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Iraq: Construction Site of the Century

Iraq is a transition economy of the Middle East. The task is to transform the economy—dominated by central planning, price controls, and extensive state ownership—into a genuine market economy. The process will take years and billions of dollars. After security has been achieved and remnants of the former regime have been eradicated, a postwar economic strategy needs to be developed and implemented.

Iraq can be seen as the newest addition to the group of transition economies. Baathist Iraq modeled its economy on Eastern European communism, including central planning, price controls, and extensive state ownership. In the 1960s Iraq collectivized its agriculture. Just like the transition economies of the 1990s, Iraq faces immense economic challenges.

Iraq is endowed with abundant economic and human resources and has the second highest proven oil reserves in the world at around 112 billion barrels (after Saudi Arabia with 262 billion barrels). But the 35 years of Baathist rule; the nationalization of the country's main export commodity, oil; the extensive central planning of industry and trade; the 1982–88 war against Iran; and the invasion of Kuwait, which precipitated the 1991 Gulf War, have devastated the economy. GDP has shrunk by 75 percent since 1979. According to World Bank figures, the number of underweight children soared from about 10 percent of children in 1990 to about 20 percent in 2000, while primary school enrollment fell from nearly 95 percent to about 75 percent during the same period. Child and maternal mortality have also worsened significantly. According to Yale University economist William Nordhaus, living standards have fallen by 90 percent in the last 23 years. About 60 percent of the population became dependent on humanitarian food aid, partly because of economic sanctions imposed after Iraq's invasion of Kuwait in 1990.

Because of the lack of investment and access to the latest technology and the damage resulting from years of war and

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Will EU Money Be the Tune for New Members' Catch-Up Song?

by Katinka Barysch

The new member states should not expect EU money to lead to miracles. The most important ingredients of catch-up growth are a stable macroeconomic framework; supply-side policies that help markets to adjust quickly; and a well-trained, flexible workforce. EU aid will only make a positive contribution to growth in the region if it is firmly integrated into such an environment.

On May 1, 2004, 10 new members will join the EU, 8 of them relatively poor Central and Eastern European countries. Bulgaria and Romania may join in 2007. Even though eastward enlargement will increase the number of people in the EU by 25 percent, the new members together will add no more than 5 percent to the EU's GDP, perhaps twice that if GDP is measured on the basis of purchasing power parity (PPP) exchange rates. According to Eurostat statistics, on average, GDP per head at PPP in the new Eastern European members will be around 40 percent of the current EU average, and only about 33 percent at alternative PPP estimates and 20 percent if GDP is measured at market exchange rates. In short, the new members are generally much poorer than the current EU members.

The income gap has fueled concerns in both the existing member states and the accession countries. The current members fear that they could be swamped by imports from the low-cost accession countries and that firms will relocate to the new member states, where labor is much cheaper and social and environmental standards are less demanding. Countries such as Austria and Germany are also concerned that an influx of workers from the East could increase unemployment and social

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sanctions, Iraq's infrastructure disintegrated. Before the war started earlier this year, this country of 23 million people had only 675,000 fixed telephone lines. Mobile phones were banned except for government officials and the army. As a result, Iraq has become one of the world's least developed economies. Estimates indicate that an investment of around $1 billion will be required to repair and rebuild the telecommunications infrastructure alone. A country that could have been a model of development for the Arab world turned out to be one characterized by economic decline, mismanagement, and massive corruption.

Estimates of Iraq's financial obligations vary widely, but the Center for Strategic and International Studies estimates that the figure could be as high as $383 billion. That includes $127 billion worth of debt, $57.2 billion in pending contracts, and $199 billion in actual and potential Gulf War compensation claims. Reconstruction bills could top $20 billion a year for the immediate future. Compare those figures with an annual economy that could generate anywhere between $29 billion and $59 billion per year, including $18 billion a year in oil sales, and it is obvious that any Iraqi government will have a hard time meeting these obligations. The United States has already has put out feelers suggesting that some of these obligations should be written off, others restructured.

Several blueprints are circulating in Washington that outline sweeping reforms of Iraq's economy based on free market principles. The major points of these documents are as follows:

- **Privatizing state-owned enterprises.** Some insolvent Iraqi companies should be liquidated, others sold, partly by means of a broadly based mass privatization program. Ownership vouchers would be distributed to ordinary Iraqi citizens, similar to the program Russia used in the mid-1990s. According to the timetable in the documents, officials would spend a year building consensus for industry privatization, and would then transfer assets over the following three years. Privatization efforts in other countries demonstrate that privately held infrastructure, including oil production and service companies, attract modern technology and management expertise, result in greater efficiencies, improve production standards, and generate higher revenues than centrally planned and state-owned industries. Some experts on postcommunist reform efforts warn, however, that a policy of swift privatization met with mixed success across the former Soviet bloc. In many countries the rapid privatization of state-run enterprises led to severe disruptions in jobs and services as well as rampant corruption. In addition, many Iraqis interpret religious teachings as entrusting people to become guardians of the land's natural endowments, including oil, and that profits from oil production should therefore be shared among the people. Some experts suggest applying the Alaska-model, whereby every resident of the state receives an annual dividend from the oil industry's profits that often amounts to 10 percent of a family's annual income.

