bargain with the employee. The favorable tax treatment of fringe benefits explains much of their continued importance: they are deductible from the profit tax base, excluded from the payroll tax base, and exempted from income tax once in the hands of the recipient.

Where Belarus departs most from market economy practice is in the extent of tax-exempt benefits, particularly for housing. As a consequence, rent and utilities account for only 4.4 percent of family expenditures in Belarus as opposed to 19 percent in the median of twenty-three OECD countries recently surveyed. Most market economies attempt to tax in-kind benefits like other income. (The Russian government last year expanded the payroll tax base to include fringe benefits and in-kind payments.)

Assets That Are Liabilities

It is debatable whether fringe benefits should receive continued public subsidies or preferential tax treatment. But it seems obvious that in order to render enterprises more competitive and government more efficient, "social assets" should be divested from the enterprises. Enterprises and government should be accountable for different and distinct sets of responsibilities. Once the government decides which social functions it will fund directly, the appropriate government level has to be chosen and the functions (such as health and kindergarten services) must be adequately funded. There will be some services, such as various public utilities, that will need to find new providers.

Enterprise divestiture of housing is clearly the most difficult adjustment to be made, in view of its importance to consumer budgets. Housing has always represented a liability for enterprises. Over time, the connection between employment in an enterprise and the use of enterprise-provided housing became increasingly tenuous: occupants could keep their apartments after retirement, even if they changed employers, and could swap one apartment for another. Enterprises were left with the burden of maintaining these apartments. (They started to transfer them to local councils as early as the 1980s.)

Public policy must find a way to ensure the continued availability of housing. The issue is serious as housing is critical to the efficient allocation of resources and thus to growth. Indeed, as much as one-quarter of total unemployment in transition economies has been attributed to the lack of labor mobility caused by housing shortages.

Divested services are often considered the responsibility of local governments. This is clearly the case with local infrastructure. Assigning responsibility for such services as education and health to local governments is more complicated. And the need to provide decentralized services differs from one CIS state to another: Russia, with its eleven time zones, numerous ethnic groups, and population of 150 million, needs more decentralization than...
Belarus, with its more compact area, homogeneous ethnic composition, and population of only 10 million.

Whatever level of government is assigned responsibility for divested social services, financing needs to be adequate. To be effective, local government requires some autonomy in its functions and financing. In Belarus, however, as in many countries in transition, local and regional governments raise little revenue themselves and often function as mere agents for the delivery of services such as health and education. But financing arrangements have not kept pace with the reassignment of functions to subnational governments. The subnational share of total government revenues declined from 70 percent in 1992 to 48 percent in 1996.

Revenue sharing accounts for 75 percent of subnational government revenues, but it yields more resources to the wealthier regions and thus deepens interregional imbalances. Tax breaks to agriculture have reduced revenue sharing with rural local governments. Special extrabudgetary funds were created to finance local government operation of kindergartens and housing maintenance. Revenues from these funds now exceed those from the budget. At the same time, genuine subnational taxes—where the base and rate structure is determined by the subnational government, which in turn is responsible to an electorate—raise insignificant amounts of revenue.

**Somebody Is Paying the Cost**

Appropriate financing for utilities that are the responsibility of local governments requires users to pay full cost. Low rents and utility fees were part of the Soviet Union’s redistributational policy. But subsidizing utility use for distributional reasons is counterproductive. The rule still holds—and Belarus is no exception—that better-off people benefit more from these subsidies since consumption normally rises with income. (Such subsidies are financed either by taxpayers, including those who do not use the utilities, or by “inflation taxes,” that is, printing money to finance government deficits.)

These low utility fees became unsustainable once prices were freed and Belarus no longer had access to low-priced energy. From 1994 to 1995, cost recovery ratios were raised from 2 percent to 50 percent for household maintenance, from 2 percent to 54 percent for water, from 4 percent to 65 percent for heating, and from 25 percent to 84 percent for electricity. Distributional problems are best addressed by direct income support, such as the housing allowance the Belarus government instituted in 1995.


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**The Uncertain Fate of Russian Housing Subsidies**

The annual cost of Russia’s subsidies to citizens for housing and related municipal services (electricity, water, and public maintenance) has reached 119 trillion rubles (4 percent of GDP or 30 percent of all public expenditure). This is Russia’s largest expenditure, surpassing total combined expenditure on the armed forces, the interior ministry, internal troops, the federal security service, and the border service. A presidential decree, signed of May 12, calls for reform of Russia’s housing subsidy system over the next five years. In 1997 charges to residents for housing and related municipal services will be raised from 27 percent to 35 percent of their actual cost; in 1998 users will pay 50 percent of these costs, and by 2003 they will pay the full price.

To protect those with little means, however, a rising ceiling will place a limit on housing costs as a share of a family’s income, with a cap of 16 percent in 1997 and increasing to 25 percent in 2003. Housing costs above the cap will be paid by the state. (The government will pay the subsidies directly to the needy citizens rather than to local governments and municipal service providers. At present about 5 percent of the average Russian household’s income goes to housing and related services. (Average wages are currently valued at about $150 a month.) The government calculates the reduction in subsidies will yield a net savings of 80 trillion rubles by 2003.

Moscow’s Mayor Yury Luzhkov has warned that sharp rises in housing prices could cause gigantic upheavals and the dismissal of the government. He told a trade union rally that for housing and municipal services to be reformed, wages needed to be guaranteed at a level that would put people in a reasonable financial position, without deprivation. Luzhkov—writes Renfrey Clarke of the Wall Street Journal—is much better placed than most heads of Russian municipalities to bark at the government’s schedule for rent and tariff increases. His city administration is the best-financed in Russia, and one of the best able to maintain its present subsidies.

*From news agencies reports.*
Battle Rages over Russia’s Natural Monopolies
by Peter Rutland

To their critics, they are the last vestiges of the Soviet economic system. To their defenders, they are the only corporations that have learned to survive and prosper in the transition to a market economy, and they offer the best hope for halting Russia’s economic decline. Natural monopolies in electricity, gas, and railways moved to the center of the Russian political stage with the mid-March appointment of the 37-year-old reformist governor of Nizhny Novgorod, Boris Nemtsov, as first deputy prime minister. President Boris Yeltsin tasked Nemtsov with spearheading reform of the natural monopolies.

Gazprom and the electricity monopoly Unified Energy Systems (EES) were created as independent joint stock companies in the twilight years of the Soviet Union, and are now the two largest corporations in Russia. Gazprom runs the natural gas distribution system and accounts for 98 percent of gas production. EES controls the electricity grid and 82 percent of Russia’s power-generating capacity. The state owns 40 percent of Gazprom and 31 percent of EES, but effective control of each company rests with its current management.

The government recently admitted that for a while it could not find a copy of the 1993 agreement under which the state’s shares were handed in trust to the Gazprom board (see box).

Critics argue that these companies have exploited their monopoly position to push up prices for industrial users while dodging taxes and hiding much of their earnings in foreign bank accounts and phony trading companies. Gazprom currently owes some 15 trillion rubles ($2.6 billion) in federal taxes, and its workers face an average one-month delay in wage payments. Yet Gazprom earns some $18 billion a year from gas exports, and recently moved into a lavish new headquarters complex on the outskirts of Moscow. Last year it even bought a 30 percent stake in the NTV television company.

The government’s immediate concern is to raise some cash to cover the yawning federal budget deficit and to fulfill its promise to pay off federal wage and pension arrears by July. Gazprom President Rem Vyakhirev has agreed to pay off half of Gazprom’s arrears by the end of June (the other half, which is penalties and interest on late payments, will probably be waived).

Long-term, Nemtsov hopes to rationalize the utilities’ price structure while promoting efficiency in production and consumption. For some time the IMF has been urging the Russian government to tackle the natural monopolies. A commission was set up in November 1996 under then-Minister of the Economy Yevgeny Yasin to draw up an action plan for the monopolies: Nemtsov now seems to be taking up where Yasin left off. Shortly after his appointment, Nemtsov announced a policy package for the natural monopolies that includes a stringent audit, price cuts, and changes in the ownership structure. The strategy for structural reform was outlined in a decree signed by President Yeltsin on April 28, and the government will draw up detailed proposals over the next several months.

The aim is to force both EES and Gazprom to introduce territorially differentiated prices in order to reflect real production costs. Independent companies will be allowed to bid for the right to develop new gas fields and will be given access to the gas pipelines and electricity grid. The electricity system has about 30 percent excess capacity, and many low-cost generating stations are idle. The availability of cheaper supplies should bring down prices, possibly saving some 3 to 4 percent of GDP. The EES is already partially decentralized, functioning as a holding company overseeing the regional power generators. The introduction of competition should go more smoothly for EES than for Gazprom, which is a more tightly integrated corporation.

It will take several years for this restructuring to be implemented. Nemtsov retreated from the initial combative statements he made upon taking office, and by April 4 was making it clear that the government is not contemplating radical surgery on Gazprom, EES, or the railway system. Prime Minister Viktor Chernomyrdin, the former head of Gazprom, came out in strong opposition to suggestions that Gazprom should be dismantled. Vyakhirev moved some way toward Nemtsov, announcing on April 14 that Gazprom will hive off some of its unproductive subsidiaries, releasing up to one-quarter of its 375,000 workers. EES pledged to cut industrial tariffs by 13 percent in 1997 and 25 percent next year. By early May there was a distinct scaling back of the rhetoric on both sides, with Nemtsov saying, “Only a madman would destroy Gazprom,” and “We would also like Gazprom to supply not only half of Europe but half of Asia.”

Foreign investors have bought about 28 percent of the shares in EES and 8 percent of Gazprom, but political considerations make it unlikely that foreign investors will be allowed to take majority control of any of the Gazprom or EES subsidiaries. However, both corporations are arranging billion-dollar foreign loans for development projects.

continued on page 13
The Mysterious Gazprom Documents: A Drama in Two Acts

Act I: Anchorman Yevgeniy Kisselov interviews Boris Nemtsov on NTV's "Itogi" program in April 1997. The First Deputy Prime Minister announced that he and Gazprom director Rem Yakirev agreed to preserve Russia's major gas supply company as a single entity. Gazprom not only holds very strong positions at home, it is also Russia's "visiting card" abroad. But the state's share in that company must be managed appropriately. The public must have access to information about Gazprom's operation. A detailed financial-economic audit will clarify the company's business dealings.

Q. Is Gazprom making profits or losses?
A. To be absolutely frank about it, nobody knows anything about Gazprom.

Q. Is Gazprom a state company?
A. Gazprom is a giant joint stock company, with the state holding 40 percent of its shares. Out of this 40 percent, 35 percent has been handed over in trust to Gazprom's Director Rem Yakirev for management.

Q. If these 35 percent of shares entrusted to him earn an income or profits, do these profits go into the state treasury?
A. In order to answer this question, I must see the trust agreement that in all this time I have not been able to locate.

Q. What do you mean? Is it not in the government archives?
A. Usually agreements on trust management are concluded by the State Property Committee. I take the responsibility for telling you that the State Property Committee possesses no such agreement.

Q. So, where is it?
A. I think Rem Ivanovich Yakirev has it.

Q. Who has signed this agreement on behalf of the Russian government?
A. As far as I know, it was signed on behalf of the government by [former First Deputy Prime Minister] Oleg Sokovets.

Q. What is the state's role in Gazprom? Forty percent belongs to the state, including 35 percent in trust management. Is there a state representative in Gazprom who keeps an eye on the state's interests? Is there some sort of mechanism of that nature?
A. Formally there is, but not in reality. It is not a matter of who is in the Gazprom management. It is a matter of whether any functions are carried out on behalf of the government. I believe that state representatives must above all ensure the timely payment of taxes to the budget. For the moment Gazprom's debts to the treasury amount to 14.8 trillion rubles. This is 50 percent more than the treasury's entire debt to doctors, teachers at all levels, and generally to the staff of the public sector. To my great regret, the role of the state in the management of property, including the property of giant enterprises such as Gazprom, has been reduced to naught over these years. My task is to reinstate the state's role in the management of these large natural monopolies.

