Infrastructure Is Once Again Part of the World Bank’s Mainstream Business—
Interview with World Bank Executive Director Carole Brookins

In the past decade, many transition and developing countries looking for funds to finance infrastructure projects were able to garner private funds or to borrow on the capital markets. The World Bank stepped to the sidelines, and its infrastructure lending plummeted between 1993 and 2002, especially in the middle-income countries. However, the role of private capital has diminished, and member states are now demanding more active Bank involvement. The World Bank Group has heeded the call and geared up for a major policy switch: infrastructure development is again a number one priority. Transition editor Richard Hirschler asked U.S. Executive Director Carole Brookins, an early advocate of this change, to explain the background to and the driving forces behind the revised approach.

Q: The World Bank Executive Board met in early April to discuss what progress has been made since the Bank approved its infrastructure action plan last year. Why have these ups and downs occurred in relation to infrastructure lending?

A: We had to turn the tide and focus again on this important area. It is no secret that in the decade between 1993 and 2002, the Bank’s infrastructure investment lending declined by 30 percent, and even more steeply in the middle-income countries, including the European transition economies. Infrastructure was pushed out of focus in the country assistance strategies, and the Bank’s administrative budget, allocated to regional infrastructure departments was cut by 10 percent between fiscal year (FY) 2000 and FY 2003.

Q: Last year Transition reported (Transition, “The Bank Should Invigorate Infrastructure Lending: Interview with World Bank Managing Director Shangman Zhang,” January-February-March 2003, pp. 1-3) that in 2002, World Bank lending for water and sanitation projects was a mere 25 percent of its annual average during 1993-97; for energy, mining, information, and communications projects it was only 60 percent; and for transportation projects it was 70 percent. Before that time, energy; water supply and sanitation; transport; telecommunications; and the oil, gas, and mining sectors were always in the forefront of development and a major part of the World Bank’s drive against poverty. What accounted for this decline?

A: Bank lending in infrastructure was down because of a change in strategy adopted during the 1990s. The Bank had decided to concentrate on policy and regulatory work and rely on the private sector to finance capital investments. Because of the Asian financial crisis and other reasons, private capital became much less willing and interested in investing in infrastructure in developing countries. Lending also declined as the Bank’s staff and clients became reluctant to take on infrastructure projects because of the high preparation costs, the risks involved, the difficulties inherent in managing environmental and social safeguard issues, and even the notion that the Bank should be identified more with knowledge dissemination than brick and mortar investments. Recently, the Board recognized that the decline in the Bank’s portfolio, combined with the retreat of private capital, had created a significant gap in countries’ development needs. Thus management responded with an action designed to increase the Bank’s activity in infrastructure.

Q: So what changed the mind of the Bank Group’s management again?

A: Private investment in infrastructure in developing countries declined from a peak of $128 billion in 1997 to $58 billion in 2002. The Board recognized that infrastructure is critical in executing the Bank’s mission. Without proper infrastructure services, poverty will not be overcome and economic growth cannot be assured. The Millennium Development Goals—including those related to health, education, and gender—will only be met by developing infrastructure services. Not only do infrastructure services increase productivity and access to markets, but the private sector investments; they engender the foundations for sustainable growth. That growth, in turn, generates the resources needed for governments to provide quality public goods and services, such as health and education, and in some cases facilitate their delivery.
What's Inside

Infrastructure Is Once Again Part of the World Bank’s Mainstream Business—Interview with World Bank Executive Director Carole Brookins

TALK OF THE REGION
World Bank Study Reveals Tainted Links Between the State and Businesses in Transition Economies
Structural Changes Needed in Russia—Friendly Suggestions from the World Bank
Accession Will Not Be a Panacea Warns the World Bank—EU-8 Under a Magnifying Glass

NEW FINDINGS
Small Enterprises in Transition Economies: Overpraised and Underdeveloped
Roadblocks to Deregulating Small Business in Russia
Close-Up on Russian Enterprises—Results of a Survey
Burdensome Legacy: Public Service Provision by Russian Firms
Hungary’s Multinationals on Expansion Course
Czech Universities: Deep Crisis, Few Prospects
World Bank/IMF/EBRD Agenda

DISCUSSION
Russian Privatization Revisited—A Debate Between Goldman and Aslund

EVENTS
China and Russia: Two Leading Scholars Compare Transition Experiences
Russia 2015—Conference on Hot Topics

BEST PRACTICE
Balcerowicz, Gaidar, Summers—Leading Practitioners Discuss Their Transition Experiences

VOICE
Making Services Work for the Poor World Development Report 2004 Stresses Participation

CONFERENCE DIARY
NEW BOOKS AND WORKING PAPERS
BIBLIOGRAPHY OF SELECTED ARTICLES

Water supply and sanitation, housing, and information and communication technologies are explicitly covered as development goals. In that sense, the issue is not about choosing between infrastructure or the social sectors, but about investing in infrastructure for social outcomes. Poor people need access to electricity in order to link up with technology. Access to clean water and sanitation services helps reduce child mortality rates. Transport services facilitate school enrollment. Thus infrastructure development, economic growth, and poverty reduction are all connected. No wonder that member states are increasingly demanding World Bank involvement in infrastructure investment. Current estimates point to infrastructure financing needs of about 7 percent of GDP for all developing and transition countries for both new investment and for maintenance expenditures.

Q: How much of the action plan has been implemented to date?

A: The action plan is guiding the Bank Group’s infrastructure business for the next two to three years and so far has been implemented according to schedule. Infrastructure projects in the current fiscal year (July 2003–June 2004), in terms of commitments, should reach $6 billion—compared with $5.4 billion in the previous fiscal year. For the next fiscal year, management envisages lending in the range of about $6.5 billion to $7 billion. The International Finance Corporation is currently expecting total infrastructure commitments to be about $1 billion for fiscal year 2004, which is a significant increase over the $650 million committed the previous fiscal year. The Multilateral Investment Guarantee Agency guarantees this fiscal year is expected to be approximately $830 million, the same as the year before.

However, we have to be realistic. The impact of the World Bank Group’s infrastructure lending is somewhat limited, because most investment in infrastructure, about 70 percent of current total spending, has been publicly funded. The private sector contributes 20 to 25 percent, and official development assistance finances only about 5 to 10 percent. The Bank can, however, play a catalytic role by maximizing support from both public and private sources, including other international finance institutions and bilateral donors. The Bank also has an important role to play in addressing infrastructure differences between rural and urban areas. Special challenges arise in providing infrastructure to rural areas, and the private sector often finds investments in these areas to be less attractive than investment in urban areas. The Bank will have to pay special attention to rural areas to ensure that they do not become poverty traps that feed migration to overextended metropolitan centers.

To increase lending, the Bank has stepped up its economic and sector work, which includes various country diagnostic reports, advisory reports, regional reports, and policy notes. Increasing numbers of guidance notes are also issued, that is, sector-specific suggestions based on standardized indicators on how to go ahead with infrastructure development. For example, when it comes to developing electricity services, the Bank believes that private financing is preferable for investing in power generation, whether
A: Although infrastructure investments are now mainstream, the both in building strong economies and delivering services. It will be no less meaningful for the developing countries. The Bank has several challenges that it has to overcome, namely: 

- After 10 years of decline in infrastructure investment, the Bank has to rebuild its country-specific knowledge base on infrastructure services and institutions, investment needs, and policy issues. These diagnostic works are referred to as “recent economic developments in infrastructure.” Soon the Bank is releasing 10 such reports on a number of countries, including Bulgaria, Bosnia and Herzegovina, Mongolia, and Vietnam. In addition, the Board will be watching to see how rapidly and effectively the Bank can turn its diagnostics into action and real, on-the-ground operations. 

- Infrastructure investments are often made at the local, state, or municipal level. However, the Bank requires a government counter-guarantee for municipal-level investments in IBRD countries, and therefore on-lending arrangements to states and municipalities are now the only way to become involved in projects at that level. To find opportunities for more direct interventions in the municipal market segment, the Bank Group established the Bank/International Finance Corporation Municipal Fund and GuarantCo. The Bank must also become more involved in helping countries develop domestic capital markets.

Q: What are the major policy changes?

A: Flexibility and results. We are not going to be dogmatic about how financing packages are put together, and we will look to install policy frameworks that are workable and pragmatic. Even though cost recovery will continue to be a goal for most projects, there will be greater flexibility in determining the period of time in which this goal must be reached. The Bank is becoming more involved in operations where infrastructure is developed in the context of multisectoral, multicountry arrangements. Cross-country roads, pipelines, dams, and other technologies that facilitate the flow of goods, water, and power sources are obvious candidates. The Trade and Transport Facilitation in Southeast Europe Program fosters regional integration by promoting more efficient and less costly trade flows across the countries in southeastern Europe and providing EU-compatible customs standards. The program seeks to reduce nontariff costs to trade and transport, reduce smuggling and corruption at border crossings, and strengthen and modernize customs administrations and other border control agencies. Design and implementation are highly coordinated across eight different countries. Similar initiatives are currently being considered in the Central Asia and Caucasus regions. In telecommunications, regional projects—combined with liberalization of the international segment of the telecommunications markets of the countries concerned—could provide major increases in connectivity and reduce prices, resulting in increases in the overall competitiveness of the economies concerned.

The Bank has also started to exchange data and ideas and to build common policy platforms with other international finance institutions. Such cooperation is planned together with the EBRD in Europe and Central Asia.

The Bank has introduced new, more sophisticated lending instruments and is ready to finance targeted subsidies and gradual tariff reform. The Cambodia Provincial and Peri-Urban Water and Sanitation Project, for example, uses an output-based aid approach to finance water connections by poor households, blending private sector financing with IDA subsidies. Private sector operators will provide financing for the trunk, primary, and secondary networks in four pilot towns. Supported by IDA grants, the government will make fixed subsidy payments per connection for households identified as being below the poverty line, but only after their successful connection and proof of reliable service.

Q: What other new challenges does the Bank have to face?

A: Although infrastructure investments are now mainstream, the Bank has several challenges that it has to overcome, namely:

- A key concern is the issue of the limited capacity of governments in member states to finance infrastructure investments in new assets as well as to maintain expenditures. In many countries, private investment remains limited. The Bank—together with the IMF—will need to manage the problem of promoting productive public investment while maintaining a focus on countries’ overall fiscal balances and public debt.

- The Bank must be concerned that the new infrastructure approach is completely different in design from what had previously been criticized as “white elephants.” We must ensure that institutional operations and maintenance issues are dealt with properly and that there is a local sense of ownership and of commitment to sustainability.

- Infrastructure investments are often made at the local, state, or municipal level. However, the Bank requires a government counter-guarantee for municipal-level investments in IBRD countries, and therefore on-lending arrangements to states and municipalities are now the only way to become involved in projects at that level. To find opportunities for more direct interventions in the municipal market segment, the Bank Group established the Bank/International Finance Corporation Municipal Fund and GuarantCo. The Bank must also become more involved in helping countries develop domestic capital markets.

- Even though the Bank Group will continue to ensure that infrastructure investments are environmentally and socially responsible and sustainable, some projects may be sensitive to domestic or international interests. The Bank Group therefore needs to address this potential criticism proactively by demonstrating and advocating the benefits of well-designed and well-implemented infrastructure programs.

To sum up, after nearly a decade of declining Bank engagement in infrastructure, it will take longer than a year or two to comprehensively re-establish infrastructure's centrality in the Bank Group's work as one essential element of helping client countries achieve the three interconnected targets: the Millennium Development Goals, poverty reduction, and growth. This renaissance of infrastructure is not just another development fad. Infrastructure has been critical in shaping the industrial world—both in building strong economies and delivering services. It will be no less meaningful for the developing countries.
Managers' survey responses in almost half of the transition countries suggest a decline in the overall incidence of bribery and a reduction in the impact of corruption on their businesses between 1999 and 2002. This is one encouraging conclusion of a new World Bank report. The report is less upbeat in other areas, including the prevalence of both administrative corruption across a range of public services and of state capture.

A new World Bank report—based on two rounds (1999 and 2002) of the EBRD-World Bank business environment and enterprise performance survey, which covers more than 10,000 firms in 27 countries—focuses on corruption that taints relations between businesses and the state. Indicators of corruption include the frequency of various types of bribes (both bribes paid for regular administrative dealings with the state and bribes paid by businesses to influence laws and regulations, known as state capture), the share of annual revenues paid in bribes (the "bribe tax"), and managers' perceptions of the extent to which corruption is an obstacle to business and capture has an impact on the firm.

Mixed Results

Trends in relation to corruption in the transition economies are mixed, although there are some encouraging signs. On the positive side, sample firms in at least 10 of the 24 countries that were covered in both surveys viewed corruption as less of an obstacle to business in 2002 than in 1999. Significant declines in the perception of corruption as an obstacle occurred in some countries where 1999 levels were high, including Azerbaijan, Croatia, Kazakhstan, the Kyrgyz Republic, Lithuania, and Russia. In contrast, ratings of corruption as an obstacle stayed at relatively constant high levels in Bosnia and Herzegovina, Bulgaria, Georgia, FYR Macedonia, Romania, the Slovak Republic, and Ukraine. The only countries where sample firms reported a significant increase in the perception of corruption as an obstacle to business were Belarus and Poland, both of which ranked in the lower half of transition countries in 1999. These modestly favorable results do not, however, mean that corruption ceased to be a major problem in many settings. It continued to rank among the top third of business obstacles in more than half of the countries, most notably in the Balkans and the Caucasus.

Perhaps not surprisingly, in the most advanced EU accession countries, levels of corruption are relatively low, and in some of the least reform-minded countries of the region, where tight state controls remain in place and private businesses face many other restrictions, corruption was seen as less problematic than most of the other obstacles that firms face in relation to the investment climate (see figure 1).

Incidence of Bribery

Specific trends in the frequency of administrative corruption were more mixed than general perceptions of corruption as an obstacle to business. Overall, sample firms in at least 9 of the 24 countries surveyed reported a significant reduction in the overall frequency of bribes from 1999 to 2002 (see figure 2). The reduction looks much smaller, however, when one looks at the average frequency of bribes for specific public services: bribes paid in connection with dealings with the courts and public service providers appear to have declined in many settings, while bribes in relation to tax collection and public procurement appear to have increased. Sample firms in the CIS and southeastern Europe report the highest bribe frequencies. Except for the Slovak Republic, firms in the EU accession countries report lower bribe frequencies, which is consistent with managers' lower perceptions of corruption as an obstacle to business.

Findings concerning the cost of administrative corruption—the bribe tax—were also mixed. The relative rankings of countries on the bribe tax indicator are similar...
to their rankings on the bribery frequency measure, with firms in the CIS and southeastern European countries indicating higher bribe taxes than firms in Central and Eastern Europe and the Baltics. There are, however, a few notable exceptions to this similarity among indicators. In particular, Russia appears higher on the frequency measure but more moderate on the bribe tax, suggesting more widespread but less costly petty corruption, while Azerbaijan appears higher on the bribe tax but more moderate on frequency, suggesting more concentrated bribery.

The survey results also point to the significant impact of state capture on sample firms in many countries of the region, especially in the southeastern European countries. The impact of capture appears to be most significant in commercial courts and least significant in central banks, with parliaments, political parties, and criminal courts falling in between. The number of firms directly engaging in capture behavior increased in many countries from 1999 to 2002, in some cases significantly. Apparently state capture is changing from a strategy of political influence practiced by only a small share of firms to a more widespread practice, although this does not necessarily translate into capture having a greater impact on the business environment.

Five Major Factors

The report focuses on the following:

- **Specific firm characteristics have a strong influence on bribery.** Private firms pay a larger share of their revenues in bribes, pay all types of bribes more often, and are more affected by all types of corruption than state-owned firms. Smaller firms tend to pay more bribes and pay them more often than larger ones, and newer firms pay more bribes and pay them more often than older ones, although smaller and younger firms do not appear to be quite as disadvantaged in 2002 as they were in 1999. Foreign firms appear to pay most types of bribes less frequently, but they are equally likely to engage in state capture. Firms located in large cities appear to bribe more often and to perceive corruption as having more of an effect on their business than firms in smaller towns. Manufacturing firms pay more in bribes, particularly for government contracts, but engage in less state capture behavior than firms in other sectors.

- **Better public policies and institutions help to reduce corruption over the medium term.** Many transition countries have undertaken policy and institutional reforms in recent years that have led to significant changes in the rules of the game. These changes and the resulting declines in corruption should prove sustainable in many cases. This is an important finding that underscores the critical importance of an active, credible, and well-implemented reform process.

- **Surveyed managers are optimistic in explaining perceived declines in corruption.** Only part of the decline in perceptions of corruption as an obstacle to business can be explained by a fall in actual bribes paid. Much of the decline is explained by managers’ perceptions of improvements in the general business environment.

- **In the short term, growth rates have relatively little impact on corruption.** Growth rates will only lead to lower corruption in the long term. This is not surprising, because institutional development is a long-term task.

- **Various aspects of government tenure have relatively little impact on corruption.** Sample firms in countries where the executive branch of government has held office for longer tend to report somewhat lower levels of corruption, while recent legislative elections appear to have little or no impact.