• **Reforming the central bank and the commercial banking system.** Banks should clean up their nonperforming loan portfolios and jump-start the private sector by providing fresh credits; the traditional Islamic money transfer system should be incorporated into the banking system; special credit lines should be created for small and medium Iraqi businesses. The new Iraqi government will decide on the creation of a new currency. The U.S. occupying authority has already started to pay salaries to 2 million civil servants. Over a period of three months, almost $500 million were to be pumped into the economy, thereby strengthening the exchange rate of the Iraqi dinar against the dollar.)

Economic Consolidation Under Way in Iraq

by Amir Taheri

All 67 of Iraq's cities and 85 percent of its smaller towns now have fully functioning municipalities. Several ministries, including the Ministry of Health and Education, have also managed to get parts of their operations going again. The petroleum industry is being revived with plans to produce up to 2.8 million barrels of crude oil a day before the year is out. The bazaars have more food to sell than since the late 1970s, while food prices, which jumped in the first few weeks after liberation, are now lower than they were in the last years of Saddam's rule. Most hospitals are functioning again, with essential medical supplies trickling in for the first time since 1999.

In addition, some 85 percent of primary and secondary schools and all but two of the nation's universities have reopened with a full turnout of pupils and teachers. *Mukahebrat* (secret police) agents no longer roam the campuses and sit at the backs of classrooms to ensure that lecturers and students do not discuss forbidden topics, nor are the students required to start each day with a solemn oath of allegiance to the dictator.

There has been no mass exodus from anywhere in Iraq. On the contrary, many Iraqis driven out of their homes by Saddam are returning to their towns and villages. Their return has given the building industry, moribund in the last years of Saddam's rule, a boost. Iraqi exiles and refugees are also coming home, many from Iran and Turkey. Last month alone the Iranian Red Crescent recorded the repatriation of more than 10,000 Iraqis, mostly Kurds and Shiites. Iraq no longer has displaced persons, uprooted communities, and long lines of war victims leaving the country in search of a safe haven.

For the first time in almost 50 years Iraq has no political prisoners, no executions, no torture, and no limit on freedom of expression. Today Iraq is the only Muslim country where all shades of opinion—from the extremist Islamists of the Hezbollah to Stalinists and liberals, socialists, Arab nationalists, and moderate Islamists—can compete freely in an open market of ideas. All are now represented in the newly created Governing Assembly (Majlis al-Hukum). Iraq is also the only Muslim country where more than 100 newspapers and weeklies, representing all viewpoints, appear without having to obtain a police permit and without censorship.

The media have made much of power cuts, especially in Baghdad, but this is partly due to a 30 percent seasonal increase in demand because of air conditioning use in temperatures that reach 115 degrees. In other cities, for example, Basra, the country's second-most populous urban center, more electricity is being used than at any time under Saddam Hussein.

A stroll in the open-air book markets of Rashid Street in Baghdad reveals that thousands of books, blacklisted and banned under Saddam Hussein, are now available for sale. Among the banned authors were almost all of Iraq's best writers and poets, whom many young Iraqis are now discovering for the first time. Stalls selling videotapes and audiotapes are appearing in Baghdad and other major cities, once again giving Iraqis access to a formerly forbidden cultural universe.

The free market economy is making its first inroads into Iraq's socialistic system in a number of small ways. Hundreds of hawkers are offering a variety of imported goods and doing brisk business by selling soft drinks, often bottled in Iran, and cookies and chewing gum from Turkey. Some teahouses, in competition to attract clients, offer satellite television as an additional attraction. Every evening people pack the teahouses to watch and discuss what they have seen in an atmosphere of freedom unknown under Saddam. During his rule people could be condemned as spies and hanged for owning a satellite dish. Another symbol of newly won freedom is the multiplication of cellular and satellite phones. Under Saddam, their illegal possession could carry the death penalty.

Life is creeping back to normal in Baghdad. Weddings, always popular in the summer, are being celebrated again, often with traditional tribal ostentation. The first rock concert since the war, offered by a boys' band, has already taken place, and Iraq's national soccer squad has resumed training under a German coach.

Two Iraqs exist today: one as portrayed by those in America and Europe who wish to use Iraq as a means of damaging Bush and Blair, and the other as it really exists, home to 24 million people with many hopes and aspirations and, naturally, some anxiety about the future. "After we have aired our grievances we remember the essential point: Saddam is gone," says Mohsen Saleh, a geologist in Baghdad. "A man who is cured of cancer does not complain about a common cold."

Amir Taheri is an Iranian journalist This is a shortened version of the author's article published in the New York Post. He can be reached via http:www.benadorassociates.com. ❊

World Bank Office Opens in Baghdad—Donor Conference to Be Held in October

The World Bank will support Iraq's reconstruction and its transition to a market economy," Country Director Joseph Saba told a UN-sponsored workshop held in Baghdad on July 19. He announced that following recent assessment missions, the Bank is establishing an office in Baghdad and has hired a security adviser and local staff to support work on the ground. The Bank will soon appoint a head of mission who will reside in the Iraqi capital. The Bank and UN are also cosponsoring 11 further assessment missions that will serve as the basis for a report to be distributed at a donors conference in October. Covering 14 sectors, the assessment process will focus on determining Iraq's emergency requirements and on the possibilities of donor financing.