Act II (One month later): Yevgeniy Kisselov interviews Nemtsov on NTV's "Hero of the Day" program, May 12, 1997.

Nemtsov: The presidential decree on Gazprom that was signed today enhances state influence on this joint stock company and can be best described as a sensational breakthrough.

Q. What makes it sensational?
A. At long last Russia's largest company and one of the world's largest companies has been taken under state control. A collegium of state representatives will work out the state's position at meetings with Gazprom shareholders and its board of directors. The collegium will press for lower gas prices and timely payments of taxes and contributions to the Pension Fund. The collegium also will ensure equal conditions for all gas producers. In addition, the trust agreement with the Gazprom leadership on managing the state-owned shares should be revised.

Q. About a month ago you claimed that the trust agreement was lost. Have you found it?
A. Two hours after you left, the agreement was delivered.

Q. Who signed it then?
A. Sokovets did, but many state officials were surprised by its contents and the place where it was kept.

Q. Why was it kept?
A. In a secret location. I can only say that the agreement will be revised and Rem Yakirev, as a representative of the state, will carry out what the government asks him to do. His remuneration will be a percentage of the state-owned dividends.

Q. What revenue does the state receive from Gazprom, if it is not a secret?
A. The revenue is so miserable that it cannot be a secret. Over two years, dividends of state-owned Gazprom shares [40 percent of all shares] have yielded a total of twenty billion rubles.

Q. That is, roughly speaking, four million dollars?
A. It is even less.

Q. It's difficult to believe.
A. This is related to the fact that the government has totally lost control of the company.

(Appreciation to Davis Johnson and his Russia List)
Restructuring Firms in Transition Economies

Each of the following three articles was written by World Bank staff and each deals with the much discussed and evolving topic: How to privatize and quickly and successfully restructure the once state-owned “socialist” enterprises. Our authors come to different conclusions, and that is assuring; it proves that the “think tanks” within the Bank are aware of the issue’s complexity, and while looking for solutions, they avoid adopting a single “doctrine.”

Findings of a Survey—Leaders and Laggards
by Gerhard Pohl, Robert E. Anderson, Stijn Claessens, and Simeon Djankov

Firms in Central and Eastern Europe have been struggling for the past seven years to adapt to the new market realities created by the political and economic revolutions of 1990. Our comprehensive analysis of industrial restructuring shows that privatization has been the single most important determinant of success. Privatized firms have increased productivity three to five times more than similar state-owned firms. The method of privatization has been less important. Massive giveaways of firms through voucher privatization or management buyouts have had results similar to case-by-case sales to foreign or domestic investors. Privatization of industrial and commercial firms is also the most important factor for the solvency of the banking sector.

We analyzed financial and operating data for more than 6,000 industrial firms in seven countries of the region: Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia, and Slovenia. These countries have adopted different policies to encourage restructuring; thus, the data can suggest which policies have been the most successful. The number of firms in the sample for each country

continued from page 13

Currently, the utilities are forced by the Federal Energy Commission to subsidize households by charging them roughly one-quarter of the price paid by industrial users. (This is the opposite of the situation in the United States, where industrial users pay half the domestic utility price.) Similarly, the railways cross-subsidize passenger traffic through a 20 percent surcharge on freight tariffs. The government intends to increase prices for households while cutting prices for industrial users—some of whom complain that they are paying more for energy than their Western competitors—but the utilities themselves are skeptical that the domestic users will pay the higher fees.

In their defense, the gas and electricity monopolies argue that the breakup of the oil industry into about sixteen independent companies has not prevented soaring prices and tax arrears in that sector. On the contrary, most of the new oil companies have had severe problems attracting investment and maintaining output levels (although this is largely because the State Duma has blocked the necessary production-sharing legislation). In 1996 oil output fell 2 percent while that of natural gas rose 1 percent, and investment in the oil sector fell 25 percent compared with a 6 percent fall in the gas industry.

As for tax arrears, Gazprom says that taxes and excise duties account for 60 percent of their costs, and that overall, the fuel and energy complex provides two-thirds of the federal budget’s tax revenue. They suggest that trying to squeeze out more tax revenue may kill the goose that lays the golden egg. Gazprom sees their own tax arrears as a mere byproduct of the general problem of indebtedness and lack of liquidity that plagues the Russian economy. Gazprom claims that it is owed 70 trillion rubles by its customers, including 15 trillion rubles of debt accrued during the first quarter of 1997. Of the total debt, 31.4 trillion rubles is owed by electric utilities.

The price charged to industrial users is rather irrelevant, since most of them do not actually pay. Moreover, less than 5 percent of them pay in cash, while the remainder offer such barter goods as steel pipe, coal, and the like, or even more dubious securities and tax waivers. As Grigorii Yavlinskii, head of the Yabloko, party put it, "Taxes go uncollected not because firms refuse to pay, but because the economic system is not working."

The question remains: How is Russia to break out of its vicious circle of inefficient firms in an inefficient economy? Reform of the more prosperous firms may be as good a place to start as any.

Peter Rutland (email:rutlandp@omri.cz) is an Associate Professor of Government at Wesleyan University in Middletown, Connecticut. In 1995-97 he was on leave as Assistant Director of Research at the Open Media Research Institute in Prague. [Our article, “Russia’s Dream Team Confronts Nightmares,” April 1997, p. 9, was partly based on the author’s article, “Russia: Another Lost Year for the Economy,” Transition (OMRI), 3(2):78-81, February 7, 1997.]
Table 1 Privatization in Manufacturing, 1995

<table>
<thead>
<tr>
<th>Country</th>
<th>Share of privatized firms (percent)</th>
<th>Share of privatized industrial firms (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>EBRD estimates</td>
<td>OECD estimates</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>2</td>
<td>15</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>4</td>
<td>87</td>
</tr>
<tr>
<td>Hungary</td>
<td>4</td>
<td>82</td>
</tr>
<tr>
<td>Poland</td>
<td>3</td>
<td>55</td>
</tr>
<tr>
<td>Romania</td>
<td>3</td>
<td>20</td>
</tr>
<tr>
<td>Slovak Rep.</td>
<td>3</td>
<td>74</td>
</tr>
<tr>
<td>Slovenia</td>
<td>3</td>
<td>54</td>
</tr>
</tbody>
</table>


Table 2 Labor Productivity Growth, 1992-95 (percentage per year)

<table>
<thead>
<tr>
<th>Country</th>
<th>Privatized firms</th>
<th>State-owned firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>12.4</td>
<td>-1.4</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>8.6</td>
<td>-2.6</td>
</tr>
<tr>
<td>Hungary</td>
<td>6.0</td>
<td>3.2</td>
</tr>
<tr>
<td>Poland</td>
<td>7.5</td>
<td>1.4</td>
</tr>
<tr>
<td>Romania</td>
<td>1.0</td>
<td>-0.5</td>
</tr>
<tr>
<td>Slovak Rep.</td>
<td>7.8</td>
<td>-4.1</td>
</tr>
<tr>
<td>Slovenia</td>
<td>7.2</td>
<td>1.8</td>
</tr>
<tr>
<td>Average</td>
<td>7.2</td>
<td>-0.3</td>
</tr>
</tbody>
</table>

*Firms privatized by 1995

ranges from 700 to more than 1,000. These firms account for a large share of the employment in the manufacturing sector (ranging from 40 percent to more than 90 percent). In order to make the analysis comparable across countries, we adjusted the data to reflect differences in accounting standards both over time and from country to country. The sample also excludes firms in the utility, banking, and agricultural sectors, and new private companies. We focused on restructuring measures that incorporate the most reliable elements of the data. For example, we emphasize comparisons of labor productivity (value added per man-hour). This measure does not take into account depreciation, debt service, and taxes, which are more likely to differ from country to country because of historical circumstances, differences in tax laws, or accounting standards.

Table 1 shows the privatization progress of the manufacturing sectors in the seven countries, based on detailed ownership data for the firms in our sample. We define as "privatized" any firm that has more than 33 percent of its shares transferred to private investors. We measure the extent of privatization both by a simple count of the number of firms classified as privatized and a weighted average based on output to reflect differences in size. On all measures the Czech Republic, Hungary, and the Slovak Republic were ahead of the other four countries. At the opposite end, Bulgaria has made very little progress in privatization.

Privatization has a large effect on the speed of restructuring. As shown in table 2, labor productivity growth during 1992-95 averaged 7.2 percent annually for privatized firms, but -0.3 percent for state-owned firms. In other words, privatization accounts for almost all the productivity growth observed in the region. The exception is Hungary, where state-owned firms achieved half the productivity gains of privatized firms. By contrast, in countries with insignificant privatization (for example, Bulgaria and Romania), productivity in state-owned firms is declining.

Similar results were obtained when total factor productivity (the productivity of all factors of production) was taken as an indicator of restructuring. Figure 1 shows the cumulative change in total factor productivity for privatized firms since the time of privatization and compares this with the gains for state-owned firms in the sample. (There is evidence that managers of state-owned firms carrying out restructuring will improve their performance before privatization if they expect to be held accountable by new owners and want to prove their ability.) The analysis shows that privatization has increased annual total factor productivity growth by about 4 percent.

Initially it was believed that mass privatization and management-employee buyouts would not lead to much restructuring. Our results do not confirm these fears. One indicator is productivity growth (see table 2). It is slightly higher in the Czech and Slovak Republics, which...
implemented mass privatization programs, than in Hungary and Poland, which relied more on case-by-case privatization. The results are similar for profitability: the Czech Republic now has the highest percentage of profitable firms and the lowest percentage of financially distressed firms in the region. We also used econometric methods to test for the effectiveness of alternative privatization methods in the case of the Czech Republic (where data for different methods are available for a sufficiently long time period). These show only minor differences for varying privatization techniques, but strong effects from ownership concentration.

Restructuring is likely to be encouraged if the workforce does not initially absorb all of the productivity gains as higher wages. Our analysis shows that the large productivity gains from privatization (see table 2) have been largely retained by firms to finance productivity-enhancing investments. For privatized firms, labor productivity growth has been faster than real wage growth in all countries (above the diagonal in figure 1). By contrast, real wage growth in state-owned enterprises has exceeded labor productivity gains, eroding internally generated financing.

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Czech Enterprises Seeking True Owners

by Ulrich Hewer

Six years into Czechoslovakia's reforms, and four years after the birth of the Czech Republic, the country has learned that political and macroeconomic stability and fast privatization of state enterprises—while a necessary prerequisite for successful reforms—is only the first step toward industrial restructuring and maintaining high growth.

After a quick fiscal stabilization and successful trade reorientation, the economy has grown at high rates, while preserving low or moderate external indebtedness. At some 3 percent, unemployment has been surprisingly low, while inflation hovers at around 9 percent. At the same time, privatized enterprises are struggling to find effective owners capable of rendering them internationally competitive, banks and financial conglomerates have yet to become efficient intermediaries, and regulatory frameworks need to be strengthened and applied more rigorously.

Since the architects of the Czech mass privatization scheme had always emphasized that the new owners, rather than government bureaucrats, would be in charge of reorganizing enterprise activities, it is not surprising that the question of how much enterprise restructuring has actually taken place in the Czech Republic has become a hotly debated issue—especially in comparison with other countries such as Hungary or Poland, where more traditional privatization methods were applied. The major movers and shakers of the restructuring process are:

The government. The role of the state has dramatically changed since the demise of socialism. About 80 percent of output is now produced in the private sector, compared with less than 4 percent in the late 1980s. Nonetheless, the Czech government, as shareholder via the National Property Fund (NPF) in many enterprises and banks, is in a position to exert considerable influence, directly or indirectly, on economic developments.