### Figure 2. Bribe Frequency Index for Sample Firms by Country, 1999 and 2002

<table>
<thead>
<tr>
<th>Country</th>
<th>1999</th>
<th>2002</th>
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<tbody>
<tr>
<td>Slovenia</td>
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<tr>
<td>Estonia</td>
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<td>5</td>
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<tr>
<td>Croatia</td>
<td>5</td>
<td>5</td>
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<tr>
<td>Armenia</td>
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<td>5</td>
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<tr>
<td>Czech Republic</td>
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<td>5</td>
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<tr>
<td>Hungary</td>
<td>5</td>
<td>5</td>
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<tr>
<td>Lithuania</td>
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<tr>
<td>Latvia</td>
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<td>Poland</td>
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<td>5</td>
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<tr>
<td>SAH</td>
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<tr>
<td>Uzbekistan</td>
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<td>BiH</td>
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<td>FYROH</td>
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<tr>
<td>Belarus</td>
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<tr>
<td>Azerbaijan</td>
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<td>Bulgaria</td>
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<tr>
<td>Kazakhstan</td>
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<tr>
<td>Ukraine</td>
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</tr>
<tr>
<td>Moldova</td>
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<tr>
<td>Slovak Republic</td>
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<tr>
<td>Romania</td>
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<tr>
<td>Russia</td>
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<tr>
<td>Albania</td>
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<td>5</td>
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<tr>
<td>Kyrgyz Republic</td>
<td>5</td>
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Note: SAM=Serbia and Montenegro; BiH=Bosnia Herzegovnia, FYROM=Macedonia. Source: Authors.
Structural Changes Needed in Russia—Friendly Suggestions from the World Bank

Despite the vigorous development in Russia in recent years, some structural changes are necessary if the country wants to maintain its present growth dynamic. The World Bank, among others, proposes tough rules to force oligarchs to respect the rules of competition and recommends eliminating Russia’s overdependence on oil and gas extraction.

Russia finds itself in an excellent position at the beginning of 2004. The economy grew by a cumulative 38 percent in the five years between the 1998 financial meltdown and the end of 2003, and growth shows no signs of abating. Inflation has gradually declined, reaching 12 percent in 2003. Macro-level accounts are all in the black, with the federal budget running a surplus in 2003 for the fourth year in a row and another surplus forecast for fiscal year 2004. The current account surplus was 11 percent in 2003, and reserves hit record highs of $86 billion in February 2004. Vladimir Putin recently declared the objective of doubling GDP in 10 years, and the government’s medium-term strategy for social and economic development aims at diversifying the economy away from natural resource production to limit the risks to long-term growth from dependence on international energy prices.

Excluding structural change, the impressive rebound since 1998 is due to four broad factors, namely:

- External factors, such as price increases for Russia’s main commodity exports
- Endogenous adjustments triggered by the 1998 crisis, mostly relative price adjustments, such as a massive real exchange rate devaluation, and real wage decline
- Changes in the behavior of economic agents, including economic policymakers
- Availability of underutilized productive capacity of capital and labor arising from the years of decline before 1998 and then from the crisis itself.

However, gains from increases in capacity utilization and the benefits from low real wages have effectively run their course. With the appreciation of the real exchange rate, the positive impact of exchange rate depreciation has also been mostly utilized. Oil prices, while currently quite strong, are inherently volatile, and therefore imply some degree of uncertainty. The government’s ability to maintain surpluses and prevent crowding out of the private sector will remain an important underpinning for future growth. The underpricing of gas and electricity to key parts of the economy, while helping to boost certain sectors in the short run, will ultimately have a negative impact on the competitiveness of the economy.

Dimensions of Structural Change

The following are five connected dimensions of structural change:

- Spatial reallocation, caused by the legacy of industrialization and urbanization under central planning, is likely to persist. Subsidization of this legacy imposes costs on viable segments of the economy. Individuals follow employment opportunities, and this suggests that relocation of the population can be expected to continue. Large population shifts are occurring away from the cold northern and eastern regions that were urbanized under central planning. While lowering the transaction costs of moving is economically sensible, this needs to be done without assigning target areas where people should go. People will relocate where economic opportunities exist.

- The reallocation of employment across the economy’s main sectors, especially from industry to services, is important not only to correct the bias of central planning toward industrial production, but also to determine spatial adjustment. Russia’s economic structure has made significant adjustments: the share of employment in industry has declined and the share in market services has increased. These sectoral shifts have considerable spatial implications, and regions have become more diversified over time. However, there is a persistently low share of employment in agriculture and an exceptionally high share of employment in nonmarket services and in the public sector in general. The pace of structural change has slowed since 1998.

- A larger source of growth than restructuring between sectors is restructuring within sectors, particularly industry, but much of the necessary restructuring lies ahead. As expected, the oil and gas sector (in industry) and finance (in services) are positive outliers. Market services have made rapid employment gains, a trend that is only now becoming discernible in industry. In addition, detailed labor survey data show that the highest growth in job creation in Russia most recently took place in establishments with 30 to 100 employees, that is, small but no longer micro-sized facilities. In general, labor productivity is increasing, but the government needs to support the creation and growth of new firms that can absorb some of the labor shedding from old companies and help the public sector strengthen social protection for those who have become laid off as a result of the necessary downsizing.

- Restructuring in the industrial sector should include the downsizing of some over-concentrated production facilities. Job creation has been strongest in the small and medium enterprise sector. Russia is in the early stages of dissolving existing structures and introducing new activities, but the
The World Bank

The world has not yet found its equilibrium or defined the core sectors that will allow it to grow in a sustainable way. Russia’s industry has large and excessively concentrated and physical production facilities plant size appears overly concentrated in relation to the size of the market. However, the average firm is small, and markets are not very concentrated if firm sales are taken as the yardstick, whereas production facilities may still be in need of downsizing and firms need to be consolidated to enhance efficiency at the plant level.

- The concentration of ownership effects industrial restructuring and economic performance, therefore the state should ensure that rules of fair competition are observed. Firm ownership is highly concentrated in all segments of the private sector and is dominated by a group of the largest private owners and their business groups (see the table). Financial-industrial groups with significant ownership nationwide perform no better than smaller, private, domestic owners.

A World Bank investigation based on detailed data on ownership and control in Russia addresses three principle questions. The data cover about 1,300 large listed and unlisted firms in industry and services and employ 3.3 million people. The firms represent 17 percent of Russia’s industrial employment and 57 percent of industrial output, while banks in the database account for 68 percent of assets in the banking sector. The three questions are as follows:

- How concentrated is ownership in Russia’s economy? Ownership concentration is substantial in the sense that the ownership positions of a number of business groups are significant at the national level. The 23 largest private owners and their financial-industrial groups tend to control enterprises in a number of strategic subsectors, namely, oil and raw materials, automobiles, and chemicals. In other parts of the economy, however, ownership and control is not particularly concentrated and there is a preponderance of smaller, domestic, private owners with high ownership concentration at the level of individual firms.

- What are the implications of this concentration for economic performance? While concentrated ownership positions in individual firms are generally beneficial, concentrated ownership at the national level may be less so. None of the data suggest that firms controlled by large business groups perform any better than firms owned by other private owners (or firms controlled by foreigners). They do, however, perform much better than state-owned firms. Firms controlled by financial-industrial groups have investment rates that are up to 30 percent higher than those of other domestic firms, but these high levels apply only to the energy sector.

- What do the data imply about state capture, that is, the ability of businesses to obtain preferential treatment from government agencies? Firms controlled by local private owners and firms controlled by foreign investors are more likely to receive preferential treatment from regional governments than firms controlled by the largest owners, who operate nationally, and firms with dispersed private ownership. However, the benefits from receiving preferential treatment and the negative impact on the growth and economic performance of other firms in the region is greater if national financial-industrial groups move into a region than if regional enterprises receive the preferential treatment.

Looking Forward

There are some concrete steps that should be taken in order to accelerate Russia’s economic development:

- The challenge for policymakers is to stop subsidizing the moribund legacy of central planning at the expense of more vibrant parts of the economy. Accelerating structural change can make a substantial contribution to economic growth in the long run, despite possible adverse effects in the short run. In addition to the necessary removal of subsidies, there are opportunities to change the incentive system through public investment. For example, people’s ability to relocate, both

<table>
<thead>
<tr>
<th>Oligarch (organization)</th>
<th>Key sector</th>
<th>2001 sales ($ billions)</th>
<th>Number of employees (thousands)</th>
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<td>Vagit Alekperov</td>
<td>Oil (Lukoil)</td>
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<td>Roman Abramovich</td>
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<tr>
<td>Vladimir Kadannikov</td>
<td>Automobile manufacturing (Avtogaz)</td>
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<td>Alexei Mordashov</td>
<td>Steel (Severstal)</td>
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<td>Oleg Deripaska</td>
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<tr>
<td>Victor Veselberg</td>
<td>Aluminum, oil (Renova)</td>
<td>1.8</td>
<td>33</td>
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</table>

Source: World Bank; Newsweek.
geographically and from job to job, will increase with investment in transport infrastructure and, even more important, in education. Major distortions, such as the pricing of domestic energy, need to be tackled decisively to avoid adverse impacts on long-term growth, for example, from the installation of energy-intensive equipment that will be unable to compete as soon as the subsidization of energy prices ends.

- The current overdependence on natural resource exports, which account for 1 percent of the workforce and almost 20 percent of GDP, should be reduced. Less dependence on oil and gas will enable Russia to escape vulnerability to international price changes and, in particular, to improve upon the present situation, where annual growth above 5 percent has only occurred with increasing hydrocarbon prices. Nonetheless, policymakers should avoid economic or industrial policies designed to redistribute resources, for example, by giving tax breaks to selected industries.

- The state should accelerate structural change by establishing the rules and the framework within which economic activity takes place. The private sector has often moved far ahead of reforms initiated by the public sector. This performance gap has an adverse impact on the speed and efficiency of structural change. Examples abound, for instance, slow reforms in the government’s monopoly sectors and the threat that today’s price distortions may damage the future structure of production, and the slow reforms in education and transport infrastructure and the tax this imposes on people’s capacity to move to new jobs and locations.

- The most powerful driver of economic growth is competition. Thus competition needs to be protected, not only by removing arbitrary interference in small and new businesses, but also by imposing rules on the noncompetitive behavior of big businesses, which may operate through collusion by powerful, private groups in the marketplace or by collusion between private and public agents. Russia needs legislation and institutions that safeguard competition without putting big businesses and other firms into a straitjacket. Above all, it needs active and clear-cut competition policy.

The way forward is clear. It is based on protection of private property, strict antitrust policies, free competition, and global integration. Advances in this direction may need to overcome powerful interest groups, but the ultimate reward will be a business environment that can unlock the potential for rapid growth in all parts of Russian society.

This article is based on the executive summary of the Country Economic Memorandum, which in turn is based on the findings of research that was carried out between May and December 2003 and included two workshops and several visits to Russia by World Bank staff based in Moscow.

Accession Will Not Be a Panacea Warns the World Bank—EU-8 Under a Magnifying Glass

The EU-8 countries will join the EU on May 1, 2004. This long-awaited event marks the reintegration of these countries with the rest of Europe. However, their accession will not be a panacea for these countries in their efforts to catch up to average European income levels, as the experience of earlier accession countries clearly demonstrates. Success will depend mainly on the policies the countries choose to pursue.

The Economic and Political Situation in the EU-8

Political instability in Central and Eastern Europe has heightened as most of the EU-8 countries continue to struggle with high unemployment, general voter dissatisfaction, and low credibility of government policies. Fragile coalition governments (whether formal or informal) are balancing on the edge of or below parliamentary majority in the Czech Republic, Latvia, Poland, and the Slovak Republic as supporting deputies come and go. In Poland, Prime Minister Leszek Miller announced his resignation effective May 2 on the backdrop of the Democratic Left Party’s weak standing in opinion polls and the defection of a group of party deputies; in Hungary, the finance minister was replaced; in the Slovak Republic, Ivan Miklos, deputy prime minister and minister of finance, was subjected to a vote of no confidence (but survived); in Latvia, the prime minister was replaced; and in Lithuania, the president is undergoing impeachment proceedings. Elections to the European Parliament in June may lead to further shake-ups and political instability, with early parliamentary elections in some countries being a distinct possibility. Political instability is generally slowing the pace of reform.

Macroeconomic stability in the region remains characterized by a mixed picture (see table 1). Output growth is rapid in some countries, notably the Baltic countries, and slow in others, especially the Czech Republic and Slovenia; inflation is low in most countries across the region, but remains significant in Hungary, the Slovak Republic, and Slovenia; fiscal deficits are contained in the Baltic countries and Slovenia, but are a major concern in others, notably the Czech Republic, Hungary, Poland, and to a lesser extent the Slovak Republic; and current account deficits are high in some countries where domestic demand growth is high, in particular, the Baltic countries, where it has reached worrisome levels, and Hungary, but low in others. No country stands out as a particularly strong performer on all counts.
percent of GDP already in 2004. Draskovics has indicated that allocate public resources according to strategic priorities being implemented, with envisaged savings on the order of 1 Proper public expenditure management is a set of institutions launched by the new Finance Minister Tibor Draskovics is management remains in its infancy in most of the countries. Also, squeezing public expenditure. The plan includes administrative measures that, if and cofinancing requirements. The so-called Hausner plan (aimed at rationalizing social impact on budgets, reflecting contributions to the EU budget funding is being fueled by expansionary fiscal policies and/or rapid real wage growth. Latvia and Lithuania continue to lead the pack with high growth rates of 8 to 9 percent year-on-year. Growth has also strengthened markedly in Poland, albeit partly reflecting a cyclical recovery from the slump of 2001-02. However, stronger growth has generally not been associated with a reduction of fiscal imbalances, in particular in Poland, or of external imbalances, especially in the Baltic countries.

High unemployment levels are slowly coming down in the most rapidly growing countries, that is, the Baltic countries and the Slovak Republic, but remain stubbornly high in Poland and are rising in the Czech Republic. Hungary and Slovenia are exceptions.

Large fiscal imbalances remain the major concern in the Visegrad countries. In Poland, the 2004 budget is providing a sizable fiscal stimulus despite the improved growth environment, and large deficits are leading to a rapid increase in public debt. The Czech Republic and Hungary are also struggling with sizable fiscal deficits that are proving difficult to bring under control. By contrast, Slovakia has not seen the same degree of fiscal slippage and its fiscal balances remain strong. Most countries have adopted informal, medium-term fiscal targets aimed at converging to levels needed for euro adoption, but in general these targets are not sufficiently underpinned by concrete fiscal reform plans and measures. In Poland, the government approved the fiscal reform plan (the so-called Hausner plan) aimed at rationalizing social expenditure. The plan includes administrative measures that, if implemented, could result in savings of around 1.5 to 2 percent of GDP annually by 2007. In Hungary, a fiscal reform plan launched by the new Finance Minister Tibor Draskovics is being implemented, with envisaged savings on the order of 1 percent of GDP already in 2004. Draskovics has indicated that the government’s objective is to lower deficits by at least 0.5 percent of GDP each year from 2005, with larger reductions in expenditures. In the Czech Republic, the government secured approval of a fiscal package projected to save more than 2 percent of GDP annually. This package—as in Hungary—is focused mainly on administrative savings, while reforms of key social spending programs remain on hold. Progress in other reform areas is uneven as countries have focused on adopting the acquis communautaire and political instability has increased.

- As demand recovers and excess capacity gradually declines, signs indicate that core inflation may be edging up across the region, especially in Hungary and the Slovak Republic, and to a lesser extent in the Czech Republic, where large increases in administered prices and indirect taxes are leading to high consumer price index inflation that may be spilling over to core prices. Buoyant demand is also putting upward pressure on prices in the Baltic countries, especially Latvia. Central banks across the region are on alert, although Hungary and the Slovak Republic reduced interest rates, which is surprising given the backdrop of upward pressure on their currencies.

Surging external current account deficits are becoming worrisome in the Baltic countries. Current account deficits are now in double digits in Estonia and close to 10 percent in Latvia and Lithuania. With foreign direct investment down across the region, these rising deficits are increasingly being financed by debt. The widening external imbalances are being driven by consumption-related imports and real appreciation of local currencies, especially in Estonia and Lithuania, whose currencies are pegged to the euro. However, net external debt still remains relatively low in these countries.

Public Expenditure Management Practices and Reform Options

Notwithstanding its significant benefits, EU accession will also bring with it many fiscal challenges arising from the need to provide counterpart financing to EU funds, make fiscal room for further investment in infrastructure, converge toward Maastricht criteria for European Monetary Union accession, and reduce high levels of taxation to maintain competitiveness. EU accession will have a direct, negative impact on budgets, reflecting contributions to the EU budget and cofinancing requirements.

While the EU-8 countries have made significant progress in enhancing fiscal transparency, broader public expenditure management remains in its infancy in most of the countries. Proper public expenditure management is a set of institutions that allocate public resources according to strategic priorities
and ensure effectiveness and efficiency in the provision of public services.

**External Environment**

The global growth outlook is broadly positive. Recent indicators confirm that the world recovery is well under way, led by the United States and Asia. It is reflected in recuperating domestic demand and improvement in worldwide trade flows. The recovery has a relatively broad base across regions and sectors and is helped by unusually expansionary macroeconomic policies, both fiscal and monetary. In the EU, even though economic activity is still weak, it seems to be bottoming out. Business and consumer sentiment surveys suggest some uncertainty about the prospects for further recovery in 2004. The strengthening of the euro against the dollar is putting some pressure on competitiveness in Europe in general and in countries whose currencies are pegged to the euro, including in the EU-8, the currency boards of Estonia and Lithuania (see table 2).