The July discussions in Baghdad focused on the Bank's activity and experience in the transition countries. "A big challenge will be creating jobs," Saba said. "Fifty percent of the population is under 16 years old. So the challenge is to translate resource wealth into productive, efficient employment and create proper jobs for these young people," he pointed out. The Office of the Special Representative of the UN Secretary General for Iraq moderated the meeting. Attendees included Iraqi journalists, business people, former government officials, Iraqi and international advisers to the Coalition Provisional Authority, and UN staff.

- **Revising the Tax Code and tariff system** A comprehensive income tax system consistent with current international practice should be drafted by the end of the year.
- **Modernizing the Baghdad Stock Exchange.** Within a year the U.S. administration envisions converting Iraq's rudimentary prewar stock market into a "world-class exchange" for trading the shares of newly privatized companies. The plans also call for setting up a tough securities commission to prevent abuses.

To date the U.S. Agency for International Development has awarded nine contracts for the reconstruction of Iraq worth $2.4 billion to American companies, including Bechtel, Halliburton, Motorola, MCI, and the Research Triangle Institute. Bechtel's $680 million contract gives the American company the responsibility for designing, rehabilitating, upgrading, and reconstructing Iraq's infrastructure, including one seaport, five airports, electric power plants, road networks, rail systems, municipal water and sanitation services, schools and health facilities, selected government buildings, and initial satellite communications systems. The U.S. Agency for International Development has allowed these American companies to subcontract up to half the value of their contracts to non-U.S. firms, with an eye to benefiting from the excess capacity available in the region. Furthermore, U.S. federal regulations prohibit American companies from supplying materials if the cost is more than 6 percent higher than local costs.

In a recent interview U.S. Chief Administrator Paul Bremer highlighted the need to encourage both foreign and domestic investors, another key element for stimulating growth. He has formed an advisory group of Iraqi business people, economists, and politicians to discuss the rebuilding of the economy, and is also being advised by large U.S. banks, including JP Morgan and Citigroup. With more than half the working-age population jobless, unemployment is a tremendous problem in postwar Iraq.

Transforming Iraq from a military dictatorship and a secret police state into a real market economy will take years and billions of dollars. An estimated $100 billion in reconstruction costs and more than $350 billion of debt and reparations far exceed what even a rehabilitated oil industry can generate in the next few years. The country needs to invest in education, health, infrastructure, public administration, the police and army, a new legal system, a new currency, a new central bank, a new constitution, the rule of law, and then democracy. However, the signs are encouraging. Iraqis remain relatively well educated, and the status of Iraqi women is better than in many Arab countries. In addition to huge oil reserves and sufficient water resources, 4 million Iraqis living abroad can contribute experience and money.

This article draws extensively from Ariel Cohen and Gerald P. O'Driscoll, Jr., The Road to Economic Prosperity for a Post-Saddam Iraq, published as a Heritage Foundation Backgrounder, no. 1633; available on http://www.heritage.org/Research/MiddleEast/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=37452. ❊

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tensions. For their part, the East Europeans do not want their expensively educated graduates and skilled workers to emigrate in search of better-paid jobs, leaving a pool of unskilled, low-paid workers back home. They also fear that now that trade barriers between the East and West have been removed and transport costs are falling, the West's highly productive industries could simply supply the smaller Eastern markets through imports, at the cost of local production. Even if foreign direct investment keeps flowing in, they fear that it will finance only low-wage, low value added industries, while high-technology manufacturing and research and development will remain in the West.

Mixed Results of Convergence

Since it was set up in 1957, the EU has declared that reducing regional differences and, in particular, the backwardness of less developed regions—referred to in Brussels as cohesion and convergence—is one of its main objectives. In 1975 the EU, or

European Community as it was then called, set up its first regional support fund. Since then it has made ever increasing sums available through a growing variety of programs generally referred to as structural funds. Once the East European countries join, they too will be eligible for EU regional aid. The experience with income convergence in the existing EU is, however, mixed. Some evidence indicates that the EU's poorer members have grown, on average, faster than the richer countries, but this does not necessarily hold true for individual regions within countries. The following stylized facts seem to hold:

- Income levels in West European countries have been more or less converging since the 1870s. Convergence was particularly strong in the 1960s, when trade barriers came down and trade between European countries increased rapidly; however, convergence ground to a halt during the 1970s, and even went into reverse in the early 1980s. The trend toward converging incomes resumed in the 1990s.
- On the whole, the rate of catch-up has been slow, at an annual average of 2 percent in 1950-90. At that rate the East European countries would take around 30 years to halve the present income gap with the existing EU member states.
- A look at regions in Europe rather than countries gives a similar picture, but the trend toward convergence has been much less pronounced. In many countries, particularly the poorer, peripheral countries, the gap between rich and poor regions has actually widened significantly since the 1980s.