A significant amount of state shareholdings (estimated value: 230 billion crowns, or about $8.3 billion) is still held by the NPF, as unsold holdings (worth $2 billion at the end of 1995) and as strategic enterprises ($6 billion). The NPF has remained a largely passive owner: its small staff of 230 people could not even begin to exercise enterprise management control. It has been selling equity shares, mostly on the stock market and through tenders, and hopes to complete these sales by the end of 1997. In a few instances the state—through the NPF—has intervened directly to influence the restructuring and privatization of certain enterprises, for example, steel and aircraft manufacturers. The state has remained direct owner of some companies such as the railroads.

The investment privatization funds (IPFs). The investment funds acquired almost 60 percent of all enterprise assets that had been privatized via the coupon method. They emerged as the main industrial equity holders. Initially many analysts expected that these funds would take care of enterprise governance and make genuine restructuring efforts. But only the largest IPFs, those holding significant stakes in a few enterprises in selected sectors, met these expectations and demonstrated a
strong interest and commitment to effective corporate governance. Most funds are passive investors and have not bothered to replace the managers of the companies they control. This passive behavior is explained by several factors:

- Enterprise managers continue to be considerably better informed about the operations and performance of their companies than fund managers. Close monitoring of enterprises is costly, and prohibitively so if investment funds have spread themselves thin by acquiring shares in too many enterprises.

- Many investment funds, owned by commercial banks, have allowed the banks to take charge of the companies.

- Investment funds find the trading of shares, transfer pricing, and nontransparent equity transactions far more lucrative than striving for profits and dividend payments through efficient governance. Indeed, profits and dividends have been an insignificant source of fund income so far.

The commercial banks. (During the mass privatization program, individuals “sold” their vouchers to proliferating investment funds, largely owned by the banks, which, in turn, are largely owned either by the government or by large investment funds.) Banks, as owner and lender, have a twofold stake in enterprise governance and restructuring. As lenders, they find it more attractive to extend loans to their traditional clients, rather than getting involved in debt restructuring or reorganizing production, including bankrupting inviable enterprises.

Some analysts claim that the banks' dual role creates conflicts of interest, and that shareholders have to pay the price. This has contributed to the slow development of the Czech capital market. Other observers, however, suggest that the performance of enterprises in which banks own significant equity is comparable with the performance of companies where banks do not have such a role. At any rate, debt financing has hardly become an instrument of enterprise restructuring, and enterprise performance has not yet become a determining factor for obtaining credit.

As competition in the banking sector is still relatively weak, banks can generate sizable profits through large spreads between deposit and lending rates, allowing them to set aside the necessary provisions and reserves. Moreover, the partial removal of the banks' inherited bad portfolio, and their partial recapitalization, have tended to reinforce the banks' passive behavior rather than bring about fundamental change.

The enterprise managers. The managers, with their clear advantage in controlling information and operating the available networks, have resisted outside influence, especially in mass-privatized enterprises, where dispersed ownership has tended to strengthen their position. Apart from in foreign-owned enterprises, few managers seem to have been replaced. Although most Czech managers are highly skilled in their professional and technical abilities, they are still learning in such areas as finance management, product development, and marketing, skills very much required in a market economy.

Individual shareholders. Citizens, having participated with great enthusiasm in mass privatization, seem to be less involved in the postprivatization phase. Having received their shares almost free, and making large returns on the money invested, they do not exert sufficient pressure on fund managers to improve enterprise performance. On the macroeconomic level there is plenty of evidence that the structure of the Czech economy has undergone substantial change over a brief period of time: more than one million jobs have been created in the services sector, exports have been reoriented dramatically, and purchase of capital and equipment goods represents an important share in total imports, an indication that many enterprises are indeed in the midst of modernizing production facilities.

At the enterprise level considerable "passive" restructuring of assets and liabilities has taken place initially, to maintain a certain cash flow or to improve cash management in general. But evidence of successful physical restructuring is less compelling. Except in sectors representing traditional strongholds of the Czech economy, such as glass and ceramics production, most products have not yet reached world class levels.

There are, however, examples of significant improvements in enterprise performance, especially when they involve strategic partnerships with foreign investors, such as the Skoda-Volkswagen enterprise. A recent study—using export performance, efficiency in applying labor and material inputs, and enterprise profits and losses as indicators—suggests that Czech companies in general have surpassed their counterparts in other transition countries.

But the recent slowdown in export performance, modest productivity gains, and failure to bring down inflation further could be an indication that the easier part of restructuring may have come to an end. That waste and inefficiencies were so endemic under socialism made it relatively easy for Czech enterprises to take advantage of export markets close by when they were faced with hard budget constraints and rapid privatization at home—two key reforms applied more rigorously in the Czech Republic than in the other Central European countries. Czech managers, known for their
entrepreneurial talents, could hardly fail to reorganize and expand production quickly during the initial transformation phase, a window of opportunity aided by the large devaluation, low wages, and peaceful labor unions. The situation has changed recently: banks and investment funds are attracting the best minds of the Czech entrepreneurial class as sophisticated financial deals have become extremely rewarding. In comparison, the second stage of enterprise restructuring—though more needed than ever—is less rewarding, more risky, and requires continuous hard work.

Ulrich Hewer is Senior Economist at the World Bank. This article is based on his recent study, "The Czech and Slovak Republics in Search of True Owners."

Inside the Czech Stabilization Package—Another Package

The Czech government took steps at the end of May to deal with growing economic problems. Prime Minister Vaclav Klaus announced a new set of austerity measures that include budgetary cuts, wage restrictions, and possibly new import barriers. A month earlier the government presented a package of economic measures, but it did not go far enough: attacks against the Czech crown intensified and the national bank had to sacrifice much of its foreign reserves. That package comprised the following measures:

- **Budget expenditures** will be cut by 5 percent (25.5 billion crowns) this year in order to compensate for lower tax revenues. The public sector wage growth rate will be slashed to 7.3 percent from the planned 11.9 percent, and spending on pensions and social security contributions will be reduced by 3.3 billion crowns. Government investments will generally be reduced by 20 percent (7.7 billion crowns, or $254 million), except in transportation infrastructure and defense, where cutbacks will total only 8 percent. Noninvestment government subsidies will be reduced by 9 percent.
- The government will seek to reduce wage growth rates at state-owned or partially state-owned companies, including banks and energy sector companies, and through this, to exert downward pressure on wage settlements in the private sector. (Wages grew by more than 18 percent year-on-year in 1996, compared with labor productivity growth of only 11 percent.)
- **As of April 17**, 20 percent of the value of all food and consumer goods imports is to be deposited by importers interest-free in the banking system for 180 days. All local banks are to be allowed to participate in the scheme. Prices for imported consumer products may rise by 1 to 3 percent, as a net impact of the measure.
- **Tax collection discipline** will be tighter: company management will have to declare bankruptcy if a firm is unable to pay its taxes or health and social security contributions. A new body to supervise tax collection and initiate relevant legislative changes is to be established.
- Efforts to strengthen capital markets supervision will be intensified, through establishment of an independent securities commission.
- In the longer term the government will step up the state's day-to-day control over enterprises in which it retains a significant stake; it will accelerate the privatization of banks and of regional electricity and gas companies; and it will continue to reduce tax rates—the corporate tax rate is to be cut from 39 percent to 35 percent by 1998.

The reform package has been announced in response to signs of weak economic performance:

- GDP is expected to grow by less than 4 percent in 1997.
- The current account deficit reached 8 percent of GDP in 1996. The foreign trade deficit more than doubled last year to nearly $6 billion (160 billion crowns), followed by a 1997 first-quarter trade deficit of $1.3 billion (40.2 billion crowns). (A current account deficit of around 8 percent of GDP this year would be among the largest in the world.)
- **The budget deficit for the first quarter of 1997 reached some $330 million (10 billion crowns) and is growing. (Between 1992 and 1996 the government maintained a balanced budget every year.)** There is a widening gap between planned budgetary income and lower-than-expected tax revenues, for several reasons. First, economic growth is slowing (the budget was calculated on the basis of 5.4 percent real GDP growth this year); second, the debt owed to the state by many companies and banks has grown to around 40 billion crowns for taxes and 7 billion crowns for social and health care contributions; and third, "creative" accounting used by large companies and other corporate institutions is considerably reducing taxable income.
- Most enterprises are still struggling with overemployment (official unemployment is only 4.1 percent), low labor productivity, and low profitability. Microeconomic transformation—that is, streamlining, rationalizing, and increasing productivity at the enterprise level—is required to improve the country's economic performance.

Excerpted from reports by: Jiri Pehe and Joiyon Naegele for RFE/RFL; and Oxford Analytica, the U.K.-based international research group.
Each approach to privatization implies trade-offs among various goals:

- **Case-by-case privatization** (such as sales for cash or initial public offerings) is characterized by efficiency; it generates revenue, establishes shareholder control over managers, and provides access to capital and skills. But this approach does not promote widespread public participation in the privatization process and is relatively slow.

- **Voucher-based mass privatization** programs, on the other hand, are designed to promote equity in the distribution of wealth and widespread public participation in privatization. But mass privatization programs don't ensure efficiency; they fail to bring in new capital or skills, create control of shareholders over managers, or generate revenues. (See the World Bank's 1996 World Development Report, chapter 3.)

- **Initial Public Offerings Plus**, IPO-PLUS, is a new form of privatization that attempts to promote both efficiency, through creating incentives to restructure enterprises, and equity, through widespread participation. IPO-PLUS thus embraces positive features of both case-by-case privatization and mass privatization.

The IPO-PLUS scheme is now being implemented in Uzbekistan (see box) and is being discussed in Turkmenistan.

What Is IPO-PLUS?

This initiative is based on establishing privatization investment funds (PIFs) that are privately owned but licensed and regulated by the government. These funds will be able to purchase at auction shares of firms slated for privatization, for a relatively low price. They will finance the purchases by issuing and selling their own shares (public participation shares). When buying enterprise shares, the funds will also be able to defer payments—a special facility will permit them a long grace period, long maturity, and low interest rate, and possibly a debt write-off.

To ensure broad public participation, the fund shares are sold for a uniform low price and the number of shares to each individual is limited. The risks of fraud and misrepresentation, which have been a feature of investment funds in some emerging markets, are mitigated in the IPO-PLUS by the fact that PIFs do not appear spontaneously as in the Czech or Russian programs, but are a built-in feature of the scheme. Thus, the program cannot start until a coherent legal and regulatory framework for investment funds and for registering and trading enterprise shares is in place.

To promote efficiency in IPO-PLUS and provide incentives for PIFs to restructure enterprises, PIFs are encouraged to buy large stakes in enterprises up front. Ideally, 51 percent of enterprise shares are to be offered to PIFs in special auctions at preferential terms (see below). Thus, PIFs have incentives to be involved in corporate governance of privatized companies. They also have the resources to do so because, in contrast to other mass privatization programs, PIFs collect cash from the population, which can be partly used to pay for management services. Thus, they avoid one of the more serious weaknesses of voucher privatization funds: shortage of liquid resources.

Enterprise shares are offered to PIFs at preferential terms, initially at a fixed low price. If oversubscribed, to prevent bidding up of prices, shares are allocated on a pro rata basis among the funds. If undersubscribed, share prices are allowed to drop below the initial offering price; the remaining shares are sold to the highest bidder. In contrast to the Polish program in which all enterprises are allocated to funds, in IPO-PLUS, PIFs are not obliged to purchase enterprise shares at any price.