Emerging market debt spreads are at record lows. This has been facilitated by low international interest rates and improved fundamentals in emerging markets. However, these favorable conditions might gradually be reversing. In the first quarter of 2004, spreads widened because of a perceived possibility of a change in the bias of the United States’ monetary policy. As long as confidence is sustained, the demand for emerging market debt instruments should remain relatively stable and strong.

The European Commission is in the process of preparing the next EU budget for 2007-13. Despite calls from the largest contributors to limit the size of the budget, expectations are that it will be drafted according to current policies, that is, at the level of about 1.26 percent of the EU’s GDP. This is good news for the EU-8 countries, which will be major recipients of structural and cohesion funds: out of the total of Euro 336 billion allocated for regional aid during 2007-13, the EU-8 countries will be allocated almost Euro 140 billion, or about 40 percent. However, the extent to which these countries will be able to absorb these funds effectively depends crucially on whether they can strengthen their administrative and technical capacity to prepare quality projects eligible for funding.

In addition, the World Bank is strengthening its support to the EU-8 accession countries. While EU accession does not affect countries’ eligibility for borrowing from the World Bank, the Bank is adjusting its assistance so that it is more relevant to the development of these countries after they join the EU. The new approach emphasizes the need to support capacity building so as to facilitate the integration process, especially effective and full utilization of structural funds. In some sectors and countries, the Bank foresees financial support to cover part of the counterpart financing that the new member states must contribute to projects funded with structural funds. In addition, the new members must pre-finance investments for subsequent reimbursement from the structural funds. World Bank funds would also be available for this purpose. In addition, the World Bank intends to simplify its procedures and rely more on countries’ own systems, introduce new flexible lending instruments, and enhance cooperation with the main European financial institutions. Since the transition began in the early 1990s, World Bank lending to the EU-8 has totaled $12.1 billion for 153 operations through fiscal year 2004 (ending June 30). Of these, 32 operations worth $1.6 billion are still being implemented.

This article is based on the first issue of the EU-8 Quarterly Report, published in Warsaw, which monitors economic and reform developments in the eight Central European and Baltic EU accession countries (the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, and Slovenia). The principal author is Marcin Sasin, the World Bank’s country economist for Poland, supported by a team of Bank economists led by Thomas Laursen, lead economist for Central Europe and the Baltics. The publication is available at http://lnwebl8.worldbank.org/eca/eca.nsf/General/02502ABF40FC4CBA8S256E7D0054A94A?OpenDocument.

### Table 2. Exchange Rate Arrangements and Planned Monetary Integration of the EU-8

<table>
<thead>
<tr>
<th>Country</th>
<th>Exchange rate arrangement</th>
<th>Exchange rate mechanism 2&lt;sup&gt;a&lt;/sup&gt;</th>
<th>Intended/likely entry to the European Monetary Union</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td>Managed float</td>
<td>2007-08</td>
<td>2009-10</td>
</tr>
<tr>
<td>Hungary</td>
<td>Peg to euro</td>
<td>“No rush”</td>
<td>2009-10</td>
</tr>
<tr>
<td>Estonia</td>
<td>Currency board euro</td>
<td>Soonest</td>
<td>2006</td>
</tr>
<tr>
<td>Latvia</td>
<td>Peg to SDR</td>
<td>2005</td>
<td>2008</td>
</tr>
<tr>
<td>Lithuania</td>
<td>Currency board euro</td>
<td>2005</td>
<td>2007</td>
</tr>
<tr>
<td>Poland</td>
<td>Pure float</td>
<td>2007-08</td>
<td>2009-10</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>Managed float</td>
<td>n.a.</td>
<td>2008-09</td>
</tr>
<tr>
<td>Slovenia</td>
<td>Tightly managed float</td>
<td>2005</td>
<td>2007</td>
</tr>
</tbody>
</table>

n.a. not available.

<sup>a</sup> The exchange rate mechanism 2 prepares countries for full membership in the monetary union. Domestic currency is locked to the euro.

*Source: World Bank.*

Economists are keen to learn more about the relationship between openness, growth, and democracy in developing countries. Empirical evidence shows that a stable, democratic government, with good policies, is more likely to promote economic and political freedom than an authoritarian one. Also, sustained economic growth, equitable distribution of income, and access to education create a favorable environment for maintaining stable democracies.

Does economic growth led by openness promote individual freedom in developing countries? As noted by the late Sir Arthur Lewis, winner of the 1979 Nobel Prize in Economics, one of the main requirements for raising growth is capital formation, including the effort to economize, and the increase in knowledge and its application. One advantage of an open economy is that a country can use savings elsewhere in the world to finance its own investment. According to neoclassical economic theory, developing countries should grow faster because of diminishing returns to capital in industrial countries and capital should flow to developing countries where returns should be higher. Higher investment and imported technology are supposed to promote higher growth, leading to convergence between industrial and developing countries. In reality, however, foreign direct investment has benefited only a few developing countries in East Asia and Latin America, and more recently India. Only in the last 15 years have economists rediscovered that institutions, such as economic freedom (property rights, legal protection, free trade, rule of law), social capital, and investment in people (education, health) are important for economic growth.

In recent years, economists and social scientists have intensified their research into the relationship between openness (e.g., trade and globalization), economic growth, and democracy. Several empirical studies show that international trade has a positive effect on growth. For example, economic freedom is closely linked to economic growth and sustained economic growth through international trade promotes democracy in developing countries. These studies also indicate that improvements in the standard of living, as measured by a country's real per capita GDP, substantially increase the probability that political institutions will become more democratic over time. In addition, studies show that for most countries (exceptions include Bangladesh and India), economic growth generated by openness contributes to the strengthening of democratic states (see the box for the case of Slovenia).

Nevertheless, research on the relationship between economic growth and individual freedom has not been so clear-cut. There is no conclusive evidence that a democratic government is necessarily able to guarantee individual freedom. The crucial factor is whether a government is able to formulate adequate policies that give rise to effective institutions that protect individual freedom over time. Furthermore, some studies suggest that a government must

Slovenia: The Road from Being Part of Yugoslavia to Independence

When communist Yugoslavia was created 60 years ago, its states, including Slovenia, had little political and economic freedom. However, starting in the 1960s, Slovenia gradually gained more economic freedom. In contrast with the southern parts of the former Yugoslavia, Slovenians were allowed to own houses and some land, and small businesses were allowed to have more employees than those in the south. Willingness to invest in the north increased, while borders with such wealthy neighboring countries like Austria and Italy opened up. These gradual steps to economic freedom led to increased economic growth. By the 1980s, Slovenia was the richest part of the former Yugoslavia with an extensive middle class. Investment of remittances by returned workers, knowledge from the West, and imports of licenses and technology also helped increase the strength of the middle class, who were in the vanguard of those who pushed for democracy and independence at the end of the 1980s. Slovenia is now a well-established democracy, demonstrating that sustained economic growth supported by a relatively equal income distribution and the development of a middle class can lead to a widespread movement for democracy.

After independence from Yugoslavia, state-owned enterprises and old-regime institutions were transformed through privatization and new banking and regulatory systems. Slovenia’s transition experienced both successes and failures and points to a number of lessons. The banking reform, for example, was extremely successful, because sound commercial banking law replaced the old banking system. By contrast, privatization, which was facilitated through vouchers—later transformed into securities—was incomplete and did not adequately protect small shareholders (each citizen received an equal amount of vouchers, but many people lacked experience with holding securities and trading them on the stock market).

Taking all the pluses and minuses into consideration, since it gained independence in 1991, Slovenia has become a success story. Today it is one of the richest transition countries, with a per capita GDP of $17,000 purchasing power parity and is looking forward to becoming a fully fledged member of the EU in May.
be credible: the regime should last, and the government should be able to continue the policies it has committed to over the long term. They also argue that using democracy as a proxy for guaranteed property rights is inappropriate; however, there is no doubt that autocracy cannot guarantee economic and political freedom. For example, a study finds that dictatorships are invariably hostile to private property except in a few cases such as Chile, Singapore, and South Korea. The studies show that what matters most is that the development of good policies supported by effective political, legal, and economic institutions can be powerful in promoting democracy as well as in protecting individual freedom in emerging democracies.

Countries’ experiences also reinforce the view that good policies matter in the long run. While China has only partial economic freedom, undefined and informal property rights, and weak capital markets, it has successfully developed institutional innovations suited to local conditions, such as the household responsibility system, township and village enterprises, special economic zones, and partial liberalization in agriculture and industry. As a result, China has been growing at double digits each year for the last decade. However, there is less consensus about whether China will be able to sustain its level of economic growth without further institutional reforms.

A reasonable assumption is that a stable, democratic government should be able to promote good policies to guarantee individual freedom, such as the rule of law, individual liberties, freedom of expression, and institutional checks and balances. Thus a logical question is how the international community can help emerging democracies realize openness and economic growth, especially given that economic openness can also have some highly undesirable consequences, such as income inequality in developing countries. For instance, technology transfer from industrial countries to less developed countries is likely to result in a skill bias that rewards skilled workers but not unskilled workers. Consequently, the labor market will be segmented into losers and winners, which may lead to social unrest and could even destabilize emerging democracies.

Recent experience in developing countries sheds some light on the importance of income distribution and equality for economic growth and the development of democracy. For example, the experiences of many Latin American countries suggest that the relationship between openness, growth, and equality has become less positive. The Inter-American Development Bank states that the low returns to basic education in Latin America may reflect the adverse effects of globalization by exerting pressure on earning for workers with only a basic education. Trade liberalization, combined with macroeconomic policies that foster the adoption of technological change, seem to have displaced labor demand. In those Latin American countries that have invested heavily in tertiary rather than basic education, a relatively small number of winners with higher education appear to have captured the benefits of trade liberalization.

By contrast, South Korea and Taiwan (China) have developed greater individual freedoms over their period of sustained economic growth. For example, South Korea’s export-led economic growth promoted openness and new ideas that drove up investment in education. The level of education is closely linked to wages earned during economic development, while everybody had access to basic education. Consequently, the higher level of education among the population helped create a large middle class. Once economic freedom had been achieved, people sought recognition by exercising their political freedom. Achieving individual freedom in South Korea has been a gradual process over the different phases of its sustained economic development.

The starting point for democracy—level of income—matters. Low-income countries struggle to survive, and thus the demand for democracy is slight. In middle-income countries, such as Chile and South Korea, higher growth reduces poverty, giving rise to a greater demand for democracy. Some studies indicate that higher levels of median income bring about greater political stability and suggest that countries are more likely to democratize or remain democratic after they have achieved a certain level of average per capita income.

Overall, based on the experience of various developing countries, the relationship between openness, growth, and democracy has generally been positive, but whether economic growth led by openness promotes individual freedom is less evident. Nevertheless, a stable, democratic government with good policies is more likely to promote economic and political freedom than an authoritarian one. At the same time, sustained economic growth, equitable distribution of income, and access to education are important for maintaining stable democracies in developing countries. Then a majority of the population can realize the benefits of economic liberalization as the South Korean case shows. How to ensure that these things will happen in developing countries? The international community should help them adopt sound policies, suited to local conditions, by strengthening institutional effectiveness with the right incentives.

Boris Pleskovic is research manager at the World Bank. This article is a shortened version of his presentation given on March 11 during the conference on Economic and Individual Freedoms in Emerging Democracies held at the Northwestern University Law School, Chicago.
Small Enterprises in Transition Economies: Overpraised and Underdeveloped

by Robert J. McIntyre

Even countries seen as leading exemplars of successful transition, have made little headway in building up productive, modern, small enterprise sectors. Despite many positive accomplishments since 1989 and extremely high expectations for the role small and medium enterprises (SMEs) would play, announcements about market transformation and the end of transition do not match the facts.

Successful development of SMEs beyond subsistence farming and small-scale trading and service activity needs a complex set of institutions and behavior patterns that only emerge slowly and requires an active state role in creating both markets and market institutions. Conversely, SME development is largely thwarted by the rampant criminality that appears wherever a weak or ideologically de-legitimized state fails to create relatively predictable, law-governed conditions. Assuming that healthy markets would emerge; would be dominated by small-scale, individual entrepreneurship; and would achieve self-organization was unrealistic, but these expectations interacted with ideological preferences to deflect policy attention from essential institution building tasks. Automatic market processes are not enough to bring a viable SME sector into existence.

False Hopes

Transitologists widely assumed that the small enterprise sector would play a predominant role in normalizing centrally planned economies. Unfortunately, the methods economists use to analyze behavior within established market systems offer no basis for choosing specific institutional forms and carry no knowledge of how to build them from scratch. The policy environment in most previously centrally planned economies reflected the “early-naive” Washington consensus, which implicitly assumed that viable entities would spontaneously emerge to fill the interstices between shrinking large organizations.

A decade after transition began, SMEs’ role in these countries is important, but generally unsatisfactory. Some—notably Hungary and Poland—experienced strong growth in SME numbers, while in others, in particular Russia and Ukraine, development was slow and weak. Even though SMEs in both Hungary and Poland are numerous and now account for the bulk of employment, most operate in market niches and are not competitive. Most are extremely small micro-enterprises that are better viewed as their owners’ second or third jobs. For example in 1996, 70.2 percent of Polish SMEs had one or fewer full-time employees including the owner-entrepreneur.

What complicates the picture is that statistics about the SME population are unreliable. New SMEs that never actually came into operation were counted and real SMEs that failed were never removed from the reported figures. Pervasive overcounting of registrations and statistical immortality once registered produced a false picture of both the level and evolution of the SME sector, but an eager audience accepted such statistical good news. The belief in the automatic emergence of successful markets similarly led to a favorable interpretation of the rapid growth of small trader and shuttle trader activity (the latter shuttle across borders, taking advantage of the price differences between countries).

Much of this measured growth reflected the pursuit of individual survival strategies. Very small-scale activity (excluding traditional skilled trades and professions) is a dead-end of an essentially subsistence character that has little cumulative developmental effect. In many countries, the large numbers of new enterprises indicate the intensity of unemployment and poverty, not a developmentally functional dynamism.

Finance Is Critical

The illusory sense of immediate success delayed or diverted attention from serious SME policy. Approaches exist that could allow transition economies to capture some of the secrets of Italian, Japanese, or south German small enterprise systems. Standard business environment improvement and entrepreneurship support programs are of some value, but usually focus on regulation and crime while failing to address the major problems of inadequately developed institutions and organizations, the lack of product market access for small-scale producers, and, most critically, the lack of finance.

Small-scale credit is obviously central to successful, cumulative SME development, but conventional micro-credit approaches are not developmentally functional in the middle-income, urbanized settings that characterize the bulk of the CIS and Eastern and Central European countries. Even in agricultural areas they are of dubious long-term value, because micro-credit propagators often work to prevent the rise of alternative, self-supporting credit institutions, such as genuine credit cooperatives. Based largely on grant funds and building no viable, locally-owned institutions that are able to grow and evolve to a scale sufficient to finance serious small enterprise development, they are at best a poverty palliative. The enthusiasm with which various donors and multinational institutions view micro-credit is not justified.

Dynamic economic growth requires locally-owned banking institutions, such as credit cooperatives-tasked with serving local small enterprise interests. Locally-owned banks and small enterprise systems function successfully on social capital that is extremely costly for large banks to acquire.
With no inherent local development mandate, for large banks to provide the type of patient, step-by-step credit and other financial service support that firms of a nascent small enterprise sector require does not make sense.

**Successful Models**

The successful local developmental state model that has been pervasive since World War II from Austria, Germany, and Italy to Japan, South Korea, Taiwan (China), and more recently China, suggests that alternatives are available. National-level success in rebuilding and modernizing after World War II was heavily dependent on SME support measures carried out by local-level governments as part of a national strategy, but this experience has been conspicuously absent from policy advice or practice in the transition economies after 1989.

The remarkable success of local authorities as facilitators and direct entrepreneurs is central to the dynamic Chinese development after 1978, and local authorities in Central and Eastern Europe and the CIS economies in some ways face similar situations. Some new Chinese ownership arrangements are like the multi-owner partnerships that are widely successful in advanced market economies. Many small and medium local state-owned enterprises slated for comprehensive reform and loss of national subsidies are likely to end up under township or local government control as joint stock cooperatives with some degree of employee ownership.

Beginning in the 1890s, sparsely populated Finland used cooperatively-owned, local financial institutions as part of a national economic development strategy. The cooperative banking system received public deposits, overcoming initial trust and scale problems, and formed local banks into regional alliances under a national confederation to assure political visibility. The Finnish experience is a useful addition to debates about SME financing and suggests new tools to support market-based economic growth in impoverished and remote areas of transition economies. Parallel to and with the support of cooperative banks, a wide array of production and marketing cooperatives arose. Combining cooperative saving and lending institutions with production, processing, and service cooperatives is a promising strategy in many transition economies. The hundreds of "new wave" cooperatives formed during the severe Finnish depression of the early 1990s are similarly promising. Many are technology and technical service companies in the form of multibranch work cooperatives and single-branch expert cooperatives.

These examples embody a core insight: too often SMEs in transition economies are assumed to have a future only as atomistic competitors, whereas real world experiences point to the centrality of a small enterprise system for both micro- and macro-level success and the viability of a wide range of possible organizational and ownership forms. Finnish-style use of national policy to create conditions in which local-level saving, financial services, production, marketing, wholesale buying, and other cooperatives take root is directly relevant to the puzzling failure of productive SMEs to play a significant role during the first decade of transition.