Looking beyond the aggregates, individual EU members have gone through very different growth trajectories (table 1). Portugal and Spain have narrowed the distance to EU average income levels, and Ireland has overtaken the average in the past decade. Greece, however, has only recently begun to make significant progress in narrowing the gap.

- Spain's GDP per head was around 60 percent of the EU average in the 1960s. Catch-up growth rates followed trade liberalization and market-friendly reforms in the 1970s, but progress came to a halt in the early 1980s. Since the mid-1980s, Spanish GDP per capita has gradually risen to just under 85 percent of the EU average. Spain joined the EU in 1986, and subsequently became the largest recipient of structural fund money.
- Ireland started from a similar level in the 1960s; however, unlike Spain, it stagnated for the next two decades, with neither EU accession in 1973 nor the receipt of EU regional aid making much of a difference. By the mid-1980s its per capita GDP had crept up to around 70 percent of the EU average, but after the Irish government fully embraced policies based on free trade, low taxes, low public deficits, and stronger competition, growth took off strongly. Now Ireland has a GDP per head that is nearly 20 percent higher than the EU average, although its GNP and living standards are lower than this figure suggests, because foreign firms repatriate much of the profit earned from their Irish operations.
- Greece's economy also stagnated for almost 20 years. Its GDP per capita was around two-thirds of the EU average when it joined the union in 1981, and the ratio did not change for a long time. Signs of catch-up growth have appeared only recently, since the government started to consolidate public finances ahead of its entry to the euro zone.
- Portugal has a mixed history of economic reform. It liberalized trade in the 1960s, but returned to heavy state intervention after the 1974 revolution. It returned to more market-oriented policies in the 1980s. Economic growth followed a similar pattern: GDP per head rose from 45 percent of the EU average in the 1960s to around 60 percent in the mid-1970s. It then remained around this level until the late 1980s, but since then has risen to around 70 percent of the EU average.

As with the Mediterranean countries, the Central and East European candidates started to open their economies to trade and investment from the EU well before joining the Union. By 2002 trade between the EU and the candidates was almost completely liberalized. In proportionate terms (or as a share of total trade), many of the candidate countries now trade with the EU as much as, or more than, the EU members trade with each other. Foreign direct investment flows from the EU into Eastern Europe have been strong for years, amounting to 5 percent of GDP or more in the case of the best performing countries. In theory, therefore, the candidate countries should be well advanced in the process of catching up with the richer EU states.

Table 1. Convergence in the EU15, Selected Countries and Years

(GDP per head, EU15 = 100)

Country	*1975*	*1985*	*1995*	*2001*
Greece	62	64	66	65
Ireland	66	69	93	118
Portugal	56	57	70	69
Spain	82	74	78	84

Source: 1975 and 1985: OECD; 1995 and 2001: Eurostat.

Far to Go

In practice, according to Eurostat figures, average per capita GDP in the 10 East European candidate countries now stands at around 40 percent of the EU average (table 2). Indeed, the gap between the average EU income level and that of the candidate countries has widened considerably since 1989. The EU's real GDP grew by 30 percent between 1989 and 2002, whereas for the 10 East European accession countries the increase amounted to only 8 percent during the same period. The widening of the gap is mainly attributable to the sharp fall in GDP in most of the region immediately after the shift from central planning. However, the gap has not diminished appreciably even since the beginning of growth, generally in the mid-1990s, in part because of macroeconomic mismanagement in some countries; slowing structural change in others; and the impact of external shocks, such as the 1998 Russian financial crisis.

Available evidence suggests quite strongly that the accession countries have followed the pattern of the Mediterranean

Table 2. GDP Per Head, EU Candidate Countries, 2001

(EU average = 100)

Country	*At market exchange rates*	*At PPP based on 1993 GDP comparisons*	*At PPP based on post-1996 GDP comparisons*
Bulgaria	8.2	22.7	24.3
Czech Republic	26.2	47.5	58.7
Estonia	18.0	26.3	36.2
Hungary	24.5	38.3	50.3
Latvia	15.2	21.6	28.5
Lithuania	15.5	20.4	27.8
Poland	21.7	32.4	39.0
Romania	8.5	19.5	27.7
Slovakia	17.6	36.8	47.3
Slovenia	44.8	60.7	70.4
Average	18.4	30.9	38.9

Source: 1975 and 1985: OECD; 1995 and 2001: Eurostat.

countries, in that recent economic growth has gone hand-in-hand with a marked widening of regional income differentials. The fastest growth has occurred in the regions centered on capital cities and in those geographically close to the EU. Smaller towns, rural areas, and the eastern parts of the accession countries have generally lagged behind, with poverty, high unemployment, and a lack of competitive industries characterizing the regions along the EU's future eastern border with Belarus, Russia, and Ukraine.

If current trends continue, regional differences in the East European countries will continue to widen. This divergence in regional economic fortunes matches industrial specialization patterns. A reasonably well-developed infrastructure and a better-educated workforce has given East European capitals a head start compared with more remote regions. Foreign direct investment has done the rest, crowding into urban areas and western regions while tending to avoid the more remote eastern regions. As a result, the region's capitals have experienced a veritable boom. According to official EU figures, Prague and Bratislava, for example, now have per capita income levels that are above the EU average, whereas unemployment in eastern regions is still rising, further eroding local income levels. There is therefore a *prima facie* case for the EU to concentrate its regional development efforts on the poorer, eastern regions of the new member states.