Investment and portfolio planning by PIFs require that the list of enterprises slated for privatization be announced at an early stage, before launching the program. After publication of the list, the sale of funds' shares to the public continues simultaneously (say, weekly) with auctions of enterprise shares to the funds. The selection of good companies is important to stimulate further demand for PIFs' shares. Still, the quality of enterprises plays a smaller role than in case-by-case privatization due to the deferred payment scheme and the low initial prices of both enterprises' and PIFs' shares.

In IPO-PLUS, PIFs are exclusive vehicles of intermediation between investors-citizens and the privatized companies. This exclusivity makes IPO-PLUS different from most other mass programs in which funds, although usually considered conducive to corporate governance, are not considered absolutely essential. Two notable exceptions are the Polish and Kazak programs in which funds are exclusive intermediaries. In the Polish case, funds are established by the government. Although eventually privatized through vouchers, government initiation makes for a major difference from IPO-PLUS, in which PIFs are initiated and established by private individuals. This is so because in IPO-PLUS the establishment of PIFs is the first check of the program's viability. Without a sufficient number of
private businesses willing to invest their cash in founding PIFs, the program cannot get off the ground. To launch the program, the government must convince a sufficient number of potential fund managers that managing PIFs can be an attractive line of business. The government can do so only by setting attractive credit terms and low prices for company shares and by selecting attractive companies for privatization through IPO-PLUS.

IPO-PLUS is a more commercial program than the other mass programs because PIF managers have to demonstrate marketing skills and build marketing channels that will encourage citizens to invest money—both in the program, in general, and in their PIF in particular. Such marketing savvy is a litmus test of the fund managers' financial capability and business acumen, which will later be critical for restructuring the companies they purchase.

IPO-PLUS allows policymakers to privatize a relatively small number of enterprises at a time and still ensure broad public participation. IPO-PLUS is particularly appropriate where the objective is to encourage the involvement of outside owners, the emergence of stock market intermediaries, and concentration of company shares in investment funds.

Together, these components provide the foundation for enterprise restructuring and economic growth. This method of privatization should be of particular interest to policymakers in China, Viet Nam, and African countries. It offers alternatives to voucher privatization, which may be technically inappropriate or politically unacceptable in these countries. IPO-PLUS allows widespread public participation in privatization, but is more commercially oriented than the mass privatization programs carried out in the FSU and Eastern Europe.

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Uzbekistan Prefers IPO-PLUS

Uzbekistan's President Karimov has made clear his government's intention with regard to privatization: "...to abandon a faceless voucherized proprietor and turn over property to a real owner, capable of using the property and ensuring its efficient utilization." In view of the government's opposition to a voucher-based approach, a joint government-bank team has had to cope with the challenge by developing an innovative approach with the following features:

• The price of a public participation share is 100 sums (around one U.S. dollar, or 10 percent of the minimum wage) and each citizen can buy only up to 100 shares in each investment fund.

• Investment funds pay only one-sixth the purchase price of enterprise shares. The balance is a deferred payment, repayable after a four-year grace period, at seven years' maturity, with low interest. About 300 companies in some of the more attractive sectors, such as food, grain and cotton processing, and edible oils, were preselected and approved in September 1996. (The World Bank's enterprise reform loan, negotiated in September 1996, provided the crucial impetus for ensuring that good enterprises were included on the list of selected enterprises.)

• A presidential decree, adopted in June 1996, established the legal framework for investment funds; thus, supervision and monitoring of the funds' activities—among others, to prevent pyramid-like schemes—could start right away.

• Prior to launching the program, infrastructure for share registration and trade was completed, including computerized screen-based trading and a nationwide system for distributing participation shares, through the local networks of two major banks. An important advantage of the Uzbek program was the use of a centralized stock exchange and a centralized share registry (depository) to conduct the auctions of enterprise shares and facilitate the sale of PIFs' shares to the public.

Progress to date:

• More than fifty PIFs have been licensed, indicating that a large number of local private businesspersons were ready to invest their money in fund management.

• Some twenty-eight PIFs have sold enough shares to the public to purchase enterprise shares in auctions. More than 50,000 citizens have purchased public participation shares, and sales have been steadily accelerating since the beginning of 1997.

• Shares in seventy-five enterprises have been sold in eight auctions since the first pilot auction on December 6, 1996.

• Television and radio advertising has been used to educate the public about investing in securities in general, and in privatization funds in particular. A more intensive campaign, extended to all regions of Uzbekistan, is about to start.

The Uzbek government believes that since IPO-PLUS is more commercially oriented and more gradual than the voucher-based mass privatization programs of other CIS countries, it will provide a more solid and conducive basis for enterprise restructuring and capital market development than voucher programs.
Integration into the international trading system leads to membership in the World Trade Organization (WTO). Many transition economies are already members of the WTO: countries like Bulgaria, the Czech Republic, Hungary, Poland, Romania, Slovakia, and Slovenia either were original members of the GATT and agreed to the WTO treaties or became members subsequently. Some fifteen other countries are at various stages in the accession process.

What are the main benefits of joining this club of free trade?

- **Securing market access.** At present, most transition economies are given most-favored-nation (MFN) treatment voluntarily by their trading partners. Exports to the United States, in the absence of MFN treatment, would be subject to high tariffs (averaging 30 percent) compared with an MFN tariff average of about 5 percent. [MFN refers to the standard tariff treatment the United States extends to more than 160 countries; it is not a special privilege or reward.] The United States annually extends MFN status to Russia and CIS countries, contingent on a review of these countries' free emigration policy (as stipulated in the so-called Jackson-Vanik amendment of the 1974 Trade Act). WTO membership would confer permanent and unconditional MFN status on these countries. Membership for exporter nations could also deter the imposition of quantitative restrictions on sales. (For example, the EU continues to impose quantitative restrictions on steel products from Belarus, Russia, and Ukraine—which may not be consistent with provisions under the WTO.)

- **Protecting a liberal trade regime.** Adherence to international trade rules, embodied in the WTO—that is, assuming legally binding obligations regarding tariff levels and other practices (even granting some temporary protection under specified conditions to address protectionist pressures at home without compromising on an overall liberal trade stance)—will help to withstand domestic protectionist pressures.

- **Ensuring fair settlement of trade disputes.** By belonging to the WTO, even small countries with little power in international trade can get a fair hearing and resolution of potential trade grievances against major trading powers.

The accession process can be lengthy—in excess of two years from beginning to end. Once a country writes a letter to the WTO indicating its interest in becoming a member, the WTO sets up a working party to consider the application. The members review the applicant country's trade—both policies and practices—in goods, services, and intellectual property rights. The applicant also has to fill out a detailed questionnaire. (Technical assistance in the preparation of the country's presentation and in the development of its policies is available to acceding members from bilateral donors such as the United States and Switzerland, the EU, and the World Bank, as well as the WTO itself.)

After an understanding is obtained that the applicant country's overall policies and practices are compatible with the WTO, the working party surveys, item by item, the concrete levels of maximum tariff protection that the applicant will apply. These tariff levels are "bound"—that is, the country cannot change them unilaterally without giving other members "compensation" by reducing other tariffs. The applicant also pledges to accept certain obligations over a certain time period. These commitments are made part of the final agreement that governs the accession. The more liberal and transparent the trade policy regime of a candidate country, the easier the membership negotiations.

In the case of transition countries, a key question has been the extent of continued state trading activities. These enterprises may enjoy monopoly positions in importing or exporting; further, they may not face a hard budget constraint and thus can sell products at prices unrelated to their true costs. Under Article XVII of the GATT, the WTO expects member countries to notify the secretariat about the activity of their state trading enterprises. The provision, however, was never intended to apply to a situation where much of the trade was conducted by state-owned enterprises. Countries in transition have also faced considerable questioning on certain preferential trading arrangements, including the free trade arrangement in place among the CIS countries, and the customs union that in principle has been agreed among Belarus, Kazakhstan, Kyrgyzstan, and Russia. The four countries have agreed that each will apply for accession with its own tariff schedule, rather than applying as a member of a customs union with a common external tariff.

Whereas WTO members have to adhere to some basic requirements and principles, there are no specific rules as to the maximum level at which a country has to bind its tariffs; or how many services it will liberalize; or whether it need establish antidumping legislation; or how fast it has to adhere to liberalization of its agricultural regime. Even while adhering to WTO commitments, countries' trade regimes may be, within certain ranges, more or less protective.

continued on page 27
What Is the WTO?

The WTO administers the international rules governments have agreed to abide by in the conduct of trade. It also provides the setting for rounds of negotiations aimed at global liberalization of trade. Established in 1994 following the conclusion of the Uruguay Round of negotiations—conducted under the auspices of its predecessor, the GATT (the General Agreement on Tariffs and Trade)—the WTO now has a membership of 129 countries. An additional twenty-nine countries—more than half of which are transition economies, including China and Russia—are now applying for membership.

The WTO administers three international treaties:
- **The GATT.** Based on an original understanding reached in 1947 and later amended and expanded in 1994 following the Uruguay Round of negotiations, the GATT governs trade in goods. It has been credited with providing the setting for a series of negotiations that led to substantial liberalization of trade in the post-World War II era.
- **The General Agreement on Services (GATS).** An agreement reached during the Uruguay Round, GATS pertains to the conduct of international trade in services.
- **The Treaty on International Property (TRIP).** Also agreed at the Uruguay Round, TRIP sets out rules that govern protection of intellectual property rights.

WTO membership requires participation in all three agreements.

Each of the agreements embodies a number of fundamental principles that governments have agreed will govern their trade relations and to which new members will have to subscribe. Perhaps the most famous of these is the most favored nation (MFN) principle, which underlies all three treaties and requires that a country accord to all members the same treatment as that accorded to the most favored among them—that is, that it not discriminate in the imposition of tariffs or other impediments to trade. A second principle is Reciprocity, which requires that commitments in trade liberalization made by one country be reciprocated by others. Operating on this principle in negotiating rounds, countries would offer to reduce their trade barriers in exchange for reductions in trade barriers by other members. With the Reciprocity principle in effect, the largest countries with the biggest markets can have the greatest leverage because their markets hold such importance for other countries.

Regarding trade in goods, an important principle is that protection of domestic industries can be sought only through tariffs (except in specified circumstances), not through licenses or other quantitative barriers to trade; and each government is committed to follow a specific schedule of "bound" tariffs covering its trade in goods that it has negotiated with other members. In services a fundamental principle is National Treatment, which requires governments to accord foreign providers of services at least as favorable treatment as that given to national enterprises; but unlike trade in goods, where all commodities are covered, in services countries have unilaterally declared the range of services to which National Treatment and other rules of the GATS apply.

The agreements also include provisions that spell out the circumstances under which members can deviate from established principles and commitments. It is possible, for example, for a country to have a lower set of tariffs than a trading partner in a customs union or a free trade area, provided the agreement meets a set of criteria; similarly, a country can offer preferential treatment to imports from developing countries under the Generalized System of Preferences (GSP).

Developing countries also are exempted in many cases from the principle of Reciprocity, for example, in liberalizing their trade regimes. And all countries are permitted to raise tariffs temporarily, in cases where imports cause serious injury to domestic industry or in balance of payments emergencies. Special rules and provisions apply to particular aspects of trade policy or sectors, for example, regulations on the use of subsidies and countervailing duties, procedures regarding antidumping, and the trade regime governing agriculture and textiles.

The WTO also has a dispute settlement mechanism that permits any member to bring before a panel a complaint against another member's practices if it considers these to be in violation of the agreement. An important innovation of the WTO treaty is that if a member is found to be in violation of the agreement, the decision of the WTO is binding—the offender cannot ignore it without risking retaliation by other members.