**Policy Conclusions**

The most successful SME development has occurred in economies that had a relatively substantial SME sector during the central planning period, that is, Hungary, Poland, Slovenia, and the new German states. Thus pretransition existence of the sector seems to have a large effect.

Innovative and technologically progressive SMEs are not a significant aspect of any of the current transition economies except China. Hopeful expectations proved to be false in part because they reflected a misunderstanding of the environment within which successful, productive SMEs function in advanced countries. They require successful large enterprises as customers and suppliers, corporate research laboratories, and government support of fundamental and applied research. The SME sector needs the large enterprise sector as a source of inputs, as a market for outputs, and as the major source of individual entrepreneurial leadership. Policies to support the creation of a synergistic SME-large enterprise relationship should be a high priority.

The fundamental conclusion that has emerged from the last decade of experience is that the small enterprise sector is not, by itself, enough to create sustained economic growth. The SME sector simply does not solve any of the problems of transition by itself. Successful SME policy interventions must address its real conditions and needs, not retreat to folk images of solitary entrepreneurship.

The article is based on the findings of a World Institute for Development Economics Research project on small enterprises in transition economies directed by the author, who is senior researcher at the Institute for International Economic and Political Studies, Moscow; email: mcintyre@transecon.ru. The studies of 11 contributing authors were edited by Robert J. McIntyre and Bruno Dallago and published in 2003 as Small and Medium Enterprises in Transitional Economies by Palgrave Macmillan, Houndmills, Basingstoke, Hampshire RG21 6XS, United Kingdom, and 175 Fifth Avenue, New York, N.Y. 10010, United States.
Roadblocks to Deregulating Small Business in Russia

by Oleg Zamulin

After a dynamic deregulation of inspections, licensing, certification, and registration in Russia, the process slowed down in 2003. The Moscow-based Centre for Economic and Financial Research (CEFIR), in collaboration with the World Bank and with financial support from the U.S. Agency for International Development, continues to monitor the progress of deregulation reform.

Russia’s original deregulation package, launched by the federal government in 2000, included laws that significantly cut down on administrative procedures and reduced administrative costs. In 2003, the government adopted new rules applicable to small business in relation to the simplified tax system.

Monitoring

The monitoring of the deregulation is being conducted by means of repeated surveys of 2,000 firms in 20 Russian regions. Firms interviewed in each region include 80 firms that have been operating for at least a year and 20 recent start-ups. The old firms were asked questions about licensing, certification, inspections, and tax administration. Following the same firms over time allows comparisons between the various survey rounds and assessment of changes over time in the extent of the administrative burden. By contrast, interviews with recent start-ups provide information about the cost of entering the market, the registration procedure, and the acquisition of licenses and certificates.

The first three rounds of the survey took place in spring 2002, fall 2002, and spring 2003. Questions pertained to the prevailing situation and experiences during the preceding six months. The next rounds are planned for spring 2004 and spring 2005.

Conclusions after the first round were reported in Transition (see Transition, “Small Businesses Harassed in Russia Despite New Deregulation,” July-August-September 2003, pp. 44-45). The first survey was conducted before any of the deregulation laws had come into effect and found that regulation in every area was significantly more severe than the target levels spelled out in the new deregulation laws. It also revealed that the bureaucratic burden increased in proportion with a firm’s size and business performance. Business planning had become challenging for firms given the erratic and inconsistent nature of administrative processes.

The second round of monitoring allowed progress after the enactment of the new laws on inspections and licensing to be evaluated. The third round reflected progress after the registration procedure had been reformed and the new simplified tax system rules for small businesses had been adopted.

Areas of Regulation

The new law on inspections, which became effective in July 2001, limited the number of planned inspections at a firm by any one agency to one every two years. Likewise, the rules for unannounced inspections were spelled out carefully to protect firms from abuses of power. The second round of monitoring demonstrated that the number of inspections by all government agencies had dropped substantially, on average by 33 percent, in the first half of 2002, compared with the second half of 2001. The third round of monitoring revealed a 12 percent drop in inspections in the second half of 2002 compared with the first half of the year. Accordingly, in the first round respondents claimed that their managers spent an average of 11.4 percent of their time on inspections, but by the second round this had dropped to 9.2 percent, and in the third round it had fallen to 8.2 percent. Thus the time spent on unproductive activities has diminished.

However, significant abuses by the inspecting agencies persisted, and in some cases increased. For example, in 2002, 23.3 percent of enterprises were victims of direct violations of the new law by fire safety agencies and 17.7 percent of the enterprises had to endure abuses by sanitary and epidemiological supervision agencies. During that year, these agencies carried out repeated planned inspections at these firms, even though the law permitted only one planned inspection every two years. Respondents also complained about frequent unplanned inspections, for instance, 60 percent of police visits were unannounced. Increasingly, government agencies failed to produce a warrant during unannounced inspections. The proportion of fines exceeding the official scale has also increased: for the police from 43 to 73 percent and for the fire service from 25 to 43 percent. Thus while the average number of inspections has fallen, abuses of power have intensified.

The enactment of the new law on licensing in February 2002 also led to some improvements. The law significantly reduced the number of activities subject to licensing, simplified the procedure for license acquisition, and increased the required term of validity to five years. The CEFIR surveys indicate that the percentage of enterprises that applied for licenses and permits dropped from 31 percent in the second half of 2001 to 21 percent in the first half of 2002 and remained level in the second half of 2002. The process became simpler and cheaper in the second round of surveys, but in the third round the cost of obtaining a license and the waiting period increased again. In the second round, the time required to obtain a license had dropped, on average, from 37 to 33 days, but had increased to 39 days by the third round. Local authorities issued permits for trade and other types of
activities that were not subject to licensing. Some licenses continued to be issued for activities that according to the 1998 law were no longer subject to licensing.

The new registration rules became effective in July 2002. According to the new rules, registration should take place at the Ministry of Taxation, should take no more than five days, and should cost Rub 2,000. The third round of monitoring revealed that in the second half of 2002, registration had indeed become faster and simpler, but also more expensive.

One key principle of the reform—introducing a “one-stop-shop” concept—clearly failed, although most entrepreneurs no longer had to visit local administrations and registration chambers whose functions had been handed over to the Ministry of Taxation. Nevertheless, entrepreneurs still had to visit other government agencies, such as the Pension Fund, the social and medical insurance funds, and the fire and sanitary and epidemiological services. The number of agencies they had to visit thus decreased from five to four. Previously firms waited 11 to 14 days to hear back from these agencies. Waiting time for registration eased from 6 days to 10 days. In addition, the inflow of entrepreneurs to the ministry’s offices seeking to register new firms drove up the monetary cost of the procedure, which rose from an average of Rub 3,500 to more than Rub 4,000.

The third round of the survey revealed that after the introduction of the new law on the simplified tax system for small businesses, firms were ready to adopt the system, as 48 percent of all eligible firms chose to exercise this right, in contrast to 27 percent in the previous round. Firms that switched to the system in 2003 paid, on average, 6 different types of taxes and levies, down from 10 in 2002.

**Perceptions and Reality**

Besides measuring administrative costs in terms of time and money, CEFIR also looked at subjective perceptions of potential problems facing small businesses. The finding was quite encouraging, because most problems lost their significance over time. Fair competition, which in an ideal situation should be the only problem businesses face, is now perceived to be the third worst problem, preceded by the high tax levels and the macroeconomic instability.

Thus the three rounds of monitoring indicate that the reforms have had an impact, but have not reached their declared goals. After a significant improvement in the second round of monitoring, the third round revealed a mixture of good and bad news, indicating that the deregulation process had slowed down, but the hope is that this is only temporary.

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**Close-Up on Russian Enterprises—Results of a Survey**

by Maria Gorban

Foreign direct investment (FDI) is still relatively low in Russia, mainly because of various institutional barriers, inefficient bureaucracy, and corruption. According to a recent business survey conducted by the European Business Club (EBC), foreign companies have major advantages over their Russian competitors, including better technologies, stronger brands, and better business organization, and an overwhelming majority is there to stay.

In mid-2003, the EBC Business Monitoring Project carried out a survey of foreign companies that are members of the EBC. Around 75 companies from different sectors participated, and the formal survey was complemented by a series of extended interviews with company representatives. Companies were asked about:

- The institutional barriers to investment and how the operations of major state agencies had changed
- Their motivation for investing and/or producing in Russia
- The nature of competition and the extent of integration with Russian companies
- Their future investment plans.

Institutional Barriers

In relation to the various institutional barriers, the companies were most concerned about inefficient bureaucracy and corruption. In addition, interviews revealed that even though large foreign companies, which accounted for most of the sample, seem to suffer less because of the greater resources available to them and better treatment by the government, they often have stricter ethics policies and try to comply fully with the letter of law, which can make their lives more difficult, instead of seeking compromises.

Companies were asked about changes they have noticed over the last year in the operation of major state agencies. About 31 percent of respondents—mainly large manufacturing firms—noticed a “slight improvement” in customs operations, noting that the government’s customs committee has become more open to dialogue with businesses. The customs authorities are gradually squeezing out black and gray imports, thereby making domestic production more profitable. In addition, the customs authorities are now moving away from demanding that companies meet completely absurd requirements, especially the submission of various documents, as was often the case in
the past. However, more than half the companies (52 percent) think that the overall situation has not changed, and 13 percent said it has worsened. Companies complain about the inconsistency of requirements, the lack of predictability, the illogical use of tariff nomenclature, and the extent of corruption.

As to the operation of the certification authorities, 59 percent of the respondents observed no change, while 17 percent said that these agencies were performing worse than a year ago. The recently adopted Law on Technical Regulation creates the framework for improving the regulation of certification and allows a seven-year transition period for companies to adopt the corresponding regulations in each industry. Meanwhile, the existing rules remain unchanged, and for a vast number of goods certification is still required before they appear on the market. Thus the procedures remain time-consuming and expensive, and, moreover, are even more difficult than before.

As concerns the performance of various inspectors and licensing authorities, where new legislation was introduced a long time ago, some positive changes have occurred, for example, 32 percent of the companies reported improvements in relation to licensing. However, the picture is less positive for inspections: only 17 percent of the companies say that the situation has improved to some extent, 70 percent have not observed any change, and 9 percent think it has become worse. The agency that gained the lowest marks was the visa service, which is undergoing administrative reshuffling this year.

Motivation for Investing

The survey results were noticeably different between those companies that run manufacturing operations in Russia and those that import goods from abroad. The former care more about issues such as the rising labor costs, the lack of export possibilities, and the uncertainty about WTO membership; are generally more positive about local conditions; are better adapted to local institutions; and characterize problems more often as “less critical” than “critical.”

According to the interviews, companies’ decision to invest in manufacturing in Russia is motivated primarily by the size of the market, with the institutional factors being secondary considerations. Usually a company starts local production after it has established itself as an importer, because running a distribution network for a period of time results in better understanding of the market, as well as of different cultural and institutional aspects. In many cases, the decision to invest in local production or imports depends on the types of products involved. For expensive and high-quality manufactured products that require sophisticated know-how, large sunk costs, and a skilled labor force and for which the market is relatively limited, importing may remain the best option.

All the companies surveyed that produce locally (about 20 percent of the sample) have either built new facilities or modernized existing ones. The latter usually implied that the companies installed new facilities on the site of an existing plant, with basically no old equipment left. For half the companies, Russian firms are their major suppliers. The share of imported inputs tends to depend on the sector. In the machine and equipment building industries it can be as high as 50 to 70 percent, whereas in the food industry it is only 10 to 20 percent.

Nature of Competition

What helps foreign companies compete with Russian ones? The most important factors are better technologies (75 percent of respondents), stronger brands (66 percent), and better business organization (63 percent). The quality of personnel (55 percent) and the possibility of obtaining additional financing from the parent company (44 percent) are also major advantages. As for obtaining bank credits, only 26 percent think that foreign investors have advantages over Russian companies.

As to the advantages Russian companies enjoy, more than half the respondents pointed to lower personnel costs and a better relationship with the local government. In addition, 37 percent of the respondents think that Russian companies’ involvement in the shadow economy and tax evasion creates additional advantages for them. Only one-third of those surveyed think that better knowledge of the market can be regarded as an important advantage for Russian companies. Because most foreign companies that participated in the survey have been working in Russia for many years, they are confident that given their market expertise, they can compete successfully with locals.

Investment Plans

In response to whether companies planned to increase their activities in Russia over the next two years: 92 percent said yes, with more than 33 percent planning a significant increase. Only 8 percent said that their activities would remain unchanged, and none was planning to withdraw or cut its involvement in the Russian economy. Finally, 60 percent of the respondents plan to introduce new products in the Russian market, 27 percent plan to create or increase their retail networks, 21 percent hope to build new production facilities, and 17 percent aim to modernize existing equipment.

This positive attitude toward future investment may be considered an indicator of a future increase in FDI flows. According to Goskomstat, FDI in the first nine months of 2003 reached $4.7 billion, compared with $4 billion during each of the preceding three years.

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Burdensome Legacy: Public Service Provision by Russian Firms

by Pertti Haaparanta, Tuuli Juurikkala, Olga Lazareva, Jukka Pirttilä, Laura Solanko, and Ekaterina Zhuravskaya

To ascertain why the Russian economy has been lagging behind the economies of most other Central and Eastern European countries, the authors looked at the country's public services and public infrastructure. Both are crucial for sustainable development, and their lack could be a major obstacle to firm investment and growth. In Russia, enterprises still provide the bulk of public services.

As part of the Infrastructure and Welfare Services in Russia: Enterprises as Beneficiaries and Service Providers Project, the authors surveyed 404 medium and large manufacturing firms in 40 Russian regions. They gathered data about the extent to which the firms provide social services and infrastructure; the firms' assessments of the quality of public infrastructure and the regulatory environment; and the firms' ownership, investment, performance, competition, and finance decisions.

During the Soviet era, the authorities delegated both the supply of social services and the building and maintenance of infrastructure to enterprises, which ran housing, kindergartens, schools, health centers, and vacation homes (by 1992, enterprises accounted for 41 percent of the total housing stock). This was a consequence of the way the Soviet economy organized production. In order to reap economies of scale, the government assigned certain regions to build large plants for the production of a small variety of specialized goods. In these regions, nearly everyone was employed by a single, large, local producer. Hence there was virtually no distinction between the government and the firm.

After the collapse of the Soviet system, enterprises continued to supply public services and maintain the infrastructure. During the mass privatization of the early 1990s, enterprises were obligated to transfer major social assets, such as housing, kindergartens, and medical centers, to municipalities; however, both the speed and the scope of divestiture varied significantly by the type of asset and by locality. For example, according to survey data, most kindergartens were divested in the mid-1990s, while housing divestment is still ongoing.

Despite the major divestments of social assets during the 1990s, most firms still provide at least some form of social services. For example, 56 percent of the firms surveyed have their own housing or subsidize housing, and 73 percent of the firms have recreation facilities or subsidize their employees' recreation activities. While managers view the provision of social services as non-essential and costly, many firms continue to provide these services even to users other than their own workforce. [Editor's note: This can be explained, in part, as a way of trading favors with the local governments, relieving them from some of the social burden in exchange for tax relief. Also firms can buy labor's loyalty by providing social services.]

Respondents' generally assessed the quality of public infrastructure as good or satisfactory, and were the least satisfied with the quality of roads. More than half the firms provide their own heat, mainly for technological reasons, although occasional interruptions in public service may be another reason. Of the firms surveyed, 24 percent provide support for the construction and maintenance of public road networks.

The regulatory burden the firms face continues to be severe. For example, in more than half the firms the general manager has to spend more than two weeks per year in negotiations with the authorities about public infrastructure. At the same time, many of the firms have received financial support from the government, such as tax extensions, tax breaks, subsidized loans, or direct subsidies. Roughly 5 to 10 percent of the firms admitted to a high incidence of capture of legislative power at each level of government by firms.

The survey data clearly show that Russian firms are still extremely active in social service provision and in some infrastructure provision. The motives behind this provision may differ considerably across firms and regions. While firms clearly would like to divest themselves of some of their social assets, some may view service provision as a way to increase their market power in local labor markets. Firms' relationships with local authorities shape both social service provision, as shown by the difficulty of divesting the assets to municipalities, and infrastructure provision, as demonstrated by the support they provide to public infrastructure. Regulatory capture also seems to be a serious problem. In general, firms that provide services beyond the average seem to have closer ties to public authorities than other firms.

The initial results indicate that there is still large scope for improvement in the quality and quantity of public service provision in Russia. The extent of enterprises' engagement in social service provision should be explored further, the construction and maintenance of the road network need to be improved, and the ease of the regulatory burden should continue. Addressing these issues is likely to be important for the sustainability of investment and growth in Russia.

This article is a summary of the paper "Firms and Public Service Provision in Russia," BOFIT Discussion Papers no. 16/2003. Pertti Haaparanta and Tuuli Juurikkala are with the Helsinki School of Economics, Olga Lazareva and Ekaterina Zhuravskaya are with the Centre for Financial and Economic Research, and Jukka Pirttilä and Laura Solanko are with the Bank of Finland Institute for Economics in Transition.
Hungary’s Multinationals on Expansion Course

by Tamás Réti

Hungary is the leader among the transition countries in terms of capital exports, according to the United Nations Conference on Trade and Development’s World Investment Report 2003. Hungary’s neighbors are the primary target for Hungarian investors.