Under current EU rules, regions with a per capita GDP of less than 75 percent of the EU average automatically qualify for EU regional aid under the so-called Objective 1 facility (see the box). This means that almost the entire area of all the East European countries will be eligible for EU aid. If the EU maintained the current extent of redistribution (net payments or receipts as a share of per capita income differentials) after enlargement, the new members would be due to receive enormous sums. Latvia, for example, would receive transfers amounting to more than 13 percent of its GDP per year, and Poland would receive 8 percent. However, flows of this magnitude will clearly not be forthcoming, nor would they be easily absorbed. To begin with, the total EU budget is capped at just under1.3 percent of total EU GDP, with 0.46 percent of this amount allocated to the structural funds. In addition, the EU has capped structural fund spending in the new member states at 4 percent of the recipient country's GDP, arguing that the newcomers would simply not be able to deal with any larger inflows, an issue often described as a lack of absorption capacity.

The EU's 1999 Berlin summit set out how much the new members could expect to receive after they joined the Union (see table 3 and 4). In the current budget, which covers 2000-06, the EU has earmarked a total of •42.6 billion ($45.96 billion) for the new members, of which more than half will be paid out through structural funds. Poland will be by far the largest recipient, with more than •11 billion, followed by the Czech Republic and Hungary, with •2 billion to •3 billion each. However, the money will be slow to come in. Both regional aid and agricultural payments (the other major spending category in the EU budget) will be phased in gradually after 2004. Moreover, structural fund projects have long lead times, and even common agricultural policy payments are only reimbursed with a delay. The European Commission expects that in 2004, the year of accession, the new members will receive transfers amounting to only 1 percent of their combined GDP, rising to 1.5 percent by 2006. This is much lower than the 3.6 percent of GDP Greece received and the almost 2 percent of GDP Portugal and Spain received. In per capita terms, the new members will get between •200 (US$215) and •600 (US$645) per head at the most in 2004-06, compared with the •1,000 to •1,500 per head Greece, Ireland, and Spain received during the last budget period.

Table 3. EU Money for the New Members, 2004-06

(• billions in 1999 prices)

Category	*2004*	*2005*	*2006*	*2004-06*
Common agricultural policy	1.9	3.7	4.1	9.8
Regional aid	6.1	6.9	8.8	21.8
Structural funds	3.5	4.8	6.0	14.3
Cohesion funds	2.6	2.2	2.8	7.6
Internal policies and administration	1.9	1.9	2.0	5.8
Other	1.3	1.3	0.9	3.3
Total	11.1	13.8	15.8	40.7
Approved in Berlin	11.6	14.2	16.8	42.6

Source: European Commission.

Whether the new members will actually receive the allocated amounts in full is uncertain. The East European countries tend to have weak state administrations and little experience with either regional support policies or with handling large-scale fiscal transfers. The systems for applying for and implementing EU

regional support are so complex that even current member states regularly fail to spend the full amounts they have been allocated. This problem will be much worse in the new member states. In addition, the new members will have only two years to identify projects and obtain Commission approval for their funding before the current budget period runs out (although they will not actually have to spend the money until the end of the decade).

Absorbing the Money

The EU created a pre-accession regional aid facility, the Instrument for Structural Policies for Pre-Accession, to help the candidates get used to handling structural funds. Of the •4 billion allocated under the facility, the candidates had managed to spent only •200 million by the end of 2002. One of the problems is that the candidates simply cannot find enough viable projects (the value of each project is supposed to exceed •5 million, which is a substantial amount in small transition countries). Another is the requirement that 25 percent of each project has to be cofinanced out of national or regional budgets. Cofinancing requirements under structural fund rules can be lower, 15 to 20 percent, but they will be an additional burden on already stretched government budgets. The Commission has tried to alleviate these problems by paying out a larger share of money through the cohesion funds, which pay for straightforward infrastructure or environmental problems and do not have cofinancing requirements; nevertheless, EU aid inflows are likely be a trickle rather than a flood in the first couple of years after accession.

The real impact of the structural funds is therefore likely to come during the next EU budget period, which will run from 2007 to 2013. How much money the new members will receive during that period will be decided in forthcoming budget negotiations. With the accession of the East Europeans, average EU GDP will drop by about 10 percentage points. This means that many of the regions that currently have GDP per head less than 75 percent of the EU average, and so qualify for regional support, will no longer do so. As a result, all

Table 4. Cohesion and Structural Fund Allocations to the New Member States, 2004-06

(1999 prices)

Country	*Cohesion fund (• millions)*	*Structural fund (• millions)*	*Total (• millions)*	*Per capita (•)*
Czech Republic	836	1,491	2,327	228
Estonia	276	342	618	441
Hungary	994	1,853	2,847	279
Lithuania	543	823	1,366	569
Latvia	461	575	1,036	296
Poland	3,733	7,635	11,368	294
Slovakia	510	1,050	1,530	289
Slovenia	169	237	406	203
Total	7,522	14,006	21,528	292

Note. Cohesion fund allocations are the author's calculations based on the mid-range of the European Commission's indicative share. Malta and Cyprus are not included.
Source: European Commission, "Second Progress Report on Economic and Social Cohesion"; author's calculations.