[On April 28 World Bank President James D. Wolfensohn and World Trade Organization Director-General Renato Ruggiero signed a cooperation agreement that will allow the two organizations to coordinate their efforts to further integrate member countries into the global economy. The Bank's focus is primarily on national trade reforms. The WTO consolidates these reforms and promotes equitable and efficient world trade.]
The right negotiating strategy also includes focusing on institutional weaknesses of the acceding transition countries and, accordingly, requiring extra time for developing appropriate legislation—for intellectual rights protection, for example. In this manner, transition countries can take full advantage of the opportunities that accession to the WTO—and integration in the international economy—offers.

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Cuba's Small Businesses: Taking a Wild Ride
by Philip Peters

Cuba's cuentapropistas—170,000 entrepreneurs operating with a license plus at least an equal number working outside the legal system—mark the arrival of a new small business sector within the island's socialist economy. They are dramatically improving their standard of living, supplying needed goods and services, and learning the habits of independent actors in competitive markets. They account for about 8 percent of the labor force and probably put food on the table of one in ten Cubans.

These small businesses—in official parlance, "self-employment"—are the result of one in a series of new policies that respond to Cuba's economic crisis. These include reduced subsidies to state enterprises, large-scale layoffs, increased foreign investment, introduction of incentives in the agricultural sector, and legalization of dealings in foreign currency. After a 35 percent contraction of GDP between 1990 and 1993, official figures showed nominal growth in 1994 and 1995, and 7.8 percent growth in 1996.

The impetus for change seems to come both from economic policymakers, who want to use market forces to spur growth, and from the Cuban security forces, who are concerned that deteriorating economic conditions could provoke social unrest. Officials praise self-employment as a source of jobs, services, and growth—even as they reaffirm that the fundamental socialist character of Cuba's economy will not change.

By official estimates, 10,000-15,000 Cubans were self-employed in 1993, working as hairdressers, tailors, shoe repairmen, and in other home-based occupations. A September 1993 decree allowed self-employment in 117 new occupations. Initially, university graduates were not eligible, but that ban was lifted on July 1, 1995. As additional occupations were permitted, the number of licensed entrepreneurs reached 170,000 in June 1995 and peaked at 209,000 in January 1996.

By December 1996, principally due to the introduction of a personal income tax for the first time in thirty-seven years, the level dropped to about 180,000. Today it stands at 170,000, and officials say it is growing again.

The labor ministry estimates that 58 percent of these entrepreneurs were previously unemployed, 26 percent are retirees supplementing their pension income, and 16 percent still hold a full-time job in the state sector. One in four is a woman.

The largest concentration is in food service: 29 percent are involved in preparing and selling snacks and workers' lunches.
In May 1996 about 1,800 small private restaurants were operating—the famous paladares that took their slang name from a Brazilian soap opera broadcast in Cuba. The rest of this sector is spread across a broad range of service providers, including carpenters, plumbers, auto and tire repairmen, “messengers” (shoppers), barbers, hairdressers, glasscutters, bicycle parking lot operators, flower vendors, tutors, home video theater operators, taxi drivers, and others.

Ten days of observation in Havana last December showed that many of these entrepreneurs are well educated and trained. They are industrious and use great ingenuity to keep prerevolutionary cars and equipment in working order and to obtain basic supplies. They calculate market conditions, scout good locations, try to set optimal prices, and care about customer service. (One paladar owner told us that after seeing the slow service in competitors’ establishments, he set a standard, which he meets, of serving his customers within ten minutes of receiving their order.)

For their hard work, many earn several times the salaries they earned in government offices or state enterprises. Elena, a single mother working at a Havana food stand, was typical. She earned 171 pesos monthly as a government secretary; in her current job, she earns that in a week. “I prefer this kind of work,” she said. “Here you always see the results of your work and I can take better care of my daughter.”

The cuentapropistas we interviewed described their main challenges and concerns:
- Lack of access to a legal wholesale supply system means that they have no predictable basis for calculating prices and profit margins. Many must resort to black market sources, a risky and time-consuming practice that exposes them to possible legal penalties.
- Some regulations are designed to limit competition with state enterprises. For example, the self-employed cannot hire employees unless they are in food service. Paladares are not permitted to offer beef or shellfish, they are limited to twelve seats, and they can only employ family members.
- There is concern that the government might reverse course and reduce the scope for self-employment.
- Cuba’s new personal income tax, enacted to produce revenue and reduce income inequality, has led to widespread confusion and misunderstanding. Clearly, it has driven some entrepreneurs out of business and others underground. But last December, dozens could also

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### Taxes, Wages, and Prices in Havana, December 1996

Income tax rates and monthly minimum tax payments for each occupation are set by the Ministry of Finance. Nationwide, the average monthly payment is 102 pesos ($5.10, as $1 = 20 pesos); local averages range from 40 pesos ($2.00) on the Isle of Youth to 174 pesos ($8.70) in Havana. The monthly payments count against a taxpayer’s year-end tax payment, which is calculated by applying the progressive tax rates to total income. Overpayments are not refunded. Regardless of occupation or actual expenses, entrepreneurs may deduct 10 percent of gross income to account for business expenses. The year-end tax computation is done in January and February. Taxpayers are required to submit income statements by March 1.

#### Hypothetical Tax Return: Havana Hairdresser

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996 gross income (pesos)</td>
<td>7,200</td>
</tr>
<tr>
<td>10 percent deduction for expenses</td>
<td>-720</td>
</tr>
<tr>
<td>Taxable income</td>
<td>6,480</td>
</tr>
<tr>
<td>Tax owed (5 percent of first 3,000 pesos, plus</td>
<td></td>
</tr>
<tr>
<td>10 percent of next 3,000</td>
<td></td>
</tr>
<tr>
<td>plus 15 percent of remainder = 150 + 300 ÷ 72</td>
<td>522</td>
</tr>
<tr>
<td>Total of twelve monthly minimum tax payments</td>
<td></td>
</tr>
<tr>
<td>of 200 pesos</td>
<td>2,400</td>
</tr>
<tr>
<td>Year-end tax payment due</td>
<td>0</td>
</tr>
</tbody>
</table>

Since this taxpayer paid 2,400 pesos in monthly minimum tax payments, and these payments exceed the tax she would owe based on the progressive rates, she owes no additional tax at year’s end. Her 1,878 peso overpayment is not refunded. Her effective tax rate is 33 percent since her monthly payments equal one-third of her gross revenues.

#### Income and Purchasing Power

Monthly salaries in state enterprises range from 150 to 200 pesos for secretaries and laborers to 300 to 425 pesos for engineering and medical professionals. Pensions are generally 120 to 190 pesos per month. Self-employed persons rarely had exact figures to offer, but most seemed to make a monthly net of about 300 to 1,200 pesos.

To give an indication of purchasing power, the following are prices observed at a Havana farmers market, in December 1996 (in pesos): 1 pound rice: 4; 1 pound tomato: 3; 1 bunch carrots: 1; 1 orange: 1; 1 whole turkey: 200; 1 pound pork: 28; 3 heads garlic: 3; 1 pound black bean: 10; 1 lime: 0.5.
be found in lines at local tax offices signing up to pay taxes. Their revenues made the tax payments affordable, and they wanted to end their risk of being fined for tax evasion.

What Does the Future Hold?

Cuba has clearly weathered the economic crisis that produced a near-standstill in 1993 and 1994. But serious economic difficulties remain, including severely restricted and expensive international credit options, dilapidated capital stock, and vast underemployment. Policymakers are under pressure to generate growth. Against this backdrop, self-employment represents an attractive option. The entrepreneurial energy of Cuba’s people represents the only sure source of goods, services, and employment that requires no credit or investment from overseas.

Self-employment is unique in another respect, however. Because it is the one economic reform that relies not on state planning, but on individual initiative, it is politically sensitive. It has given independence and high incomes to scores of thousands of Cuban citizens.

Last December Cuban officials called for the “consolidation” of the sector, by which they mean enforcement of regulations and getting businesses on the tax rolls. Reports from Cuba indicate that some enforcement actions targeted tax evasion; others were aimed at allegedly stolen raw materials; still others may have been aimed at reducing competition with state enterprises. (Of course, the surest way to “consolidate” the sector, end theft of raw materials, promote recordkeeping, and collect more tax revenue would be to adopt pending proposals to create a legal wholesale supply system for cuentapropistas, and to allow entrepreneurs to hire employees.)

Rhetoric has also heated up. In an April speech President Fidel Castro said Cuba now confronts both external and internal capitalism. He called for an ideological offensive to counter selfishness, mercantilist psychology, the desire for unfair profit, and consumerism. With rhetorical winds blowing in the antireform direction, Cuban economic policy may tread water until the October communist party congress, or beyond. It seems unlikely that Cuba’s entrepreneurial sector will be permitted to reach its full potential in the near term.

But in economically strapped Havana, rhetoric doesn’t always guide policy.

World Bank/IMF Agenda

World Bank/IMF Support to Romania

The World Bank on June 3 approved three loans totaling $550 million to Romania in support of the government’s reform policy to alleviate poverty and to get the economy moving again. The new loans will finance social protection ($50 million), the agricultural sector’s adjustment ($350 million) and improvements in Romania’s highways ($150 million). On April 23 the IMF approved a thirteen-month standby agreement for Romania including credits totaling $430 million. The first installment of about $86 million was made available immediately. Four additional quarterly installments of the same amount will be subject to the observance of performance criteria and a review of exchange rate policy.

The main objectives of the government’s program are to reduce monthly inflation to about 2 percent in the second half of the year, cut the current account deficit to $1.4 billion from last year’s $2.3 billion, and increase foreign exchange reserves. The government has also pledged to privatize about 3,000 enterprises and at least 2 banks by the end of the year, close 10 industrial enterprises that account for 7.5 percent of all state-company losses, and shutdown a further 20 unprofitable state-owned farms. Romania will formally accept the IMF’s Article VIII in July or August and then consider a trading band for the leu, National Bank Governor Mugur Isarescu announced on May 29 in London.

Romania’s monthly inflation fell to 6.9 percent in April from the all-time high of 30.7 percent in March; the country’s current account deficit narrowed to $182 million in the first two months of 1997 from $291 million in the same period last year. Foreign direct investment increased to $191 million from $26 million during the same period. The country’s foreign exchange reserves will reach $2 billion in June, compared with a current level of $1.2 billion and $700 million at the end of 1996, according to the National Bank of Romania.

World Bank Expects to Lend Poland $200-400 Million

The World Bank expects to lend Poland between $200-$400 million annually over the next three years in support of the private and social sectors, including reform
of the pension and school systems, public finance, and environmental protection, and will provide guarantees for financing big projects such as Poland's highway building program—James Wolfensohn announced during his recent visit to Poland. This amount will be less than the $3.7 billion the World Bank allocated to the country in the first four years of market reforms after 1989, but it could exceed the $543 million in commitments over FY94-96, depending on the pace of major policy reforms.

Europe and Central Asia Country Departments Moving to the Field

As part of the World Bank's effort to provide greater country and client focus, the Europe and Central Asia Regional Office (ECA) is expanding the number of country directors, as well as gradually moving some of them into the field from the bank's Washington, D.C., offices. As Vice President Johannes Linn in an earlier interview with Transition pointed out, "Over time, such functions as procurement and disbursement can increasingly be carried out from the field. The decentralization will proceed carefully, otherwise it could be quite costly." The following eleven country directors have been selected assume their positions as of July 1, 1997, and to move World Bank operations for the respective countries (their nationality is shown in parentheses):

- Arntraud Hartmann (German): Albania, Croatia.
- Judy O'Connor (Ireland): Armenia, Georgia.
- Ishrat Husain (Pakistan): Azerbaijan, Tajikistan, Uzbekistan.
- Paul Siegelbaum (U.S.): Belarus, Ukraine.
- Christiaan Poortman (Netherlands): Bosnia.
- Roger Grawe (U.S.), from the Budapest Office: Czech Republic, Hungary, Moldova, Slovakia, Slovenia.
- Basil Kavalsky (South Africa), from the Warsaw Office: Estonia, Latvia, Lithuania, Poland.
- Kiyoshi Kodera (Japan): Kazakhstan, Kyrgyz Republic, Turkmenistan (he takes over as of August).
- Ajay Chhibber (India): FYR Macedonia, Turkey.
- Michael Carter (U.K.), from the Moscow Office: Russia.