Hungary’s trade with Bulgaria, Croatia, the Czech Republic, Poland, Romania, and Slovakia, all countries of the Central European Free Trade Agreement, is increasingly coupled with capital exports in the form of acquisitions and, less frequently, greenfield investments. More than half of all Hungarian capital exports went to these countries in 2003, with the rest going to Western companies, often offshore firms.

Several factors motivate investment by multinationals based in Hungary. The most important considerations have been market expansion to increase corporate value, with in some cases companies seeking to acquire a leading position in the region. Companies generally look to the riskier, but potentially more profitable, markets east of Hungary, given that strong competition limits expansion toward the west. Another motivating factor has been export promotion by establishing new enterprises abroad. Hungarian investors also look for investment preferences, including exemption from corporate taxes and cancellation of customs fees.

In Romania, Hungary’s accumulated foreign direct investment had reached $240 million by December 2003. Hungary was the 13th largest foreign investor in that country, with an investment share of 2.5 percent. The Hungarian Petroleum and Natural Gas Company has been the largest Hungarian capital investor not only in Romania, but also in Croatia and Slovakia. It owns more than 70 gas stations in Romania, has purchased a majority share in Slovnaft in Slovakia, and holds a minority share (25 percent) in INA in Croatia. Its strategic plan is to create a regional network of oil refineries from the Baltic Sea to the Adriatic. Another large Hungarian investor in Romania is Dunapack, which bought a packaging material factory for $16 million. In addition, Richter Gedeon, one of Hungary’s leading pharmaceutical companies, purchased Armedica, Romania’s fourth largest pharmaceutical plant.

Hungary’s largest savings bank, the National Savings Bank, purchased Slovakia’s IRB Bank for $38 million and Bulgaria’s second largest bank, the DSK Bank, for about $300 million. Hungarian capital investments in Slovakia comprise about 600 small and medium enterprises, around 10 percent of which are under sole Hungarian ownership, with the rest being joint ventures. Most of these companies are traders of consumer goods. Only a few joint ventures are involved in manufacturing, including lumber, food, and chemicals.

The initial surge of Hungarian capital exports into Slovakia was followed by a lull, as the former government under Meciar tried to slow the flow of Hungarian capital, which was primarily targeting southern Slovakia. Hungarian and other foreign investors were barred from bidding for state-owned enterprises slated for privatization. Later, the government of Dzurinda realized that Slovak owners needed foreign investors in the relatively undercapitalized economy and encouraged more active involvement by multinational companies, including the Hungarian ones already in Slovakia.

Accession to the EU could give an additional boost to Hungarian capital exports. Growth would certainly continue, although radical changes in the pattern of foreign direct investment are not expected. Increased investment in the Balkan economies is likely. In Serbia, for example, in the Voivodina region where most of the Hungarian minority is concentrated, large-scale privatization is planned that would provide good possibilities for Hungarian investors. Even starting out as suppliers for multinationals, Hungarian companies will have various opportunities to enter foreign markets.

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*I love nature, except that of my boss.*

From the Hungarian magazine Hócipő
Czech Universities: Deep Crisis, Few Prospects

by Petr Matejů

The Czech higher education system is in crisis. Because of financial constraints and structural rigidity, students from poorer families are finding it harder to enroll, and the Czech Republic has the worst record among OECD countries in relation to equal access to tertiary education. Implementing cost sharing and providing financial aid to needy students would help solve the crisis.

Faculty members of Czech public universities are protesting and university rectors have warned politicians that their protests will intensify. At first glance, their complaints appear to be legitimate. Since 1994, the budgets of Czech public universities have declined steadily and none of the governments, including the current socialist one, which declared its determination to build a knowledge-based society, have made any significant steps toward helping the higher education system out of its deep financial hardships. Estimates indicate that the universities' accumulated deficit is equivalent to approximately one-third of their total annual budget.

The higher education system has entered a critical phase. According to OECD data, the Czech Republic ranked 5th among the 30 OECD countries in secondary school completion, but 29th in tertiary-level completion and 28th in the percentage of GDP devoted to tertiary education. In short, the Czech Republic represents a particularly vivid example of the consequences of limited public budgets and the resulting limited capacity of the higher educational system.

The rapidly worsening financial condition of public universities is also a problem in many other countries; however, in response, universities in most industrial countries increasingly generate some of their incomes from private resources, including tuition fees. Thus in OECD countries, the percentage of private funds in the budgets of tertiary education institutions is around 25 percent, and in some countries, such as Australia, Canada, South Korea, and the United States, the figure exceeds 40 percent.

Nevertheless, for the sake of accessibility, both governments and universities provide significant financial support to students from low-income families. In OECD countries overall, financial assistance to students averages 15 percent of total expenditures on higher education, while in Australia, Canada, the United Kingdom, and the United States it ranges from 20 to 35 percent. The benefit is that the rising demand for tertiary education, driven by changes in the world economy and labor markets, can be accommodated while expanding access to higher education for children from poor and disadvantaged families.

This is not the case in the Czech Republic. Private sources account for less than 15 percent of the total budgets of Czech public universities (the law does not permit charging tuition fees), while financial assistance to students is as low as 7 percent of total expenditures on higher education. Given the already high budget deficits and the government's priorities (pensions, health care, social and unemployment benefits), the universities stand little chance of winning the battle for a higher portion of government spending, at least in the foreseeable future.

Access to Czech universities, already the worst among OECD countries, is becoming even more unequal because of the universities' limited capacities, which are an outcome of financial constraints and the system's structural rigidity. Competition to get into the universities is enormous, and places tend to go to children from higher social strata. The problem is exacerbated by corruption during the admission process, examples of which are occasionally reported in the Czech newspapers, but that has not resulted in any change in admission policies.

No wonder that recent public opinion surveys show increasing support among students and the general public for a thorough reform of the Czech university system. Such reforms would include the introduction of tuition fees balanced by strong financial aid programs. However, both the socialist government and a majority of deans at public universities vigorously reject these reforms. The government is unwilling to abandon rigid ideological dogmas, even as many left-wing voters are moving away from such views. In turn, university deans are unwilling to accept tuition fees, which would inevitably put stronger pressure on universities to provide higher quality education that is more relevant to students' job market needs.

In the long run, broad reform of higher education finances—implementing cost sharing and providing financial aid to needy students—would certainly help solve the universities' financial crisis and improve access to university education. Higher education institutions would be more accountable to students, who, in turn, would become more sensitive to labor market requirements and the quality of educational services. All this would lead to vertical differentiation among universities. Apparently this is too high a price for university deans to pay for improving the budget situation of their universities.

The only way out of this trap is strong political will to design and implement consistent reform of the higher education system, and this is a task that the next government will have to carry out. So as not to waste time, however, experts and future policymakers could start preparing a blueprint for such reform. Once a new government takes office, the hope is that it takes advantage of and implements the prepared reform program and has a better understanding of the importance of education as the way to increase the competitiveness of the Czech economy.

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Global Development Finance: Private Capital Flows Return to Selected Economies,

Net private capital flows to developing countries as a whole rebounded to $200 billion in 2003, up from $155 billion in 2002, but most of the increase was concentrated in just a few relatively better-off countries, while official development assistance to poor nations increased only marginally, says the annual World Bank report, Global Development Finance 2004, released in mid April. The increase in net private flows—bonds and bank loans—most of which went to Brazil, China, Indonesia, Mexico, and Russia, is the major factor in the overall increase in net capital flows to developing countries from all sources, public and private, to $228 billion in 2003 from $190 billion in 2002. Net private capital flows rose to all developing regions except the Middle East and North Africa.

Flows to Europe and Central Asia (ECA) of $63 billion, up from $55 billion in 2002, were particularly strong. Remittances sent home by migrants working in rich countries have climbed steadily since 1998, reaching $93 billion in 2003, up 20 percent from 2001. They are now the second most important financial flow to developing countries after foreign direct investment (FDI) and are almost double the flows of official aid. Net resource transfers from rich to poor countries remain negative. Net official development assistance rose by only $6 billion to $58 billion in 2003, with half of this increase accounted for by debt relief and some administrative costs to donor agencies rather than new resources to developing nations.

FDI Flows to Transition Economies Will Recover, and

FDI flows into ECA fell sharply from $33 billion in 2002 to an estimated $26 billion in 2003. Few major privatization deals were completed, reflecting the end of privatization for some countries in the region. FDI to the Russian Federation surged sharply, however, mostly in the oil and gas sectors. Net portfolio flows to the region rose modestly to $0.7 billion. Nevertheless, FDI in the region is expected to recover. The Czech Republic, Hungary, and Poland are expected to receive more FDI in services as their competitive cost structure encourages investors to set up headquarters and research and development facilities, whereas light manufacturers may move to lower-cost EU accession countries, such as Romania. Russia and Turkey are expected to receive higher levels of FDI in coming years.

Robust Growth Is Expected in the ECA Region

The outlook for 2004 and beyond is for continued robust growth in the region as a whole. During 2004-06, growth in Central and Eastern Europe is expected to be close to 4.5 percent as effective implementation of EU-related structural reforms provides a stronger foundation for expansion. In the CIS, growth is projected to ease to 5 percent by 2005-06, largely because of moderating oil prices.

Last year, led by a tripling in capital spending growth to 9 percent, economies in the ECA region grew by 5.5 percent, up from 4.6 percent in 2002, according to Global Development Finance 2004. Despite sluggish activity in the euro area, growth in Central and Eastern Europe accelerated from 3 percent in 2002 to 4.1 percent in 2003, as several countries increased their export market shares in the EU. The average growth rate in Russia and other CIS countries increased from 4.7 percent in 2002 to 6.6 percent in 2003, powered by a significant increase in consumer spending and domestic investment as a result of strong oil revenues. Russia grew by 6.8 percent in 2003, up from 4.3 percent in 2002. The pace of integration of ECA into the global economy accelerated with a 27 percent increase in export revenues, the highest growth rate of all regions, compared with 9.5 percent in 2002.

IMF: Economic Outlook Is Bright, but Concerns about Terror and Oil Prices Remain

The IMF is warning that its projections of stronger growth for the global economy could change if terrorist attacks occur or oil prices spike. The IMF’s latest World Economic Outlook says: “With global trade rising sharply, financial markets buoyant and the US economy rebounding, the balance of risks has significantly improved. In the short run it is possible that global growth may be higher than projected, although geopolitical risks—including terrorist attacks—and oil prices have become increasing concerns.” The IMF raised its forecast for world economic growth to 4.6 percent in 2004 and 4.4 percent in 2005, or 0.6 percent higher than its last forecast in September. The improvement reflects stronger than expected performances by Japan, Russia, the United Kingdom, and the United States and by developing countries in Asia.

Kristalina Georgieva Appointed as New World Bank Director in Moscow

Kristalina Georgieva has been appointed as the new director of the World Bank’s Moscow office and permanent representative in Russia. Georgieva will take up her new appointment on May 1, 2004. Julian Schweitzer, the former director, will return to the Bank’s headquarters in Washington, D.C. and will become director of the Human Development Department in the South Asia Region.
Georgieva confirmed that Russia’s and the World Bank’s priorities on reducing poverty and accelerating economic growth coincide.

**EBRD Predicts Sixth Year of Growth for Eastern Europe**

The economies of Eastern Europe and the former Soviet Union are set to expand by 4.9 percent in 2004 and record their sixth successive year of strong growth, according to a report published in mid-April by the EBRD, the region’s multilateral bank. The study highlights continuing investment opportunities in the region nearly 15 years after the Berlin Wall fell and just two weeks before eight previously communist states join the EU on May 1. But the authors also emphasize the challenges that all 27 states face, including the need for further structural reforms and tighter control over public finances. According to the report: “Continuously high fiscal deficits in many EU accession countries, the heavy reliance on remittances and dwindling official aid in much of south-eastern Europe, vulnerability to commodity price movements in the resource-based economies of the [former Soviet Union], and the high levels of external debt in some of the poorer countries of the region are all risks.”

Willem Buiter, the EBRD’s chief economist, said in an interview that the larger EU accession states—the Czech Republic, Hungary, Poland, and Slovakia—were seeing “real reform fatigue” and signs of “populist escapism,” with voters reluctant to back further painful restructuring. For the region as a whole, growth is forecast to fall modestly from 5.6 percent last year to 4.9 percent this year. In the accession states, the EBRD expects a rise from 3.7 to 4.3 percent, led by a recovery in Poland. In southeastern Europe, growth is expected to stay broadly unchanged at 4.3 percent, but in the former Soviet Union, economic growth rate is expected to slow from 7.6 to 5.6 percent, driven by continuing high oil prices. The report urges Russia and other oil exporters to diversify their economies through deregulation and through promoting investment outside the energy sector. The focus of the EBRD, which last year committed Euro 3.7 billion for development in its sphere of operations, was shifting towards the Balkans and the much less developed countries of central Asia and the former Soviet Union said Steven Fries, the EBRD’s deputy chief economist.

**Soros Warns EU Novices**

George Soros, the billionaire financier, warned new entrants to the EU in a speech delivered in London at the mid April annual meeting of the EBRD that their currencies may be vulnerable to foreign investors’ speculative attacks before they join the euro zone. Soros also urged the 10 nations joining the EU in May to spend as little time as possible in the euro zone’s “waiting room,” the exchange rate mechanism. Many of the newcomers, most of them Eastern European nations, are anxious to move quickly toward adoption of the euro, but many fear that locking their currencies into the trading band dictated by the exchange rate mechanism would deprive them of the policy flexibility needed to bring their economies up to par with those of the wealthier old members. Asked if new entrants would be vulnerable to speculative attacks once they adopted the exchange rate mechanism limits, Soros told a news conference: “They already are. Hungary in particular has suffered from currency instability. The same applies to Poland.”

**World Development Report 2006 to Dissect Inequalities**

The World Development Report 2006: Equity and Development, co-directed by Francisco H. G. Ferreira and Michael Walton, will assess the nature of inequality across the developing world and its role in economic development and poverty reduction. It will discuss how inequality can be reduced without harming economic efficiency and growth and can even promote them. The report will complement the two previous reports: the World Development Report 2004, which focused on service delivery to the poor, and the World Development Report 2005, which is focusing on improving the investment climate, and thus the potential for economic growth, across the developing world. Greater equity, alongside higher growth and more effective service provision, are the fundamental pillars of the Bank’s strategy to support countries in their pursuit of the Millennium Development Goals, noted François Bourguignon, senior vice president and chief economist.

**World Bank Mulls Advice to End Oil Project Funding**

The World Bank is considering how to respond to an independent report that recommends that the institution phase out investment in oil projects by the end of 2008 because of environmental concerns. The report said the institution should “devote its limited scarce resources to investments in renewable energy, resource development, emissions-reducing projects, clean energy technology, energy efficiency and conservation, and other efforts that de-link energy use from greenhouse gas emissions.” The Extractive Industry Review was commissioned by Bank President James Wolfensohn and started work in July 2001, after criticism from the nongovernmental community about the Bank’s work in extractive industries. The study, which also recommends that the Bank stay out of coal mining activities, was led by Emil Salim, former environment minister in Indonesia. Two of the Bank’s most controversial recent projects, the Chad-Cameroon and the Caspian oil pipelines, were approved by the Bank’s shareholders in the face of opposition from environmental
and nongovernmental groups that said the projects would do more harm than good. Asked in a briefing if the Bank would take the report’s recommendation on oil into account, Rashad Kaldany, director of the World Bank Group’s Oil, Gas, Mining, and Chemicals Department, said at a briefing that the Bank’s management will respond after consultations with the institution’s 184 country shareholders.

World Bank Warns That Romania Needs to Switch to a Knowledge Economy

The Romanian authorities need to take urgent steps to stimulate the development of knowledge industries and catch up with the European countries, or else Romania’s EU accession will imply major costs resulting from the economy’s chronic lack of competitiveness, warns “Knowledge Economy in Romania,” the recent joint report of the World Bank and the eRomania Gateway Association. “Romania’s economy is still very much under the effect of the industrial and agrarian era, which promoted products and services that can hardly withstand competition on the international market and are finding it harder to cope on the domestic market, as well. Experts warn that the competitive edge of an economy no longer comes from the use of products or services, natural resources or geographical or historical peculiarities. The competitive edge is created by innovation, highly-skilled work force and widespread use of knowledge; in other words by the knowledge economy,” says the report.

World Bank’s New Business Opportunities Web Site

The World Bank has launched a new business opportunities web site: http://www.worldbank.org/opportunities. The new site offers a single place where the private sector doing business with the Bank will find information about consulting, selling directly to the Bank, participating in Bank projects, or pursuing other opportunities.

Vietnam: Mobile Banks Bring Services to Remote Areas

On March 30, Vietnam put another 240 mobile banking cars into service to help bring banking services to people in remote, rural parts of the country. The Vietnam Bank for Agriculture and the Bank for Development and Investment will distribute these banks on wheels to provincial and district bank branches. Funded by the World Bank, mobile banking cars were first introduced on a large scale in Vietnam in 2000 and 2001, when 159 such cars were provided. Each mobile banking car visits an average of 62 remote locations a month, opening savings accounts, providing loans, and collecting loan payments. Following the success of the first Rural Finance Project, the Bank’s second project adds another $250 million of investment in 90,000 small and medium rural businesses, $36 million worth of microfinance loans to serve 75,000 farm households and 10,000 microenterprises, and $5 million for improving the management and operation of participating financial institutions.