EU Structural Funds

In the 2000-06 budget, the EU budget allocates some •195 billion ($210 billion) for regional aid. Two-thirds of the funds go to the so-called Objective 1 regions, defined as those with a per capita GDP at PPP exchange rates of less than 75 percent of the EU average. Another 10 to 13 percent each goes to regions that are not necessary poor, but suffer from the results of structural change (Objective 2) or regional labor market problems (Objective 3). In addition, the EU funds four so-called community initiatives, such as inter-regional cooperation, urban development, and rural development.

The EU spends another •18 billion through the cohesion funds on transport and environmental projects in countries whose per capita GDP is less than 90 percent of the EU average. The cohesion funds are different from other regional support in that they are given to countries rather than regions, and they do not require cofinancing out of national budgets.

Each EU government draws up a multiyear development program as a framework for regional aid. Once the European Commission has accepted this program, the central government, together with regional and local authorities, identifies projects that it wants cofinanced by the EU in the following areas: (a) infrastructure, that is, transport, energy, telecommunications, and the environment; (b) support for local companies; (c) training for workers; and (d) research and development.

Regional governments are usually responsible for implementing the projects, but the Commission tries to monitor that the money is spent sensibly and efficiently. The EU pays some of the cash up front, but once the project has got under way, the local authorities have to present bills to Brussels for reimbursement. EU regional aid comes in the form of grants, not loans. To make sure that the recipients still have some incentive to spend the money wisely, the EU requires that national or regional budgets cofinance each project. The cofinancing requirements depend on the type of project and range from 15 to 40 percent. Nevertheless, frequent reports cite waste, and even corruption, in the use of EU regional aid. The Commission has promised to step up monitoring, which could make the whole process of obtaining funding even more protracted than it is now.

Germany's new states, all but two Spanish regions, and all but one region in Italy will no longer qualify for Objective 1 funding. In addition, GDP per head in Spain will move above 90 percent of the EU average, which means that it will no longer qualify for cohesion fund money. Even though economic growth means that around a quarter of the regions now covered by Objective 1 funding would lose their entitlement even if enlargement did not take place, Italy, Spain, and other countries are still likely to fight to retain their entitlements in the EU budget.

Estimates by PNB Paribas, a French bank, show that if current rules were maintained, the costs of Objective 1 support (including pre-accession aid) would rise from •165 billion in 2000-06 to •251 billion in 2007-13. The amount current EU members received would fall from •1,406 billion to •936 billion, and the sums the 12 newcomers received would rise from •25 billion to •157 billion. Only Greece and Portugal would still be eligible for cohesion fund money, and the new members could expect around •26 billion from this facility.

Uncertainty about the impact of structural funding on recipients' growth rates is considerable. The sums dispensed through the EU's structural funds budget have grown significantly over the past 20 years. EU regional aid has amounted to 1 to 3 percent of Portuguese and Spanish GDP in recent years, financing 5 to 10 percent of total investment and increasing the funds available for public spending (net of transfers and health and social insurance payments) by 10 to 20 percentage points. Most of the money from the structural funds is spent on physical infrastructure, such as roads or sewage systems, with much of the rest financing education and training.

The author is chief economist at the Center for European Reform, London. This article is excepted from "Will EU Money Help Eastern Europe to Catch Up?," published in the Economic Intelligence Unit's Country Forecast, March 2003. ❊

TALK OF THE TOWN

Lessons Learned from China's SARS Crisis

by Chi Fulin

China now is at a critical stage in its economic and social transformation, when any unexpected event, if not handled properly, could lead to a social crisis. This period of transformation of institutions and traditional governance mechanisms is a precarious one. The last thing the government and public wants under these circumstances is sudden disasters, such as the Severe Acute Respiratory Syndrome (SARS) epidemic.

Reviewing Initial Shortcomings

During the recent China-Association of Southeast Asian Nations Summit on SARS in Bangkok, Thailand, Chinese Premier Wen Jiabao admitted that "confronted with the sudden and unexpected outbreak of the SARS epidemic, [China] lacked the experience to prevent and control it." Indeed, not only was the country unprepared to deal with the situation, but also, at least during its early phases, some central government departments and local authorities were not ready to make a 100 percent effort, and even tried to conceal the gravity of the situation. In addition, coordination between government departments and between the government and medical institutions was weak. As a consequence, the epidemic spread quickly and reached serious proportions. While effective countermeasures had practically eliminated the disease by June, the following lessons learned from the SARS epidemics are nonetheless valid:

- Globalization means that events in China will rapidly affect other countries and vice versa.
- The SARS epidemics has exposed some of China's institutional weaknesses. Clearly the crisis should motivate the government to accelerate institutional reform so as to strengthen its ability to provide public goods and services.
- As social stability is a major prerequisite for sustained economic growth, solving crucial social problems, including creating more jobs and reforming social insurance and the public health care system, has become more urgent.
- A crisis management mechanism should be created that can mobilize financial and social resources without delay. Relevant government departments should be able to issue warnings to the public on short notice and propose responses. In the face of the SARS epidemic the United States launched an emergency warning system and unveiled a prevention and treatment program before China had identified a single SARS case. This serves as a good example to learn from.