World Bank to Approve $1.7 Billion in Loans to Russia

On June 5 the World Bank approved six loans totaling $884.6 million to Russia:

- $600 million for wide-ranging structural reforms throughout the economy.
- $71 million to help higher education institutions reorient their teaching of economics and social sciences toward market economy conditions.
- $40 million to reform the problem-plagued power sector.
- $66 million for health care reform, including improved out-patient care.
- $85 million to help restructure privatized companies.
- $22.6 million to improve economic analysis of structural reforms.

Negotiations on an $800 million credit to strengthen Russia's social safety net, the Bank's biggest loan ever to this country, were completed in early June and will be taken up by the Board of Directors on June 26. The loan will be used to help the poor and other vulnerable groups cope with fallout from Russia's reforms, covering pensions, unemployment assistance, and welfare, including maternity and sick leave.

Wolfensohn Foresees $3 Billion Annual Lending to Russia

The World Bank is prepared to lend Russia up to $3 billion annually, provided the government delivers on an accelerated program of structural reforms, World Bank President James Wolfensohn announced during his recent visit to Moscow. New annual lending of $2 billion would support the Russian government's economic restructuring in order to reduce the wage and pension arrears and make timely social payments. These loans will be provided if the government makes considerable progress in regulating natural monopolies and reforming its tax, pension, and privatization policies. A further $1 billion a year would finance investment in such areas as water supply, district heating, and power generation.

Guarantees for Sea Launch Venture

The World Bank has approved partial risk guarantees worth $200 million to cover Russian and Ukrainian enterprises involved in the Sea Launch joint venture that is aimed at launching commercial satellites from a converted oil platform. (Joint venture partners are the U.S.'s Boeing, Russia's RSC Energia, Ukraine's Yuzhnoye, and Norway's...
Kvaerner Maritime.) Russian and Ukrainian rockets and launch systems will be transported to the United States to be assembled with Boeing satellites and taken to a remote area of the Pacific for launching. The guarantees cover political risks and involve the companies as well as the governments of Russia and Ukraine. World Bank Vice President Johannes Linn commented: "The Bank's partial risk guarantees will help Russia and Ukraine take advantage of their expertise in the aerospace industry, while also creating much-needed jobs in their countries." (According to estimates, the joint venture will generate close to $2 billion of incremental exports for Russia and Ukraine over the life of the project, thereby helping to maintain 20,000-30,000 high-wage, high-skill jobs in the two countries.)

**IMF Releases $696.7 Million**

In late May the IMF approved the release of a $696.7 million tranche from a three-year, $10 billion extended fund facility credit to Russia, along with a return to a quarterly economic review process from the earlier monthly monitoring practice. For this year, Russia could receive up to $2.8 billion in credit from the IMF if it meets quarterly performance criteria. (Russia has committed to limit its primary fiscal deficit to less than 1 percent of gross domestic product this year as against 1.5 percent in 1996. Under the program, Russia's inflation is expected to decline to 12 percent by December from nearly 22 percent the year before. Russia's foreign borrowing in 1997 will be around $9.8 billion.)

**Hungary Receives EFSAL**

Hungary has received a $112.5 million loan from the World Bank as the first installment of a $225 million Enterprise and Financial Sector Adjustment Loan (EFSAL). The agreement was signed during the semiannual meeting of the IMF and the World Bank in Washington, D.C. Agreements on a proposed $200-250 million World Bank Public Sector Adjustment Loan (PSAL) will be finalized in 1997. Talks with the World Bank are also currently under way regarding additional loans to support reforms in higher education and vocational training in Hungary. The World Bank is supporting Hungary's accession to the European Union.

**Loans Withheld from Uzbekistan**

Over the past few months, excess money has fed inflation in Uzbekistan and the government has tightened exchange and trade restrictions, leading the IMF and the World Bank to withhold around $450 million of previously planned official credits that were tied to macroeconomic targets the country could not meet, according to the Financial Times and World Bank staff. According to central bank figures, in the fourth quarter of 1996, the Uzbek base money supply grew by 70 percent, partially as a result of massive budgetary onlending intended for the cotton sector. Prime Minister Utkur Soltanov candidly defended his country's monetary policy: "Over five years of the existence of our state, this is the first time, and we hope the last time, that we had to resort to such a credit emission. We had to choose. Either we do nothing and lose our cotton sector, or we sacrifice some inflation." However, pressures on the balance of payments and the exchange rate are unlikely to dissipate under the current policies—the black market rate for the Uzbek sum has soared to more than double the official rate and shows no signs of moderating, noted World Bank staff.

**Recent World Bank Support to China**

The World Bank's International Development Association (IDA) expects to provide China with $3.5 billion in loans annually over the next three fiscal years, according to World Bank Director Nicholas Hope as reported in the Indian maga-
Bulgaria Receives World Bank Loan for Emergency Purchases...

The World Bank approved a $40 million Critical Imports Rehabilitation Loan to Bulgaria on May 8. The loan will help finance the immediate purchase of medicine, wheat, and fuels, which are currently in extremely short supply. The loan will be at the standard interest rate for LIBOR-based, U.S. dollar, single-currency loans with a twenty-year maturity, including a five-year grace period. Since Bulgaria joined the World Bank in 1990, Bank commitments have totaled about $933 million for thirteen operations. On April 11 the IMF finally approved the long-awaited $657 million loan, comprising a $510 million standby arrangement and a $147 million emergency credit for cereal imports to offset a bad harvest. On May 23 the European Bank for Reconstruction and Development (EBRD) announced that it has approved new loans for Bulgaria totaling $300 million. The loans will help Bulgaria upgrade and develop its railroads, highways, and airports, as well as privatize parts of the tourist sector and create competitive markets in agriculture.

...and Readies Its Currency Board

A team of IMF officials is helping Bulgarian officials set up a currency board by the end of July. The board will tie the lev to the German mark and will strictly limit the amount of currency the bank can issue, making the money supply dependent on the bank’s hard-currency reserves. The agreement with the IMF also prohibits the national bank from providing cheap credits to cover budget deficits or the losses of state enterprises. The new government’s stated priorities are carrying out reforms agreed on with the IMF, providing for the social cost of reform, fighting organized crime, opening secret police files on public figures, returning land to precommunism owners, and bringing Bulgaria into the EU and NATO. Interim Premier Stefan Sofianski said he expected Bulgaria’s annual inflation for 1997 to be about 600 percent, lower than the 769 percent projected under a standby accord with the IMF last month.

World Bank Lending Will Support Reform in FYR Macedonia...

A $30 million loan and a $30 million IDA credit to the former Yugoslav Republic (FYR) Macedonia (approved on May 6) will help consolidate the government’s recent reforms. (By mid-1997 it is expected that 1,150 enterprises out of a total of 1,217 will have completed privatization.) Since joining the World Bank and IDA in 1993, FYR Macedonia has received $300 million in Bank/IDA commitments for eight projects. On April 11 the IMF approved a $75 million, three-year Enhanced Structural Adjustment Facility loan.

Pension Reform in Latvia

A $18.1 million loan approved on May 6 will help finance welfare reform in Latvia. Successful implementation of this project will put Latvia on the cutting edge of social insurance administration throughout Europe and help to speed up the country’s accession to the European Union, said Louise Fox, project task manager of the Bank. The four to fifteen days it currently takes to calculate pension benefits will be reduced to just fifteen minutes. The Bank will help the Inspectorate of Private Pensions to become an effective supervisory body and to provide a training program for accountants, auditors, asset managers, and fund managers. Since Latvia joined the World Bank in 1992, Bank commitments have totaled about $250 million for nine projects.

Banking Sector Reform in Mongolia...

A $10 million Banking and Enterprise Sector Adjustment Credit (BESAC), and a $2 million Banking, Enterprise, and Legal Technical Assistance Credit (BELTAC) to Mongolia (approved on May 1) will help that country to transform its banking system into an efficient and safe intermediary of resources.

Education in Moldova...

A $16.8 million loan to Moldova (approved on April 22) will help finance a General Education Project in support of the government’s education reform efforts. The project is designed to enhance the quality of primary and lower-secondary education (grades 1-9) through improved curricula, new textbooks, and teacher training for 45,000 teachers and administrative staff. Since Moldova joined the World Bank in 1992, Bank commitments totaled $248 million for eight projects.

Public Sector Management in the Kyrgyz Republic...

A $44 million Public Sector Resource Management Adjustment Credit to Kyrgyz Republic (approved on April 17) will support that government’s efforts to strengthen budgetary planning, execution, and auditing; reorganize the financial links between central and local governments; and provide essential public services that are to be divested by state-owned enterprises. Since Kyrgyzstan joined the World Bank and IDA in 1992, it has received credits of about $358 million for twelve projects.

Poverty Alleviation in Tajikistan...

A $12 million credit to Tajikistan (approved on April 10) will strengthen community-based social infrastructure and services. The Pilot Poverty Alleviation Project is designed to benefit about
250,000 poor people. It will target communities most in need, work through a social investment fund, and draw on the expertise of international nongovernmental organizations already active in Tajikistan, project manager Michael Mills explained. Since Tajikistan joined the World Bank and IDA in 1993, credits to Tajikistan have totaled $55 million for two projects.

... Real Estate Registration in Kazakhstan

A $10 million loan to Kazakhstan (approved on April 3) will help to finance a pilot program that will design and test a real estate registration system. The project will encourage the development of land and real estate markets in Kazakhstan. Since Kazakhstan joined the World Bank in 1992, Bank commitments have totaled $959 million for thirteen projects.


The World Bank Group's Multilateral Investment Guarantee Agency (MIGA) has updated its internet-based Investment Promotion Network (IPAnet). First launched in October 1995, IPAnet provides free information on investment and business opportunities. It is currently used by more than 2,000 organizations and individuals in more than 140 countries. The 1997 update offers new and expanded information resources, on-line help, and enhanced search and navigation capabilities.

World Bank President Warns about Drop in Bank's Income

World Bank President James Wolfensohn warned that the World Bank's net profits were set to drop sharply, leaving less money to help the world's poor. The warning came on April 29, at the joint International Monetary Fund and World Bank Development Committee meeting. The Bank's $15 billion in annual lending generates on average a gross annual profit of $37.5 million. But income is falling, in part because relatively lucrative fixed rate loans are expiring and because lending on the Bank's present standard terms is no longer profitable at the margin. Wolfensohn argues that the Bank is more like a foundation than a commercial enterprise, so it is more important to make its $25 billion capital base inflation-proof than to make money on day-to-day business. But income will be too low to do this by fiscal 1999. (The Bank earned about $1.2 billion in fiscal 1996, which it used to replenish its reserves, reduce interest rate charges for borrowers, and help fund low-cost loans for the world's poorest nations.)

Global Watchdogs Urged to Bark with One Voice

Finance ministers and central bank governors from the Group of Ten leading industrial countries, during the semianual meetings of the IMF and the World Bank, endorsed a report that defines the respective roles of various international institutions and urges them not to trespass on each other's territory. The report—according to an April 28 Financial Times article—concluded that guidelines to promote financial stability should be drawn up and promoted by the International Accounting Standards Committee, the G10 Committee on Payment and Settlement Systems, the Basel Committee on Banking Supervision, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors.