Russian Privatization Revisited—A Debate Between Goldman and Aslund

While the recent Russian presidential election resulted in unquestionable victory for Vladimir Putin, his policy toward the oligarchs is still shaping up. Will he renationalize some of their largest enterprises, or is he only going after his political opponents as he did with the leadership of Yukos? In this context, the debate between Marshall Goldman and Anders Aslund about the ethical and economic issues of privatization in Russia is extremely timely.

Goldman: The Rule of Outlaws Is Over

In 1991, a small group of Russians emerged from the collapse of the Soviet Union to claim ownership of some of the world’s most valuable petroleum, natural gas, and metal deposits, resulting in one of the greatest transfers of wealth ever seen. By 1997, five of these individuals were on Forbes Magazine’s list of the world’s richest billionaires. By 2003, Russia had 17 billionaires; only Germany, Japan, and the United States had more.

To attain such wealth, these self-styled oligarchs did not hesitate to use guile, intimidation, and occasionally violence, but none of this would have been possible without the faulty nature of the privatization scheme put together by a team of Russian officials led by Anatoly Chubais and a group of advisers from Harvard University. Eager to prevent a return to communism, they designed a privatization process that allowed directors to become owners of the factories they had been managing with only a minimum payment to the state. As for the public at large, they were issued vouchers that they could convert to shares of stock in the privatized companies. Having been told for 70 years that shares of stock were part of a capitalist scam, most Russians were happy to exchange their vouchers for a bottle of vodka provided by a small band of risk takers who realized that this was a cheap way to gain control of some extremely valuable assets. As a result, only a
few Russians realized any concrete benefits from the voucher program.

Equally embarrassing, from 1990 to 1998 Russia's GDP shrank by 40 to 50 percent. With the end of the Cold War, the country no longer needed at least 20 percent of its industrial output, which heretofore had been dedicated to the military industrial complex. However, the new owners' failure to restructure and invest was also a major factor. Capital flight intensified, with an outflow that sometimes exceeded $1 billion per month.

For some time, the conventional wisdom was that the new oligarchs had emerged primarily from among the nomenklatura and had simply privatized ministries and factories. Indeed, two prominent members of the former nomenklatura did join the ranks of the oligarchs: Vagit Alekperov, the former acting minister of the petroleum industry, who subsequently became the new CEO of Lukoil, and Rem Vyakhirev, the former deputy minister of the gas industry, who became chair of Gazprom. But most of the richest oligarchs previously had little, if any, standing among the Soviet establishment and were more likely to have been hustlers, off-the-books construction workers, and black market dealers. They traded currencies and provided scarce goods and services for extra profits. During the Soviet era, the authorities treated their actions as economic crimes, subject to jail or execution, but once Mikhail Gorbachev authorized the establishment of cooperatives and private businesses, they gained legitimacy. They also had an advantage over the nomenklatura in that they knew how to find goods and services in short supply.

Supplying consumer goods and services in the wake of the collapse of the centrally planned system guaranteed enormous gains. With so many rubles at their disposal, many of these traders began to establish their own banks, something made possible by another of Gorbachev's reforms. Once established, these commercial banks often served as personal ATM machines for their owners and provided them with the wherewithal to purchase those vouchers that the public was so eager to sell or swap.

Ownership of the banks also allowed the bankers to participate in the biggest rip-off of the reform: the loans for shares scheme. According to this arrangement, the bankers were to provide the state with loans to pay its bills, with the collateral being shares in state-owned companies slated for privatization, including some of the most valuable oil and metal firms. If the state could not repay its loans, the bankers were authorized to auction off the shares themselves, which is precisely what occurred. In almost every case, however, the auctions were rigged and the auctioneers, that is, the bankers, could buy the companies at a price only slightly above the value of the loans. Thus in 2002, for a mere $300 million, Mikhail Khodorkovsky gained control of Yukos, which was actually worth $8 billion to $10 billion. Similarly, Boris Berezovsky paid roughly $100 million for Sibneft, which was worth $6 billion.

As has become clear with the arrest of Yukos's number one, Khodorkovsky, in late 2003, and previously of Yukos's number two, Platon Lebedev, in July 2003, these bargain purchases provide an opening for Vladimir Putin and future Russian leaders to harass any of the oligarchs who happen to cross or antagonize them. Khodorkovsky's arrest underlines the consequences of the flawed reform process, and at the same time brings to the surface the high stakes and the "above-the-law" battle between the remnants of the former KGB and Russia's recently emerged class of billionaire oligarchs. Resentful of what they see as the illegal seizure of Russia's rich natural resources by this small circle of former "parasites," Putin's former KGB and Leningrad comrades have embarked on an unrestrained campaign to push out, or at least reign in and intimidate, the oligarchs.

Disregarding the impact on domestic and foreign investment, the hard-line authorities under President Putin have abused the government's power to reclaim these resources for the state, or in some instances for themselves. To resist invites a prison stay or worse. One former KGB official close to the Kremlin who heads a state-owned oil company, a rival of Yukos, put it this way: "Three days in Butyrke Prison and they will understand who is the master of the forest."

Putin's KGB associates, who now constitute one quarter of those in the Kremlin administration and their colleagues in the Prosecutor General's Office, continue to play tough. In addition to Lebedev and Khodorkovsky, the authorities have charged other Yukos officials with murder, attempted murder, embezzlement, fraud, and income tax evasion. Vladimir Kolesnikov, the deputy prosecutor general, issued the following admonition: "Let those who are not yet jailed think hard about what they are doing."

Despite the authorities' lack of restraint, in general, the public seems to approve of their actions. Indeed, surveys show that 70 to 90 percent of those polled favor the reconsideration, if not the renationalization, of privatized companies. People are angry at what they see as the theft of state resources and the underpayment for these valuable assets, and the oligarchs' image was not improved when one of them, Roman Abramovich, spent $400 million to purchase and upgrade the Chelsea Soccer Club of London, money that could have been put into a Moscow soccer club, complained Yuri Luzhkov, Moscow's mayor.

Even though Putin won the presidential election with a landslide, he still insists that oligarchs should stay out of politics, and in turn he would not revisit the legitimacy of the privatization process. Khodorkovsky, age 40, ignored Putin's guidelines and announced that he plans to retire from Yukos in 2008 (the year Putin must leave office) and may then run for president. Since Czarist times no entrepreneur has been able to operate without a patron high up in the government. With $8 billion at his disposal, Khodorkovsky may have come to feel that he no longer needs such a protector or "roof," as such a patron is referred to today. Should he succeed in his efforts, some of the other 16 Russians on Forbes Magazine's list of the world's richest billionaires might decide to do the same and also become involved in politics. The very thought is unsettling to those KGB types who regard the state
as above the law and the legitimate and eternal source of all power, be it under a czar, communist party leader, or president. In Putin's view, the oligarchs should align themselves with him.

Choosing who to support in this struggle is not easy. Virtually all the oligarchs helped themselves to the state's most valuable assets at a fraction of their value. As one oligarch admitted, "It was impossible to operate legally at the time." But the former KGB officials around Putin hardly deserve our sympathy, given their proclivity to using violence and abusing the law. Thus the oligarchs and the authorities harassing them deserve each other.

Aslund: Misguided Blame Game

Two leading Russian businessmen, Mikhail Khodorkovsky and Platon Lebedev, are imprisoned in their homeland. They were arrested for essentially two reasons. First, following a privatization deal in 1994, their investments were not as large as those they had committed themselves to. The case has been settled amicably, and Menatep, Yukos's "in-house bank," has paid damages. Second, the businessmen are accused of tax evasion. They took advantage of well-known loopholes used by many others that have held up in court. They might be accused of more substantial crimes, but to my knowledge prosecutors have not done so. The legal grounds for holding them under arrest are flimsy at best. The natural conclusion is that the real cause of their arrests is political, and that the problem with Khodorkovsky was that he was too powerful and too independent.

The issues at stake are infringement of democracy, property rights, and the rule of law. There is something distinctly distasteful about kicking those lying on the ground and suggesting that the budding authoritarians and vultures are morally right.

We have now experienced 14 years of postcommunist transformation, providing us with a great deal of empirical evidence. In the first stage, controlling inflation was critical, but after it had fallen below 40 percent a year, it was no longer key. Next liberalization and leveling the playing field appeared critical. Kazakhstan, Russia, and Ukraine in particular failed to achieve economic growth from 1995 to 1998, even though they had got inflation under control, because barter and implicit and explicit subsidies impeded competition. The financial crash of 1998 cleansed the economy of these aberrations, allowing private ownership to display its force.

Since 1999, something remarkable has happened. Russia, Ukraine, and other post-Soviet countries have excelled, with economic growth averaging more than 6 percent per year, while Central Europe has trailed behind with a growth rate of only 3 percent a year. The economic recovery of the countries of the former Soviet Union has been spearheaded by large, private corporations that have revived old Soviet energy and metallurgical companies. The new stars include Yukos, Sibneft, Tiumen Oil, Norilsk Nickel, Severstal, Novolipetsk, Russian Aluminum, Interpipe, and System Capital Management.

One approach to recapturing some of the economic rent the oligarchs seized during the initial privatization of state property would be to offer amnesty—that is, a statute of limitations—in exchange for significant supplemental payments to the state to compensate for the initial underpayments and undeclared taxes. Otherwise Russia will continue to be a country where the rule of outlaws will be more important than the rule of law.

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difficulties inherent in privatizing large enterprises later. Each privatization has to be negotiated for years, truncating choices, because vested interests have been activated and hardened and have to be paid off. While the interests themselves are respectable, many are wedded to corruption. Senior state officials tend to sit on the boards of several state companies, which generates substantial incomes that often exceed their official salaries. Postcommunist states with many remaining state enterprises have become cobwebs of corruption.

State revenue was not a major goal of postcommunist privatization, and rightly so. The earlier a corporation was privatized, the less was the state revenue, because the economic uncertainty and risks were great while the companies were not restructured. However, almost any owner could do more for enterprise restructuring than the state, and early privatization helped create a critical mass of reforms necessary for new economic growth. At that point both GDP and tax revenues start rising, easily outweighing the potential revenues from privatization. To take just one example, each year Yukos pays about 10 times more in taxes than its owners originally paid for the company. But GDP is, of course, far more essential for society than tax revenues. Economically, the loans for shares privatization has been a stunning success. Since 2000, Yukos, Sibneft, and Norilsk Nickel in particular have excelled in terms of output increase, efficiency, investment, transparency, stock price performance, and so on. Goldman’s allegations about their asset-stripping are simply not true.

The problem with the loans for shares privatization is thus not economic, but entirely political. Only about a dozen companies were involved, and the debate focuses on Yukos, Sibneft, and Norilsk Nickel. The new owners were outsiders who ousted entrenched, inefficient management teams. Furthermore, these companies were privatized to businesspeople who were closest to those in power at the time. Soon, however, they lost out. Today it is convenient for Putin’s people to attack them, while some in the administration want to acquire these companies cheaply. What we should be discussing is how state power, notably, the secret police, the prosecutors, and the courts, is being used to lower the prices of specific enterprises that are being targeted by entrepreneurs close to the Kremlin.

We should also take a leaf from American economic history. The U.S. robber barons were more similar to the Russian oligarchs than people realize. Half of them made their fortunes in the railways, and the secret of their success was their acquisition of land from the state for free. Does that not sound like loans for shares? The difference, however, was that the United States had no KGB. When President Theodore Roosevelt challenged John D. Rockefeller, he stopped at antitrust measures, using neither arbitrary punitive taxation (as advocated by Goldman) nor confiscation (seemingly being considered in the Kremlin). Many European properties derive from outright gifts from a monarch, many of them exempt from taxation until recently. Capitalism requires private property, and how it can be established is always a matter of politics. The secret of successful capitalism is to respect property rights regardless of how they originally emerged. The sooner that happens in Russia, the greater its economic growth will be.

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EVENTS

China and Russia: Two Leading Scholars Compare Transition Experiences

Chong-En Bai is associate professor at the School of Economics and Finance at the University of Hong Kong and a special term professor at Tsinghua University in Beijing. Sergei Guriev is at the New Economic School and a senior economist at the Centre for Economic and Financial Research (CEFIR) in Moscow. This year he is a visiting professor at Princeton University. Both recently participated in a conference in Beijing that compared the experience of transition in China and Russia (see the box). In an interview with Transition, they talked about those economic policy areas where China and Russia can learn from and cooperate with each other.

Q: What impact did the conference have on the participants’ thinking?

Bai: The conference reinforced the belief among Chinese participants that China can learn a great deal from Russia’s transition experience and that the euphoria of some Chinese policymakers and academics regarding economic development in China is unwarranted.

Guriev: Even before the conference, we all knew that Russia could benefit enormously by studying the Chinese transformation, but the conference exceeded our expectations. In some sense, Russia is moving faster than China in its transition to a market economy, but in many ways, China has accomplished much more than Russia. Differences in the speed and sequencing of specific reforms are the windows we can look through to learn from each other’s successes and failures. Modern development economics, and especially the institutional economics agenda on “development meets transition,” is skeptical about one-size-fits-all solutions. Each country may need a specific set of reforms and growth strategies; however, these growth strategies can only be designed by economists who are aware not only of institutions and initial conditions in
their own countries, but of experiences and best practices in other nations.

Q: What areas were identified where China and Russia can learn from and cooperate with each other?

Bai: The conference highlighted a few key areas where China can learn from Russia. Even though the bottom-up approach has worked well in China because local initiatives on some economic issues can succeed without national coordination, a number of economic measures require an integrated design and are not amenable to local experiments. In these cases, Russia's top-down approach would be useful in China. In this regard, Russia's experience is valuable to Chinese economists and policymakers. Contrary to the situation in China, the provision of economic advice to the government is more institutionalized in Russia, for example, it created the office of adviser to the president. This is important once a top-down reform approach is applied in many key policy areas.

Guriev: Identifying any areas where we cannot learn from each other is hard. Corporate governance—my special field—is a good example. Professor Bai and I are members of a task force, officially called the Corporate Governance Task Force for the Initiative for Policy Dialogue. This task force, chaired by Joseph Stiglitz and codirected by Patrick Bolton from Princeton University and myself, coordinates research on corporate governance in developing and transition economies and provides policy recommendations for governments and civil society in non-OECD countries. We were amazed to

Lessons of the Beijing Conference

China's much lower government expenditure relative to GDP explains in part its more favorable transition experience compared with that of Russia. Furthermore, the Chinese transition has focused on bottom-up development, whereas Russia has taken a more top-down approach, as Andrei Illarionov, adviser to the president of the Russian Federation pointed out, as he discussed China's and Russia's transition experiences with Wu Jinglian, one of China's most influential economists and senior fellow at the Development Research Center of the State Council. Wu, for his part, emphasized the difference in approach to privatization, referring to Janos Kornai's distinction between "organic development" and "accelerated privatization."

The exchange between these two prominent economic policy advisers concluded the first meeting between Chinese and Russian economists since 1989. The conference, Comparing Experience of Transition in China and Russia, was organized by the Stockholm Institute of Transition Economics and Comparative Economic Studies, one of the most influential Chinese economic journals, and was supported by the World Bank. Participants included leading Chinese and Russian policymakers and economists as well as World Bank staff. New research, including the results of several World Bank projects, was presented.

The presentations brought out a number of interesting findings from the two countries' transition experiences. Three researchers from the Centre for Economic and Financial Research (CEFIR) and the New Economic School in Moscow presented recent research on Russia. Konstantin Sonin analyzed Russia's Bankruptcy Law. A hybrid of U.K. and U.S. bankruptcy laws, it would probably work well in developed market economies, but in Russia, judicial discretion led to local capture by governors and enterprise managers. Ksenia Yudaeva found that competition with imports and foreign direct investment generally exerts a positive effect on domestic firms in Russia, and this effect can be even stronger if employees of Russian firms are more skilled. Oleg Zamulin analyzed regional variation in policy implementation, based on a survey designed by CEFIR in collaboration with the World Bank, to monitor administrative barriers to small businesses. The study identifies a number of factors that influence the extent of implementation, including local fiscal incentives, competition in local markets, political competition, and the strength of the small and medium business sector in the region or municipality.

In the session on China, Li Shi of the Chinese Academy of Social Sciences reported results from two surveys of small and medium enterprise employees in urban China, which concluded that performance improves once the right incentives are applied. Xie Ping of the People's Bank of China presented the first results of a study on financial corruption based on a survey of 3,561 banks, credit cooperatives, large and small businesses, and households in 29 cities. The study indicated that financial corruption is an important problem, that corruption in securities regulation is worse than in banking, and that increased transparency could help reduce financial corruption.

The final panel of the conference discussed some of the lessons to be learned from comparing economic development in China and Russia. Xu Chenggang of the London School of Economics and Tsinghua University presented a comparative study on legal systems in China and Russia. Ruben Enikolopov of CEFIR and Harvard University discussed a cross-country study of decentralization and political institutions, which showed that the strength of the national party system and whether local and state executives are appointed or elected determine the effect of decentralization on economic growth, quality of government, and public goods provision.
learn how much corporate governance mechanisms in
different countries depart from OECD blueprints and the
to which they differ from each other, while adapting,
sometimes inefficiently, to local conditions. We are aware
that implanting institutions may be counterproductive, and
therefore learning about each other's institutions in detail is
crucial, especially why and how they perform well or not so
well. In Russia, corporate governance institutions emerge
informally, despite government regulations, while in China,
the government succeeds in steering the development of
corporations by providing incentives both to corporate
insiders and to regional authorities. Some of these lessons
could certainly be applied in Russia.