Increasing the Role of the Media

The government must make further efforts to regain the public's confidence, including promoting better media relations in times of crisis. Providing the general public with timely, accurate, and reliable information is the responsibility of the government and the media, especially in the case of sudden disasters. As the SARS case demonstrated, information about crises affects not only the health and safety of the population in a particular country, but can have global consequences. In an open society people have access to many channels of information, and accordingly the Chinese public's demand to be informed of unexpected events has become stronger than ever before. To satisfy this demand the authorities should accelerate reform of the media.

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Curing China's Ailing Health Care System

Although SARS is finally on the retreat, it showed that China's national health system needs a thorough "tune up" after 20 years of official neglect. A cartoon in China's English language newspaper, the *China Daily*, captured prevailing attitudes about physicians' roles. A frail old lady is lying in bed and she asks her sneering doctor, "Doctor, may I leave the hospital?" He responds, "How much money do you still have?" An accompanying editorial accused hospitals and doctors of prescribing unnecessary drugs to generate revenues and recommended that patients get daily hospital bills to prevent cheating. Graft and corruption in medical care are reported to be commonplace and to be particularly egregious in relation to the distribution and sale of drugs. The average stay in a hospital run by the Ministry of Health in Beijing, for instance, costs almost Y11,500 ($1,400), equivalent to six months' salary for the typical city resident. There has been a colossal mismatch between the needs of many patients and the equipment found in urban hospitals, where staff fund running expenses and supplement their meager government pay by charging patients heavily for often unnecessary high-tech procedures.

At the end of 2002 Beijing, with a population of 13 million, had more CAT scanners than England, with a population of 49 million, according to Wang Jian, a researcher at the China Academy of Health Policy at Peking University. Yet hospitals with state-of-the-art equipment are so short-staffed that they often require relatives to bring patients their meals, and even to nurse them. The cost of delivering a baby in Beijing is three to four times the cost in the countryside, according to Wang. The big cities, where health care costs have escalated 15 percent a year, are consuming 80 percent of China's medical resources. According to the World Bank, 75 percent of health spending goes to hospital-based care, with 60 percent of that going to pharmaceuticals.

China's total medical spending was equivalent to a respectable 5.3 percent of GDP in 2000, but 63 percent came straight from people's pockets, up from 53 percent in 1995, according to the World Health Organization's (WHO's) *World Health Report 2002*. In rural areas, where 700 million of China's people live, most people have no insurance and medical costs have risen much faster than farmers' incomes. The rural health service is comparable with that in India. In both countries, according to an influential WHO report in 2001, "the rural poor pay out of pocket for around 85 percent of the total health services that they receive," and much of that goes for "unnecessary or inappropriate drugs foisted on them by clinics that fund themselves through sales of pharmaceutical products, or to unlicensed and unqualified practitioners." Sixty-five percent of rural patients could not afford to go to a hospital for necessary treatment, and of those who went more than half left prematurely. In short, the rural population and the urban poor and unemployed increasingly cannot access the health care system.

The few hundred deaths from SARS are just a fraction of the 130,000 Chinese who die annually from tuberculosis, which is preventable. Also the UN forecasts that the number of people with HIV/AIDS in China will reach 10 million by 2010. "Right now 5 million people in China have tuberculosis, 10 percent of people have chronic hepatitis B," says Daniel Chin, a WHO official, who adds that because of both the lack of resources and attention, such silent epidemics are simply ignored.

Between 1949 and 1975 life expectancy doubled and more than 85 percent of the population had some form of health care coverage, but with the economic reforms that started in the late 1970s, that system deteriorated, especially in the countryside. In 1981, 71 percent of Chinese had access to state health facilities; 12 years later the figure was 21 percent. In 1999 China ranked 144th among 191 WHO member countries in per capita health expenditures. One reason for the decaying public health system has been that during the reform era the central government has had a decreasing amount of control over the disposition of financial resources and more tasks are being pushed upon often impoverished local governments.

China's patients are also concerned about the quality of medical care. Medical errors are widely broadcast, and stories about substandard care, counterfeit medicines, inaccurate diagnostic and therapeutic equipment, inhumane treatment, and corruption are frequent. Patients who are financially able to do so choose high-tech, expensive, academic medical centers instead of adequate and less expensive local facilities. Others feel compelled to give physicians *hong bao*, red envelopes stuffed with cash, in the belief that the illegal payments will encourage better care. Apart from bad outcomes, patients also suffer from poor service. They endure long waits, inadequate facilities, rude personnel, lost records, and a lack of privacy.

China has many honorable, compassionate, skilled physicians, and they too are frustrated. Overworked, they see themselves falling behind economically. Industrious taxi drivers can make more money. Prices for health care services are set well below costs, requiring doctors to generate income from drug sales and high-tech diagnostic and therapeutic interventions to keep their hospitals solvent.