No organizations are as yet developing norms for loan classification, asset valuation and provisioning, design and use of deposit insurance, or good corporate governance. The G10 report argues that the World Bank and the regional development banks will normally be the best institutions to offer advice and finance reforms to the financial system. But financial sector conditions laid down in Bank and IMF programs are occasionally inconsistent and counterproductive. "The coordination between the IMF and the World Bank should take place at all levels, extend to regular and frequent contact between financial sector and country experts in both institutions, and be based on clear and efficient procedures for coordinating operations and establishing joint priorities for country operations," the report says.

$195 Million to Patch Up Viet Nam's Roads

Viet Nam's transportation system got a boost with the approval of a $195.6 million IDA credit to upgrade and modernize the country's highway system. The project will continue the reconstruction of Highway 1 (the main north-south road).

Paving the Way to Bosnia Donors Conference

At the end of May Bosnia's ethnic groups finally endorsed a broad package of fiscal, trade policy, and customs laws, called the "Quick Start Package," aimed at restoring the nation's financial institutions. The package came on the heels of another accord by Bosnia's Serb, Croat, and Moslem leaders to form a single central bank and an interim currency, though with different designs for each territory. The move should pave the way for $90 million in financial assistance from the IMF and spur convocation by the World Bank and the European Commission of another international donors conference, to make plans to raise $1.4 billion for aid projects in Bosnia in 1997. The conference has been postponed several times.
because Bosnia's leaders couldn't agree on a common economic policy.

Conference Diary

Investment Window for Ukraine Conference and Exhibition
July 1-2, 1997, Frankfurt, Germany
Information: Adam Smith Institute, 11-13 Charterhouse Buildings, London, EC1M 7AN, United Kingdom, tel. 44-171-490-3774, fax 44-171-490-8932, Email: 100451.312@compuserve.com

Transition in Central and Eastern Europe
July 1-5, 1997, Belgrade, Serbia, Yugoslavia
Organizer: Yugoslav Association of Sasakawa Fellows, Ryoichi Sasakawa Young Leaders Fellowship Fund.
Information: Sasakawa Forum-Belgrade 1997, Mr. Mihajlo D. Rabrenovic, The Yugoslav Association of Sasakawa Fellows, Ul. Susedgradska br. 4-A/6, YU-11090 Belgrade, Serbia, Yugoslavia, Email: m.rabrenovic@lse.ac.uk

International Conference on the Economies of Greater China: Growth, Opportunities, and Risks
July 7-8, 1997, Perth, Australia
Organizer: Department of Economics, The University of Western Australia, and the Chinese Economic Studies Association of Australia.
Information: CESAA Conference Governor, Department of Economics, University of Western Australia, Nedlands, WA 6907, Australia, tel. 619-380-3964, fax 619-380-1016, Email: ywu@ecel.uwa.edu.au

Central Banking in Post-Soviet Economies
July 10-11, 1997, Reading, United Kingdom
Organizer: Centre for Post-Soviet Studies, Centre for Central Banking Studies.

World Bank’s Bosnia Report Card

In a letter to the New York Times, World Bank Director Christine Wallich responded to charges, made in the May 18 article "For Bosnia, Peace Is Coming Up Empty-Handed," that the Bank is exacerbating political tensions there by slowing down two-thirds of the $1.8 billion pledged for reconstruction because of the country's lack of progress on economic reforms. Wallich wrote that 64 percent of the World Bank-administered funds have been spent on the ground to date, and that this is one of the best records among postwar reconstruction efforts. Reconstruction goals may be slowed, Wallich said, because donor countries may condition reconstruction assistance on political progress to comply with the Dayton accords.

Popular Guarantee Facility in Bosnia

The World Bank has helped set up a guarantee facility covering political risk—including the risk of war and civil disturbance—to encourage investment in Bosnia and Herzegovina. The scheme is designed to help restart industry and production by attracting private foreign money. The guarantee facility is administered in Sarajevo by the Investment Guarantee Agency, an independent corporation owned by the government of Bosnia and Herzegovina. Its guarantees will be backed by IDA and by other donors. A total of $18.5 million has already been donated as capital for the guarantee facility, made up of $10 million of IDA money, $7 million from the Swiss government, and $1.5 million from the Swedish government. The goal is to build the capital behind the guarantee to $50 million. Eight foreign companies have so far shown interest and have signed up for the scheme.
Institutions in Transition
September 18-20, 1997, Radenci Spa, Slovenia

The aim of the conference is to stimulate comparative theoretical discussion of different ways in which institutions evolve or are designed, and to outline the importance of institutional choice and innovation for successful transition and development. Organizer: Institute of Macroeconomic Analysis and Development of the Slovene government.

Participants include: Bruno Frey, Enrico Colombatto, Svetozar Pejovich, Zeljko Bogetic, and Fareed Hassan.

Information: Janez Sustersic, Faculty of Economics, University of Ljubljana, Kardeljeva pl. 17, SI-1000 Ljubljana, Slovenia, fax 361-61-189-2698.

European Integration as a Challenge for Structural Change
September 21-23, 1997, Breisach bei Freiburg, Germany

Language: German.


International Forum: Strengthening Women's Business Organizations
September 22-24, 1997, United States

Information: Ms. Trisha Roys or Ms. Eva Shaw-Smith, The Center for International Private Enterprise (CIPE), 1615 H Street NW, Washington, D.C. 20062-2000, United States, tel. 1-202-463-5901, fax 1-202-887-3447, Email: troys@cipe.org, ewshaw@cipe.org, Web: http://www.cipe.org

German-Czech Economic Cooperation
September 25-26, 1997, Kassel, Germany.

Language: German.

Information: Dr. Gabriele Gorzka, Ost-West-Wissenschaftszentrum, Hollaendische Strasse 36 - 38, 34109 Kassel, Germany, tel. 49-561-804-30 09, fax 49-561-804-37 92, Email: gorzka@hrz.uni-kassel.de

Social and Economic Aspects of Ageing Societies: An Important Social Development Issue
September 25-28, 1997, Ljubljana, Slovenia

Organizer: Institute for Economic Research, Ljubljana, Slovenia.

Topics: Demographic and sociological aspects of population aging, including housing and health care, economic consequences, and pension system reforms.

Information: Nada Stropnik, Institute for Economic Research, Kardeljeva ploscad 17, 1000 Ljubljana, Slovenia, tel. 386-61-345-787, fax 386-61-342-760, Email: stropnik@ier.si

Twenty-sixth Conference of the Japanese Association for Russian and East European Studies
October 4-5, 1997, Kyoto, Japan

Organizer: The Japanese Association for Russian and East European Studies (JAREES).

Topics: Changing market and society of the transition economies; issues on the collapse of the socialist system.

Information: Dr. Satoshi Mizobata, Associate Professor, Kyoto Institute of Economic Research, Kyoto University, Yoshidahon-machi, Sakyo-ku, Kyoto, 606-01, Japan, tel. 75-753-7144, fax 75-753-7148, Email: mizobata@kier.kyoto-u.ac.jp

Post-privatization Period in Eastern Europe: A Chance for Enterprises and Shareholders
October 14-19, 1997, Chisinau, Moldova

Organizer: University of Grenoble.

Information: Ivan Samson, Chairman of Organizational Committee on EU, University of Grenoble, 1241 Rue des Residences, BP 47 Grenoble, France, tel. 33-476-825-819, fax 33-476-825-862.

Banking and Finance in the Baltics '97
October 15-17, 1997, Riga, Latvia

Organizer: LBS Exhibitions and Conferences

Information: Latvian Business School, 1 Maza Pils Str., Riga, LV 1050, Latvia, tel. 371-721-1186, fax 371-722-4429, Email: lbs@mailblx.riga.lv, Internet:http://www.lvnet.lv/BFB96

Seventh Zittau Seminar on the Energy Situation in the Countries of Eastern Europe
November 3-5, 1997, Zittau, Germany


Information: Professor W. Riesner, Hochschule fuer Technik, Wirtschaft und Sozialwesen, Zittau/Goerlitz (FH), Fachbereich Wirtschaftswissenschaften, Theodor Koerner Allee 16, 02763 Zittau, Germany, tel. 49-3583-611-415, fax 49-3583-510-626.

Entrepreneurship in the Transition Economies of Central and Eastern Europe
November 6-7, 1997, New York, United States

Call for papers: Deadline May 31, 1997 (500-word detailed abstract on work in progress).

Organizer: The Institute for EastWest Studies and the Berkley Center for Entrepreneurial Studies at the Stern School of Business, New York University.

Topics: The nature, extent, and growth of entrepreneurial activity in the transition economies and the impact of entrepreneurship on the transition process.

Information: Paul Wachtel, Institute for EastWest Studies, 700 Broadway, 2nd floor, New York, New York 10003, United
States, tel. 1-212-824-4100, fax 1-212-824-4149, Email: PWACHTEL@stern.nyu.edu

5th Annual Conference on Marketing Strategies for Central & Eastern Europe
December 10-12, 1997, Vienna, Austria

Call for papers: Deadline August 31, 1997. Information: Prof. Dr. Reiner Springer, Wirtschaftsuniversitaet Vienna, Althanstrasse 51, A-1090 Vienna, Austria, tel: 43-1-3133-64371, fax 43-1-3133-6751, Email: springer@isis.wu-wien.ac.at; or Peter Chadraba, DePaul University, 1 East Jackson Boulevard, Chicago, Illinois 60604, United States, tel. 312-362-881, fax 312-362-5647, Email: pchadrab@wpost.depaul.edu

The Enlargement of the European Union and Its Globalization
January 3-5, 1998, Chicago, Illinois, United States

Organizer: Association of Comparative Economic Studies.
Topics: Macroeconomic implications of the enlargement of the European Union.
Information: Jana Serghyov, Taussigova 1155, 18200 Prague 8, Czech Republic, tel./fax 42-02-858-4640.

The Budget Cutter
From the Russian weekly St. Petersburg Press.

New Books and Working Papers

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

World Bank Publications

To receive ordering and price information for World bank publications, write: World Bank, P.O. Box 7247-8619, Philadelphia, PA 19170, United States, tel. 202-473-1155, fax 202-676-0581; or visit the World Bank bookstores, in the United States, 701-18th Street, N.W., Washington, D.C., or in France, 66 avenue d'lena, 75116 Paris, Email: books@worldbank.org, Internet: http://www.worldbank.org/


Policy Research Working Papers


Large industrial firms in Slovakia have restructured more rapidly than expected, including those regarded as "non-viable" only a few years ago. Authors evaluated twenty-one Slovak firms for the period 1991-96, based on detailed financial information and interviews with top management. Privatization to insiders, through management-employee buyouts, did not hamper restructuring because the new owners (old managers) invested heavily in new technology, laid off a substantial part of the workforce, sought foreign partnerships, and were prepared to sell controlling stakes to outsiders in return for fresh financial resources.

To order: Faten Hatab, Room H8-087, tel. 202-473-5835, fax 202-477-8772, Email:fhatab@worldbank.org


A new cross-country survey conducted in sixty-nine countries and covering more than 3,600 entrepreneurs provides comparative data on local investors' problems in dealing with the state, including the predictability of laws and policies, the reliability of the judiciary, corruption in bureaucracies, and security of property rights. Some of the major findings:

- Entrepreneurs in Asia have the most trust in government policy changes; entrepreneurs in the CIS economies are...
the most cynical about the issue. About fifty percent of entrepreneurs in both Latin America and Central and Eastern Europe distrust government measures. Entrepreneurs worldwide feel that theft and crime drives business costs, substantially higher, and that authorities do not adequately guarantee personal safety or reliably enforce property rights. Unreliable judiciaries are perceived as a major problem in the CIS economies. In Central and Eastern Europe high taxes and tax regulations are considered the most serious regulation-related obstacles, followed by lack of financing, corruption, and inflation.