Q: What role can independent economic research and policy
analysis play in promoting sound economic policies in both
countries?

Bai: Research institutes such as the National Center for
Economic Research (NCER) at Tsinghua University have
increasingly more important roles to play. The NCER, for
example, has a wide network of economists trained overseas
or locally and a network of policymakers. It is well connected
with the international economic research community and is in
a good position to cooperate with similar institutes in other
countries, including CEFIR. Its policy analysis could benefit
from the experiences and lessons of other countries. The
NCER can also provide a forum for researchers and
policymakers to communicate with each other directly. In
addition, the NCER serves as a platform for researchers to
have an indirect influence on economic policy through the
mass media.

Guriev: I was impressed by the willingness of Chinese
government officials to learn from both Chinese and Russian
economists. In Russia, the tradition of independent,
high-quality, research-based policy advice is also new, but the
impact of think tanks like CEFIR is becoming increasingly
important. We influence economic policy both directly through
policymakers and indirectly through public opinion and the
private sector. Some government officials are certainly willing
to listen to what economic research has to say.

Q: What was the single most important insight you took
away from the conference?

Bai: Together with my Chinese colleagues, I was impressed
by the quality of work done by the group of young Russian
economists who attended the conference. We concluded that
China needs to attract back more economists who were
trained overseas.

Guriev: I was impressed with the long-term growth strategy
China is successfully pursuing, and also how the Chinese
government was able to adopt a long-term view on economic
policy issues. And watch out: the Chinese economics
profession will be globally competitive much faster than
many overseas observers expect.

Russia 2015—Conference on Hot Topics
by Olga Mosina

Administrative reform, the relationship between business and
the state, and the streamlining of natural monopolies were the
major topics of the third international Russia 2015 conference,
held in Moscow in November 2003, and organized by the
Centre for Economic and Financial Research with the support
of Club 2015, a group of leading Russian managers and
entrepreneurs.

In his keynote address, Mikhail Dmitriev, first deputy
minister of economic development and trade, pointed out
that administrative reform has become a priority in Russia,
because the quality of government directly influences
economic development. Compared with countries with a
similar GDP per capita, Russia has a lower quality of
government that has remained virtually unchanged since
Soviet times. Thus improving it will be crucial for further
economic development. In addition to the problems
characteristic of transition economies, Russia—along with
many other countries—is now challenged by new economic
realities, such as globalization and the technological
revolution, and consequently must adapt its government
structure, making it more transparent, more manageable,
and more responsive.

Administrative Reform

Administrative reform is not just about improving public
administration, but in a broader sense it includes
strengthening democratic institutions and political parties
and reforming the judiciary system, said Dmitriev. He then
detailed some ideas about what reform might entail. For
example, improving the work of the executive branch of
government includes reviewing the functions of individual
organizations, changing decisionmaking mechanisms, and
reforming the budget process. He also envisaged the reform
creating a power structure with a more streamlined
hierarchy and clearer rules of subordination and
responsibility. In the new structure, a few key ministries
would decide on policy and strategic issues and would report
directly to the prime minister. Controlling, auditing, and
managing state property would be left to specialized
agencies subordinated to the ministries. Dmitriev emphasized that administrative reform would be based on the assumption that the state does not interfere in economic activity, and thus state ownership would be reduced to the bare essentials.

**Relationship Between Business and the State**

Igor Akhmerov, financial director of the oil company TNK-BP, talked about the government's influence on the growth of oil production in Russia. A large gap exists between export prices, which are highest if the oil is transported through the pipeline network, and lower domestic prices. As the state owns the pipeline network and its further development therefore depends on the government, and because the oil companies need to export at least 25 percent of their production to remain commercially viable, the planned 15 percent annual production increase will depend largely on the state's actions.

Alexander Auzan of the National Project Institute explained the Yukos affair in terms of failed expectations and the need for a new social contract. A social contract is defined as an exchange of expectations. In the Russian case, the "old" social contract refers to an unspoken agreement between large businesses and the state, in which businesses agreed not to be involved in politics and the state agreed not to interfere with the results of privatization. The old social contract failed because it was too weak and could not incorporate new interest groups seeking a redistribution of assets.

Leonid Grigoriev from the Analytical Centers Association observed that corporate governance theory is not applicable to owners who acquired their assets by means of nonmarket methods, for instance, for free, and are consequently facing high political risks. Thus the owners try to attain a high rate of return that could be as much as 40 percent and confine investment to a few sectors, including retail sales and exports of natural resources. As a result, the flows of investment into manufacturing, infrastructure, and venture projects are scarce, endangering President Vladimir Putin's pledge to double Russia's GDP in seven years.

**Gasprom Reform on the Agenda**

In recent years Russia has embarked on reforms of the electricity and railroads monopolies, and reforms of the gas sector are being debated. Viktor Kudriavi, deputy minister of energy, considers that reforms in the power sector have not taken the peculiarities of the Russian energy system into account, including the existence of two parallel markets for electricity and heat and the differences between companies working with regulated and unregulated fuels. In his view, power failures in North America and Europe have proved that outages can potentially occur wherever "the market goes before technology." In his opinion, creating three to five large, vertically integrated companies could facilitate the inflow of the needed investment into the industry.

Gas sector reformers can learn a lot from the power and oil sectors, said Al Breach, chief economist of Brunswick UBS. Reform in the latter has created competition in production and a state monopoly in transportation, and the power sector is following the same model. Similarly, gas transportation should be split from production, and the pipeline network should remain state owned, because splitting up and privatizing the network could create opportunities to control and abuse the supply. One lesson learned from oil sector reforms is that a well-built pipeline network should be in place before reform starts to avoid a gap between export prices and domestic prices.

By contrast, Nikolay Kovarsky of Club 2015 voiced his doubts that the gas sector could learn anything from the power sector. In his view, the gas sector lacks two significant features that defined the path of the power sector reform: a team of liberal, outsider reformers and an open discussion of the reform, which has somewhat balanced the interests of different stakeholder groups. Nor can Gazprom follow the reform scenario of the railroad sector, because it lacks a professional and unified team of insiders who could initiate reforms. Hence the gas sector can only be reformed under the pressure of market forces, which could happen when a large number of customers are ready to pay at least $50 per 1,000 cubic meters of gas and are prepared to demand transparency in Gazprom's price setting. A reform-minded head of Gazprom would certainly facilitate the reform process.

Bill Thompson of the OECD noted that in his personal view, talking about lessons from the power sector reform is difficult, because they have just begun. He thought that distinguishing between two issues—setting the rules of the game and acquiring assets—was important. He believed that the "obsession" with gaining control over assets has been a huge distraction from the main reform objective, which should be devising and setting the rules for the market. For example, even though power sector reform is already under way, low voltage grid pricing and regulation remain vague, and the emergence of a strong, independent regulator is still in doubt.

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BEST PRACTICE

Balcerowicz, Gaidar, Summers
Leading Practitioners Discuss Their Transition Experiences

Three leading, heavyweight economists, Leszek Balcerowicz, Yegor Gaidar, and Lawrence Summers, recently spoke at the World Bank's Practitioners in Development lecture series. All three presented important points related to the transition process and shared their perspectives on economic development. Excerpts from their presentations follow.

Leszek Balcerowicz

Transition describes the movement of an economy from its initial condition to final outcome. The key challenge for policymakers is to accelerate the process while minimizing turbulence. Initial conditions in a country play an important role in the final outcome of its transition, for example, China's were better than Russia's, thus China's transition to a market economy has been less difficult. In the late 1980s, communist societies were spending excessively on defense, police controls, and welfare. Communism deprived people of their economic liberties, which helped make their governments wasteful both economically and ecologically. Industrial sectors traditionally used excessive materials and energy in goods production, which reduced the value added for each worker; the development of infrastructure varied; and most trade was conducted with other communist countries. Private entrepreneurship was considered a crime in most communist countries. The industrial sector was oversized, and in most countries the agriculture sector was large. School enrollment was generally high, but poor economic conditions prevented high school graduates from using their skills. A thriving black market existed. When Poland removed the shackles of communism, the country immediately had to address a large foreign debt problem.

The individual countries fared differently during their transition to a free market system. The fastest growth occurred in Central Europe. All the formerly communist countries were able to lower inflation, and those countries that grew the fastest were the most effective in reducing inflation. Countries differed widely in attracting foreign direct investment. The transition period has produced a mixed record of improvement in health. The environment has improved as a result of economic growth. The reason that some countries improved more than others can be traced back to their initial conditions, access to markets, location, and extent of reforms. Countries that have liberalized more have less income inequality. Countries considered economic tigers have low taxes and low corruption. Those countries that democratized faster also implemented market reforms more quickly.

Yegor Gaidar

Why hasn't Russia followed China's gradual path to a market-based economy, a path that bypassed much of the volatility the former Soviet Union (FSU) experienced? The political and economic regimes in the FSU were closely inter-related, just like in Iraq. When the totalitarian regime in Iraq was destroyed, so was law and order in Iraqi society. In the FSU, grain procurement declined following the collapse of the Soviet government in 1991, and the threat of economic collapse hung in the air. Gradual transitions are obviously less painful, but Russia had few choices in 1991. Developing sound institutions was an immediate concern at that time. Russia had no functioning central bank, customs service, or tax system following the collapse. It needed time to shed the old system in order to create sound, new institutions. This hurdle has been underestimated, because passing legislation and creating the infrastructure was relatively easy. However, a significant part of institution building is based on culture, and Russia needed time to overcome 75 years of socialism. The economy went into recession following the political collapse. Industrial production declined, which had a long-lasting effect on the economy. Poland, by contrast, experienced a decline in production following the fall of its government, but economic recovery started in the third year of transition. The Russian leadership assumed the economy would recover in a similar fashion, but the Russian recession proved to be longer and deeper.

The recovery that started in 1999 will depend on the strength of institutions, which themselves are determined by the government's stability, protection of property rights, and implementation of tax reform. All these take time, but the trends in investment growth are encouraging. Nevertheless, the domestic and foreign investment community needs more reassurances.

Larry Summers

Several key development lessons have been gained from experiences during the 1990s.

- The central lesson is that the quality of institutions and the efficacy of political administrations are central to development. Well-executed policies that are 30 degrees off are more effective than poorly executed policies that are right on. This was the case in the transition countries, where things taken for granted in the West were not established in places such as Russia. The institutional capacity necessary to carry out the most basic functions in a society has more to do with success or failure in economic development than previously acknowledged. Combating corruption in this respect is important. Since President Wolfensohn pushed this issue,
things are getting better. Part of the solution may lie in building linkages between institutions within a society so as to develop capacity and reduce corruption.

- History is more determined by financial crises and their aftermath than one would like to suppose. Policy errors and bank-run mentalities have played a role in many of the emerging market crises and have effected those economies unduly. Averting future crises has to be at the forefront of the development agenda and is more important than mitigating a crisis once it begins. Today several dozen developing countries are borrowing money at spreads of between 300 and 600 basis points. The current capital market situation does not make a lot of sense. Many of the crises in the 1990s were precipitated by speculative measures enacted by the developing counties themselves to attract short-term capital.
- Policy reforms are more probable in the first year after a crisis than at any other time.
- Careful reflection on the implications of fungibility in development assistance is needed. The World Bank was financing projects that client countries had decided not to finance with their own money, meaning that the net value of the project was marginal to begin with.
- A constituency has to be built in the United States for development. Many are worried about the environment, global warming, and increasingly AIDS, but are significantly less concerned about the billions of people who live in poverty. This is a large political challenge, and the goals of the Bank and the development community depend on the task of instilling a passion for these issues within the United States.

Leszek Balcercowicz is president of the Polish National Bank, former deputy prime minister of Poland, and former finance minister; Yegor Gaidar is director of the Institute for the Economy in Transition in Moscow, Russia's former acting prime minister, and former minister of finance and the economy under President Boris Yeltsin; and Larry Summer is president of Harvard University, former secretary of the Treasury in the Clinton administration, and former chief economist of the World Bank.

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Broad improvements in human welfare will not occur unless poor people receive wider access to affordable, better quality services in health, education, water, sanitation, and electricity. To improve those services, says the *World Development Report (WDR)* 2004, the voices of the poor have to be listened to by the politicians and other decision-makers—their opinions, incentives, and movements have to be taken account.

Key services often fail poor people in terms of access, quantity, and quality. This imperils a set of development targets known as the Millennium Development Goals, which call for a halving of the global incidence of poverty by 2015 along with broad improvements in human development. Efforts by developing and transition countries to make services work have encountered spectacular successes and miserable failures. The main difference between success and failure is the extent to which poor people themselves are involved in determining the quality and quantity of the services they receive.

Just as a well-functioning democracy does not guarantee that poor people will benefit from public services, some one-party states achieve good health and education outcomes, even among the poor. Cuba has among the best social indicators in Latin America, and with much lower revenues than its peers, such as Chile and Costa Rica, but Cubans have poor access to other services. While China reduced infant mortality dramatically and achieved nearly universal primary school enrollment, it did not openly report early cases of severe acute respiratory syndrome (SARS) in 2002, thereby making its further spread almost inevitable.

The citizen-policymaker link is working either when citizens can hold policymakers accountable for public services that benefit the poor or when policymakers care about the health and education of poor people. These politics are pro-poor. What can be done when the politics are not pro-poor? Societies can still introduce various intermediate elements to make public institutions more accountable. Participatory budgeting in Brazil started as a way for citizens to participate in budget formulation and then hold the municipal government accountable for executing the budget. Perhaps the most powerful means of increasing the voice of poor citizens in policymaking is better information, but information is not enough. People must also have the legal, political, and economic clout to pursue their demands.

In the former Soviet Union, state and party control over public service providers ensured compliance with delivery norms for free services. Services worked and levels of health status, particularly for the poorer Central Asian republics, were much higher than for other countries at their level of income. However, the breakup of the Soviet Union weakened
According to World Bank President, James D. Wolfensohn: “Services work if they include all people, when girls are encouraged to go to school, when pupils and parents participate in the schooling process, when communities take charge of their own sanitation. They work when we take a comprehensive view of development—recognizing that a mother’s education will help her baby’s health, that building a road or a bridge will enable children to go to school.”

Poor people should stand at the center of service provision. That happens if they can avoid poor providers while rewarding good providers with their custom, and if their voices are heard by politicians, that is, when service providers have incentives to serve the poor. The WDR 2004: Making Services Work For Poor People documents three ways in which services can be improved:

- Increasing poor clients’ choices and participation in service delivery so that they can monitor and discipline providers. School voucher schemes, for example, increase clients’ power over providers and have substantially increased enrollment rates. Community-managed schools that were regularly inspected by parents lowered teacher absenteeism and raised students’ test scores.

- Raising poor citizens’ voice through the ballot box and making information widely available. Informing people about the quality of the water, health, education, and transport services they were receiving compared with neighboring districts increases the demand for better public services and forces politicians to act.

- Rewarding the effective and penalizing the ineffective delivery of services to poor people. In the aftermath of the civil war, Cambodia’s government paid primary health providers in two pilot districts based on their performance, that is, how healthy their clients were as measured by independent surveys. Health indicators in those districts improved relative to other districts, and people there were more inclined to use health services.

Providing communities with health care, education, and other services has been a contentious issue in many countries, with government services pitted against large-scale privatization. The WDR notes that while public services are frequently problematic, concluding that the government should give up and leave everything to the private sector would be wrong. If individuals are left to their own devices, they will not provide the levels of education and health that they collectively want. Indeed, no country has achieved significant improvements in child mortality rates and primary education without government involvement.

Furthermore, private sector participation in health, education, and infrastructure is not without problems, especially in relation to reaching poor people. The extreme position that the private sector should do everything is clearly not desirable. The only issue that really matters is whether the mechanism that delivers key services strengthens poor people’s ability to monitor and discipline providers, raises their voice in policymaking, and gets them the effective services they need for their families.

No one size fits all. The type of service delivery mechanism needs to be tailored to the characteristics of the service and the circumstances of the country. If the service is easy to monitor, such as immunization, and it is in a country where the politics are pro-poor, such as Norway, then the central government can deliver it directly or contract it out. But if the resources are likely to be diverted to the well-off by way of patronage and the service is difficult to monitor, such as education, then the client’s power needs to be strengthened as much as possible. Means tested voucher schemes; community-managed schools; and transparent, rules-based programs are likely to work for poor people. The report concludes that the role of information is overwhelming as a stimulant for public action, as a catalyst for change, and as an input to making other reforms work.

The WDR 2004 was prepared under the management of Shanta Devarajan, chief economist of the Human Development Network, and was co-directed by Ritva Reinikka, research manager. For more details go to http://econ.worldbank.org/wdr/wdr2004/text-30023/.

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Hidden Social Responsibility

“Drugs are so expensive, if you rob the drug store, please bring back some laxatives for my husband.”