To order: Michael Geller, Room N7-078, tel. 202-473-1393, fax 202-522-0056, Email: wdr@worldbank.org


To order: Michael Geller, Room N7-078, tel. 202-473-1393, fax 202-522-0056, Email: wdr@worldbank.org


To order: Evelyn de Castro, Room N10-019, tel. 202-458-9121, fax 202-522-3230, Email: edecastor@worldbank.org


Public spending on health can have multiple functions: improve health outcomes, promote nonhealth aspects of well-being (such as reducing individuals' risk of economic losses from health crises), and finance redistribution to the poor. Prices for curative services (user fees) can raise revenue, freeing public resources to be reallocated to public health activities and for limited cofinancing to improve the quality of curative care; or they can improve efficiency in the use of public facilities and the health care system as a whole.

The literature has focused largely on how raising revenue affects the poor, but the more important effect is likely to be the guidance of resources. User fees shouldn't be the primary means of finance. There is evidence that the wealthy are willing to pay a lot more for improving health care than the poor. If governments charge the average "willingness to pay," the wealthy will use the services more, and the poor, less.

To order: Cynthia Bernardo, Room N10-053, tel. 202-473-1148, fax 202-522-1154, Email: prdpe@worldbank.org


To order: Elisabeth Beers, Room U12-121, tel. 202-473-6175, fax 202-522-2640, Email: ebeers@worldbank.org


To order: Dean Housden, Room S11-046, tel. 202-473-6637, fax 202-522-3307, Email: dhousden@worldbank.org


To order: Selina Khan, Room N8-024, tel. 202-473-3651, fax 202-522-1153, Email: skhan8@worldbank.org


Traditional social security systems have been justified on the grounds that they are equitable and redistribute to low-income groups. Pension reforms should be carefully designed to improve equity as well as efficiency and growth. Only further empirical analyses will determine whether the redistributonal goal has been achieved.

To order: Selina Khan, Room N8-024, tel. 202-473-3651, fax 202-522-1153, Email: skhan8@worldbank.org

IMF Publications


CASE Publications, Poland

To order: Center for Social and Economic Research (CASE), Bagatela 14, 00-585 Warsaw, Poland, tel. 4822-628-0912, fax 4822-628-6581, Email: case@case.com.pl


City University School Publications, United Kingdom

To order: c/o Mrs. Debra Durston, Dept. Secretary, Room F-1344, Department of
trolled.

* Commercial banks are tightly con-

vate enterprises in transition economies, tion in relation to purchasing power par-

rency reserves. But it can only be shop on financing newly emerging pri-

region. Excessive currency undervalua-

through backing up the value of domes-

cial resources for their development. An

OECD-CCET (Centre for Cooperation

100 percent with foreign cur-

energetic and social stability in the

OECD-CCET (Centre for Cooperation

imported from Central and Eastern Eu-

Robust currency 

CREDIT: FT West

and Slovakia): Results from a Survey

Large scale enterprise, through the term

OECD Economic Surveys: Bulgaria

March 1997.

OECD Publications

To order: OECD Washington Center, 2001

Economic programs, a government should support SMEs, and not only through appropriate macroeco-

The government can make the threat of

at least in the early stage of the currency board

incentives and the state revenue can be

OECD Economic Surveys: Bulgaria

March 1997.

Michael Landesmann, Emerging Patterns of European Industrial Speciali-

es. New enterprises in transition coun-

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and capital markets.

[The contributions of Stephan Barisitz,

OECD Economic Department, CEE

Division, are highly appreciated.]

Systems for Financing Newly Emerg-

Robust currency

OECD Publications

To order: OECD Washington Center, 2001

March 1997.

OECD Economic Surveys: Bulgaria


Bulgaria needs to follow a comprehen-

sive course of reform to overcome its

current crisis, including reform of the

banking sector, closure of loss-making

enterprises, and introduction of confi-

dence-building measures. Any program

aimed at macroeconomic stabilization

should deal simultaneously with loss-

making firms and insolvent or undercapi-

talized commercial banks. Credibility in

economic policy should be restored. Un-

der the currency board arrangement, a

fixed exchange rate would be enforced

through backing up the value of domes-

tic currency 100 percent with foreign cur-

currency reserves. But it can only be

successful if, at the same time:

• Commercial banks are tightly con-

Robust currency

Commercial banks are tightly con-

OECD Economic Surveys: Bulgaria

March 1997.

The government can make the threat of

insolvency credible by isolating and

shutting down the worst loss-making

enterprises.

• Enterprises undergo thorough re-

form. The planned restrictions to subsi-
dies and credit will affect many firms.

The government can make the threat of

insolvency credible by isolating and

shutting down the worst loss-making

enterprises.

• Budget deficits are financed almost

exclusively from external sources or

from privatization revenue, at least in

the early stage of the currency board

operation. Repurchasing or restructuring

part of government debt may also be

necessary. Over the medium term, in-
centives and the state revenue can be

improved simultaneously through cutting

taxes, while also making tax laws and

regulations more stable, thus ensuring

strict enforcement.

• Incentives for foreign investment are

strengthened. Foreign investors and fi-
nancial institutions can improve corporate
governance, which is vital to successful

restructuring and the future development

of capital markets.

[The contributions of Stephan Barisitz,

OECD Economic Department, CEE

Division, are highly appreciated.]

Systems for Financing Newly Emerg-

ing Private Enterprises in Transition


Newly emerging enterprises in transition
countries, particularly small and medium-
size enterprises (SMEs), continue to

experience difficulties in obtaining finan-
cial resources for their development. An

OECD-CCET (Centre for Cooperation

with the Economies in Transition) work-

shop on financing newly emerging pri-

te enterprises in transition economies,

held last year in Paris, and supported by

the Japanese government, concluded

that governments should support SMEs,

not only through appropriate macroeco-
nomic policies, but also through export

promotion measures and entrepreneur

training.

Support for Improvement in Govern-

ance and Management in Central and

Eastern European Countries (SIGMA)

Publications, France

To order: SIGMA-OECD, 2, rue André-

Pascal, 75775 Paris, Cedex 16, France,
tel. 331-45-24-79-00, fax 331-45-24-13-00,
Email: sigma.contact@oecd.org, Web:
http://www.oecd.org/puma/sigmaweb

Civil Service Pension Schemes,


WIIW Publications

To order: WIIW, The Vienna Institute for

Comparative Economic Studies,

Oppolzergasse 6, A-1010 Vienna, Austria,
tel. 431-533-6610, fax 431-533-6610-50.

Michael Landesmann, Emerging Patterns of European Industrial Speciali-

zation: Implication for Labor Market Dynamics in Eastern and Western


Peter Havlik, Exchange Rates, Com-

petitiveness and Labor Costs in Cen-

tral and Eastern Europe, 231, October


Eastern exchange rate and wage cost

competitiveness will persist as long as

the transition countries' income and pro-

ductivity lags behind the industrial coun-

tries'. Increased protectionism against

imports from Central and Eastern Eu-

ope (CEE) would only prolong the ex-

isting gaps and endanger the already

fragile political and social stability in the

region. Excessive currency undervalua-

tion in relation to purchasing power par-

ity can be eliminated relatively quickly,

but wages in dollar terms will not soon
catch up to Western levels. The West will have to cope with competition from cheap labor in the East for years (if not decades) to come. A gradual convergence can be achieved only if accompanied by productivity improvements, better market access, and higher exports in CEE countries.


To order: Katy Wight, Edward Elgar Publishing, Inc., P.O. Box 330, Lyme, New Hampshire 03768, United States, tel. 603-795-2282, fax 603-795-2818, Email: kwight@e-elgar.com


The authors focus on the export performance of eight small transition economies, with special emphasis on the behavior of exporting enterprises. In determining export performance, the domestic economic situation as well as the inherited conditions and strategies of the enterprises seem to be more important than foreign demand characteristics. Exports have played a key role in the transition economies' recent recovery from recession. Dismantling of remaining barriers will be critical as these countries become more integrated with the Western world.


A strong central state can win over an increasing number of government and party officials to the cause of reform. Once this constituency is sufficiently large, reformers would no longer require the regions to act as a countervailing power to the central ministries in pushing for more market reforms. This doesn't mean that these ministries necessarily would become agents of reform, but their influence would wane. That would allow reformers to push forward without the need of support from the regions. The ability of reformers to act independently of local governments would allow power to be devolved to ground-level units without having to share it with local governments.

Successful devolution of power down to the level of the enterprise and household may require oversight by a strong central state if authority is not to be usurped by some intermediate level of government. This proposition contradicts the popular perception that strong centralized state power is necessarily incompatible with the establishment of market institutions.

Rejection of the characteristics of highly collectivist and totalitarian societies should not imply embracing the more extreme forms of individualistic societies. Nor can one assume that once given the freedom to do so, individuals will be willing and able to seize the opportunity to detach themselves from a previous by austere but nevertheless secure environment and plunge into the market. Uncertainty and imperfect information are constraints facing all economic agents, but they are especially so for residents in economies in transition. China's economic reform has been a balancing act between competition and cooperation and between the local and central governments.


The sale and free distribution of enterprise shares to employed workers and managers have become frequent privatization methods in many transition economies. This book considers employee ownership in fourteen transition economies.

Other Publications


The Commonwealth of Independent States in 1996: Short Handbook of Preliminary Statistical Results, Interstate Statistical Committee of the CIS, Moscow, 1997, 314 p. To order: Interstate Statistical Committee of the CIS, 39, Myasnitskaya Str., 103450 Moscow, Russia, tel. 7-095-207-46-51 and 207-42-37, fax 7-095-207-45-92, Email: statpro@sovam.com


Investing in Russia’s Securities Market: An Independent Assessment of the State of Play: December 1996, Geonomics Institute, United States, 1996, 130 p. To order: Geonomics, 14 Hillcrest Avenue, Middlebury, Vermont 05753, United States, tel. 802-388-9619, fax 802-388-9627, Email: geonomic@midd- unix.middlebury.edu


Without the support of insider managers and workers, privatization could not have been carried out in Poland or Russia. The low level of investment seen may follow from conditions of high uncertainty and lack of capital, rather than from particular ownership. Employee-owned enterprises respond to market signals just like other firms, increasing investment if profitability improves and reducing workforce in times of recession. Insider-owned enterprises, controlled by the “wrong” managers, could constitute a real hazard in the form of asset striping and rent seeking.


To order: M.E. Sharpe, Inc., 80 Business Park Drive, Armonk, New York 10504, United States.


Part I deals with growing unemployment in economic transition—its structure, causes, and consequences. Part II attempts to evaluate the effectiveness and impact of labor market policies and programs. An employment program can
only become more effective if it gains a prominent place within social and economic policies at all levels. Joint efforts by the central and local governments and the legislature can reverse the negative employment processes that have taken hundreds of thousands of people out of the workforce.

To order: ILO-CCET, Budapest H-1066, Mozsár u. 14, Hungary.


To order: University of Washington Press, P.O. Box 50096 Seattle, Washington 98145-5096, United States, tel. 1-800-441-4115 or 206-543-8870, Email: uwpoord@U.washington.edu


To order: Kluwer Academic Publishers Group, Distribution Centre, P.O. Box 322, 3300 AH Dordrecht, The Netherlands; or in the United States: 101 Philip Drive, Assinippi Park, Norwell, Massachusetts 02061, United States.

Opening and Operating Offices in Eastern Europe and the CIS, The Economist Intelligence Unit, United Kingdom, 1997.

To order: The Economist Intelligence Unit, 15 Regent Street, London SW1 Y 4LR, United Kingdom, tel. 44-171-830-1007, fax 44-171-830-1023.


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