From the Hungarian magazine Hócipő
16th Annual Bank Conference on Development Economics (ABCDE)
May 3-4, 2004, Washington, D.C., United States

Inauguration Address: James D. Wolfensohn, president, World Bank, The Future of Development: The Next 10 Years
Keynote Address: François Bourguignon, chief economist and senior vice president, World Bank, Global Distribution and Redistribution
Lessons of Experience: A Half Century of Development, Richard N. Cooper, Harvard University; The Evolution of Thinking on Development: Theory and Policy, Gustav Ranis, Yale University
Economists' Forum: Firm Dynamics and Macroeconomic Performance; Environmental Problems in Developing Countries; Modeling Global Prospects; Land Institutions for Pro-Poor Growth; Social Cohesion and Poverty Reduction
Keynote Address: Markets, Capital Markets, and Globalization, Vernon Smith, George Mason University
Behavioral Economics: Development Economics through the Lens of Psychology, Sendhil Mullainathan, MIT
Infrastructure and Development: Infrastructure and Development, Remy Prud'homme, University of Paris.
Trade and Development: Trade Liberalization in a Globalizing World, Riccardo Faini, Universita di Roma Tor Vegeta
Economists' Forum: Making Services Work for Poor People; International and Intranational Barriers to Trade; Pro-Poor Growth: What Is It and How Do We Achieve It? Access to Financial Services; Development Data for Improving Measurement and Policy

The conference is open to World Bank and IMF staff and to invited guests.


6th Annual Bank Conference on Development Economics (ABCDE)—Europe
May 10-11, 2004, Brussels, Belgium

Welcome: Jean-François Rischard, vice president for Europe, World Bank; Guy Verhofstadt, prime minister, Belgium; Marc Verwilghen, minister of development cooperation, Belgium
Opening Speech: François Bourguignon, chief economist and senior vice president, World Bank
Trade Flows: Socially Responsible Trade Integration: A Political Economy Perspective, Thierry Verdier, DELTA, France
Capital Flows: Foreign Direct Investment and Technological Transfer: Integration of Indian and Chinese Industries into International Supply Chains, John Sutton, London School of Economics
Roundtable: Pascal Lamy, commissioner for trade, European Commission; Benoit Ouattara, minister for trade, enterprise promotion, and handicrafts, Burkina Faso; Shri Arun Jaitley, minister of commerce and industry, India (tbc)
Keynote Address: Ali Babacan, minister of state for economy, Turkey
Keynote Address: Joseph E. Stiglitz, Columbia University, United States
Closing Session: Romano Prodi, president, European Commission; Guy Verhofstadt, prime minister, Belgium; James D. Wolfensohn, president, World Bank; Hilde Johnson, minister of international development, Norway

The conference is open to World Bank and IMF staff and to invited guests.


WIDER Conference on Making Peace Work
June 4-5, 2004, Helsinki, Finland

The conference aims to increase economists' focus on conflict issues and to facilitate interaction between economists and other social scientists working on conflict and on postconflict reconstruction. Conference topics will include
• Violent conflict and its causes
• Conflict prevention and peace keeping
• Postconflict reconstruction
• Foreign aid to conflict and postconflict countries
• Poverty and the human development effects of conflict.

The conference will be held in English (no simultaneous translation is available).


Social Economics: A Paradigm for a Global Society—11th World Congress of Social Economics
June 8-11, 2004, Albertville, France

Organizer: Association for Social Economics. Participants do not have to be members of the association.
Social economists think about economic affairs in ways substantially different than mainstream economists. Social economists view the economy as a social, cultural, and political institution. Social economics questions the traditional assumptions of *homo economicus*, or rational economic man, and recognizes the interconnectedness of people’s lives and work—both paid and unpaid. The Association for Social Economics (see http://www.socialeconomics.org) was founded in 1941 to challenge the emerging dominant paradigm of neoclassical economics; to broaden the scope and methodology of economics; to encourage the pursuit of economic justice; and to inspire research and analysis on policies to eradicate poverty, unemployment, hunger, and inequality and to promote an economy that values human beings and allows them to live with dignity.


**Innovation, Industrial Dynamics, and Structural Transformation: Schumpeterian Legacies**

June 9-12, 2004, Università Bocconi, Milan, Italy

Organizer: International J. A. Schumpeter Society.

The conference will focus on technology and innovation in companies and in the economy, the role of entrepreneurship, the organization of firms and industries in innovative activities, innovation and the evolution of sectors, and the relationship between technological change and the structural transformation of the economy.

The conference encourages contributions
- On knowledge, the innovation process, the organization of innovative activities in companies and sectors, innovation and the dynamics and evolution of firms and industries, technological change and the structural transformation of the economy, public policy supporting innovation and the diffusion of technology
- In a range of fields, such as economics, management, sociology, history, geography, science, and technology
- Following different approaches and theories
- From researchers active both in developing economies, Eastern Europe, and East Asia, as well as in advanced economies.

**Information:** http://www.schumpeter2004.uni-bocconi.it/.

**Transitions and Inequality in the 21st Century**

September 9-11, 2004, University of Utah, Salt Lake City, United States

Organizer: University of Utah in Salt Lake City

Objective: To bring together academics, analysts, and policymakers with interests in the Middle East and Central Asia who wish to network and share research endeavors.

The conference will include at least two prominent keynote speakers: Dr. Michael Collins Dunn, editor of the *Middle East Journal* of the Middle East Institute in Washington, DC.; and Prof. Shirin Akiner, lecturer in Central Asian Studies at the School of Oriental and African Studies at the University of London. There will be an estimated 44 conference sessions and a special plenary discussion panel on The Post-9-11 World. Other attractions include two complementary meals, an evening of Middle Eastern and Central Asian dance and music performances, and the screening of films and documentaries.

Selected papers from the 2003 conference were subsequently provided to editors of the *Journal of Muslim Minority Affairs* and *Critique: Journal of Critical Studies of the Middle East*.

**Information:** 2004 Middle East and Central Asia Conference Committee, c/o Political Science Department, 260 S. Central Campus Dr., OSH Building, Room 252, University of Utah, Salt Lake City, UT 84112, United States; tel.: 1-801-581-6047, fax.: 1-801-585-6492.

**Growing Inequality in China: Causes, Consequences, and Responses**

September 25-26, 2004, Cornell University, Ithaca, New York, United States

Organizers: Ravi Kanbur, Cornell University; Guanghua Wan, World Institute for Development Economics Research; and Xiaobo Zhang, International Food Policy Research Institute.

The object of this conference is to take stock of growing inequality in China, focusing on its causes, its consequences, and policy responses to it in the future. It will bring together the best international research on the subject—in theoretical, empirical, and policy analysis.

**Information:** http://www.wider.unu.edu/welcome.htm.

**30th Annual Conference of the European International Business Academy on Enlarged European Union: Challenges to International Business and Management**

December 5-7, 2004, Grand Hotel Union, Ljubljana, Slovenia

Organizer: Centre of International Relations, Faculty of Social Sciences, University of Ljubljana.

The organizers invite both theoretical and empirical papers that may contribute to an understanding of the consequences and challenges of the EU enlargement. Suggested topics include the following:
- Competitiveness of the enlarged EU and challenges of adjustments after the enlargement—company and government perspective
- International business and related economic theories
• Globalization versus regional economic integration
• Knowledge management, technology transfer, research and development, and spillover effects in multinational companies
• Internationalization strategies of multinational companies
• Management and organization of multinational companies
• International business and culture—ethics and related marketing issues
• International finance and accounting
• Legal and policy issues
• Emerging markets and transition economies

• Small countries and companies in the EU and the global economy.

 Papers on other aspects of international business are also welcome. All papers or contributions must be submitted no later than July 15, 2004.

 Information: Kardeljeva ploščad 5, SI-1000 Ljubljana, Slovenia; tel.: 3861-5805-190, fax: 3861-5805-109, email: marjana.jevsenak@uni-lj.si, URL: http://www.fdv.uni-lj.si/anglescina/default.btm.

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Working Papers

http://econ.worldbank.org/

Eric Edmonds
Household Composition and the Response of Child Labor Supply to Product Market Integration: Evidence from Vietnam
WPS 3235, March 3, 2004

Limin Wang and Hanan Jacoby
Environmental Determinants of Child Mortality in Rural China: A Competing Risks Approach
WPS 3241, March 12, 2004

Serdar Yilmaz, Jean-Philippe Meloche, and François Vaillancourt
Decentralization or Fiscal Autonomy? What Does Really Matter? Effects on Growth and Public Sector Size in European Transition Countries
WPS 3254, March 18, 2004

Jeffrey R. Vincent
Detecting Illegal Trade Practices by Analyzing Discrepancies in Forest Products Trade Statistics: An Application to Europe, with a Focus on Romania
WPS 3261, April 7, 2004

Other World Bank Publications

Marie-Renee Bakker and Alexandra Gross
Development of Non-Bank Financial Institutions and Capital Markets in European Union Accession Countries

Francis J. Conway, Brien E. Desilets, and Peter B. Epstein
Intergovernmental Fiscal Relations in Central and Eastern

Eric Edmonds, and Nina Pavcnik
Product Market Integration and Household Labor Supply in a Poor Economy: Evidence from Vietnam
WPS 3234, March 3, 2004
Europe: A Source Book and Reference Guide for Trainers and Practitioners
March 2004
Gudrun Kochendoerfer-Lucius and Boris Pleskovic, eds.
Service Provision for the Poor, Public and Private Sector Cooperation

Mojmir Mrak, Matija Rojec, and Carlos Silva-Jauregui, eds.
Slovenia: From Yugoslavia to the European Union

Merlinda D. Ingco and John D. Nash, eds.
Agriculture and the WTO: Creating a Trading System for Development

Developing countries have a major stake in the outcome of trade negotiations conducted under the auspices of the WTO. This volume explores the key issues and options in agricultural trade liberalization from the perspective of the developing countries. Leading experts in trade and agriculture from both industrial and developing countries provide key research findings and policy analyses on a range of issues, including market access, domestic support, export competition, quota administration methods, food security, biotechnology, intellectual property rights, and agricultural trade under the Uruguay Round Agreement on Agriculture.

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Evzen Kocenda and Jan Svejnar
Ownership and Firm Performance after Large-Scale Privatization
DP4143, December 2003

This publication analyzes the effect of ownership on postprivatization performance in a virtually complete population of medium and large firms privatized in a model large-scale privatization economy (the Czech Republic). The authors find that concentrated foreign ownership improves economic performance, but domestic private ownership does not, relative to state-owned firms. Foreign firms engage in strategic restructuring by increasing profits and sales, while domestic firms reduce sales and labor cost without increasing profits. Ownership concentration is associated with superior performance, thereby providing support to the agency theory and contradicting theories stressing the positive effects of managerial autonomy and initiative. The results are also consistent with the thesis that the presence of a large domestic stockholder may not result in superior performance if this shareholder "loots" the firm. The authors find support for the hypothesis that firms restructure by lowering and later increasing employment. The state as a holder of the golden share stimulates profitable restructuring, while pursuing a socially understandable employment objective in a period of rising unemployment. Thus the results depict the state in transition economies as a much more economically and socially beneficial agent that many recent theoretical studies.

Francesca Pissarides, Miroslav Singer, and Jan Svejnar
Objectives and Constraints of Entrepreneurs: Evidence from Small and Medium-Size Enterprises in Russia and Bulgaria
DP4142, December 2003

The authors analyze the principal objectives and constraints of small and medium enterprises using data from a survey of 437 CEOs of small and medium enterprises in Bulgaria and Russia. The CEOs hold similar views and identify a small number of specific constraints as being the most important ones. The constraint on external financing is a particularly serious one, while payments for licenses or government services (insecure property rights) are not. The analysis indicates that characteristics of the entrepreneur, the firm, and the firm's environment are important, but that the determinants of which constraints are most important vary. Both the disruption of production and the financial constraints after the abandonment of central planning appear to have been more ubiquitous in Russia than in Bulgaria.

Mark Gradstein
Inequality, Democracy, and the Emergence of Institutions
DP4187, January 2004

This paper considers the emergence of institutions as a political outcome, arguing that the support for protection of private property rights is stronger the higher the economy's aggregate income and the more equal its distribution. When these conditions initially hold, the politically influential, rich elite may prefer to relinquish its power through democratization to commit future policymakers to the enforcement of private property rights, thereby ensuring larger investment and growth. In a very unequal economy, however, this growth-enhancing democratization will not take place. These conclusions are shown to be consistent with historical and cross-country evidence.
Enrico C Perotti and Luka Vesnaver

**Enterprise Finance and Investment in Listed Hungarian Firms**
DP4194, January 2004

This paper studies the financing of enterprise investment in listed Hungarian firms during the first years of transition. These firms were selected for listing on the exchange and presumably had better access to external capital. In particular, the authors look for evidence of financial constraints that limit real investment and attempt to identify the effects of different ownership and governance structures. The empirical results indicate the presence of significant financial constraints even among the better known firms from 1992 to 1998. Consistent with studies from other countries, the authors find evidence that foreign-owned firms do not suffer from limited external finance. Previous leverage can strain investment, suggesting that hard budget constraints are binding. State ownership does not alleviate capital constraints, and larger firms do not appear to be less constrained than smaller firms, which contrasts with the evidence in Western countries.

Nauro F Campos and Dean Jolliffe

**After, Before, and During: Returns to Education in Hungary (1986-1998)**
DP4215, February 2004

How valuable are the skills acquired under socialism in a market economy? This paper throws light on this question using unique data covering the years before and during transition (1986-98) for about 3 million Hungarian wage earners. The authors find that returns to a year of schooling increased by 75 percent from 6.4 percent in 1986 to 11.2 percent in 1998. They also find that the private sector rewards formal education more than the public sector, and in terms of gender, even though women had greater returns to schooling than men in 1986, by 1998 this difference had been eliminated.

Jan De Loecker and Jozef Konings

**Creative Destruction and Productivity Growth in an Emerging Economy: Evidence from Slovenian Manufacturing**
DP4238, February 2004

In most transition countries, the aggregate-level evidence suggests that most industries are just destroying jobs because of the legacy of communism, under which excessive employment levels were the norm. This paper sheds light on whether the transition process in Slovenian manufacturing has been one of just destruction or, in contrast, one of creative destruction. To this end the authors start by documenting gross job flows for the Slovenian manufacturing sector between 1994 and 2000. In contrast to slowly reforming transition economies, where the transition process in manufacturing is characterized by little job creation and high job destruction, they find a process of both substantial job creation and destruction for Slovenian manufacturing. This indicates that restructuring in Slovenia involves a substantial reallocation process. The authors find higher job reallocation in private and small firms where the contribution of entry and exit to the job reallocation process is higher. They use the Olley-Pakes methodology to estimate total factor productivity and show that it has increased in most sectors, driven mainly by existing firms becoming more efficient and by the net entry process, that is, the entry of more efficient firms.

Andreas Irmen

**Extensive and Intensive Growth in a Neoclassical Framework**
DP4266, February 2004

Extensive growth based on the expansion of inputs is likely to be subject to diminishing returns, therefore it is often viewed as having no effect on per capita magnitudes in the long run. This paper argues that periods of extensive growth resulting from capital accumulation may be precursors to periods of intensive growth during which output per unit of input grows through endogenous technical change. Such a sequence of stages of development occurs as capital accumulation affects the incentives to engage in labor-saving technical change. A steady rise in the capital-labor ratio affects the relative scarcity of factors of production and their expected relative prices and induces innovation investments.

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Bart Capéau and André Decoster
Rise or Fall of World Inequality—A Spurious Controversy?
Discussion Paper No. 2004/02, January 2004

Anthony Shorrocks and Guanghua Wan
Spatial Decomposition of Inequality
Discussion Paper No. 2004/01, January 2004

This paper reviews the theory and application of decomposition techniques in the context of spatial inequality. It establishes some new theoretical results with potentially wide applicability and examines empirical evidence drawn from a large number of countries.

Other Publications

Ray Barrell, Dawn Holland, and Olga Pomerantz
Integration, Accession and Expansion

The imminent enlargement of the EU has raised a number of important policy issues in both incumbent and acceding members. This volume draws together research findings on the key issues related to the occasion—macroeconomic policy, migration, agricultural policy, removal of barriers to capital flows—thereby providing a context in which to analyze the impact that the enlargement is likely to have on both incumbent and acceding members of the EU. The authors draw on parallels to previous enlargements where appropriate and discuss in depth the Single Market Program, the benefits and perils of European Monetary Union membership, and the Common Agricultural Policy. They also examine the impact that enlargement is likely to have on capital flows and migration, drawing on a growing body of existing research in these key areas. Policy recommendations are offered throughout the text.

To order: http://www.niesr.ac.uk/

Carsten A. Holz
China's Industrial State-Owned Enterprises:
Between Profitability and Bankruptcy

Jayesh Kumar
Does Ownership Structure Influence Firm Value?
Evidence from India
Indira Gandhi Institute of Development Research, Mumbai, India, 44 pp.

To order: tel.: 91 98-194-14866, fax: 91 22- 2840- 2752, email: jayesh@igidr.ac.in.

Jayesh Kumar
Corporate Governance and Dividends Payout in India
Indira Gandhi Institute of Development Research, Mumbai, India, 34 pp.

This paper investigates the association between corporate governance and dividend payouts for a panel of Indian firms during 1994-2000. It explains the differences in the firms' dividend payout behavior in terms of firms' financial structure, investments opportunities, dividend history, earning trends, and ownership structure. It finds a positive association of dividends with earning trends and investments opportunities. The paper finds the debt-equity ratio to be negatively associated, whereas past investment opportunities exert a positive impact on dividends.
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