Nevertheless, there is hope. In the last five years the government has introduced social insurance reform and attempted to reverse the flagrant abuses in the provision of drugs. It has made medical records more transparent for patients and introduced a malpractice system. There is also growing awareness that health sector leaders must be trained in the business of medicine, because health care is also a competitive service industry. Beijing and local governments recently announced new funding of Y11 billion ($1.3 billion) for the beleaguered national health system.

Based on articles in the Washington Post by Gerald Lazarus and in the Far Eastern Economic Review by *David Murphy and David Lampton. Gerald Lazarus is a professor of dermatology at the Johns Hopkins School of Medicine, Baltimore, Maryland, and was a visiting professor at Peking Union Medical College Hospital from 1999 to 2002. David Lampton is director of China Studies at Johns Hopkins-SAIS and the Nixon Center in Washington, D.C.* ❊

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The current administration of China's media does not meet the development needs of an open society. If something unexpected happens, the media are unable to adjust to new circumstances, mainly for ideological reasons, a situation that also needs to be reformed. During the recent Iraqi war three channels of China's state television covered it through live broadcasting. Why couldn't state television have designated a special channel to provide continuous information about the SARS situation and provided tips on how to prevent its spread? The general public would have been able to keep up with the latest developments of the SARS situation, which in turn would have helped prevent the spread of the disease and the widespread panic among the public. Thus some government rules for administrating the media should be relaxed, and reporting and commenting on situations such as the SARS epidemic should be encouraged. The media should also be able to report on cases of irregularities, including outright corruption, in managing funds that had been assigned to fight SARS.

Ailing Health Care System

The outbreak of the SARS crisis also demonstrated the inability of the current health care system to deal with unanticipated events. It was sheer luck that this epidemic was centered mainly in the cities. If it had spread through the countryside, the consequences would have been too terrible to contemplate. Thus reform of the health care system, especially its development in rural areas, should be accelerated.

In addition, an early warning system and emergency coping mechanism should be reinforced. Furthermore, a public safeguard mechanism to control exceptionally contagious diseases should be created. The central government should offer free treatment to diagnosed and suspected SARS patients, with hospital costs covered from the government's central budget. Together with the health care system, the social security system also requires thorough changes.

Mobilizing Civil Society

Dealing successfully with unexpected events, such as reining in the SARS epidemic, depends to a large degree on the support and participation of the public at large. Close interactions between the government and a well-developed civil society constitute the key to success in coping with unexpected events. To move ahead in this direction, the following steps should be undertaken:

• Urban communities should establish autonomous governance in order to share responsibility for the prevention of epidemics.

China's Economy in the Shadow of SARS

At the end of March, China's economy was enjoying its biggest boom in six years. Foreign investors, a key engine of China's growth, pumped a record $52 billion of direct investment into the economy last year. First-quarter growth was a sizzling 9.9 percent at a time when Europe and Japan were stumbling and the United States market was shaken by war. More than $13 billion of investment poured into China during those three months. Industrial production grew 17.5 percent year on year, exports rose 35 percent, and imports increased 40 percent. China was the place investors felt they couldn't afford not to be. However, because of the SARS crisis, in the second quarter economic growth and investment slowed considerably.

Nevertheless, for all the turmoil brought about by the SARS epidemic, the most fundamental components of Chinese growth—low-cost manufacturing made possible by access to raw materials and cheap skilled labor, bolstered by investment from the government and from multinational firms—have generally been unaffected. China's economy is dominated by manufacturing, which accounts for about 54 percent of GDP, while services make up 28 percent of the economy, and there the impact of SARS has been large. Agriculture, which accounts for 14 percent of the economy, is probably insulated from a SARS shock, because the vast majority of agricultural production is sold near the place it is grown, and there is no nationwide network to disrupt. Construction makes up the remaining 5 percent, and though a real estate slump could occur, there is little sign of it at this time. In a survey of 12 financial institutions, the average GDP growth estimate for China this year was 7.25 percent, down slightly from 7.6 percent before SARS.

Even though China was the epicenter of the SARS outbreak, its robust economy and domestic demand should act as a partial buffer for export-driven Asian nations, said the World Bank in a new report updating its regional outlook. Across the region, reforms made after the financial crisis of 1997-98, large current account surpluses, and nearly $800 billion in foreign reserves were cited as other cushions. SARS could reduce regional economic growth by 0.3 percentage point, while additional multiplier effects could double that figure, causing East Asia's growth rate to slow to 5 percent from the earlier expected 5.8 percent. As for Hong Kong, which has been more seriously affected by SARS and relies heavily on tourism, the predicted 2 percent growth this year could be wiped out.

The Bank urged economies in the region to adopt a "frank, fully transparent information policy," saying it will be crucial in building trust and minimizing the economic costs of SARS. Next year growth in East Asia is likely to hit about 6 percent, the Bank predicted. The Bank is helping the Chinese government, WHO, and bilateral donors with a response program that addresses SARS management and strengthens the capacity of the country's public health system.

Based on reports by the World Bank and the Singapore-based Far Eastern Economic Review.

• Development of the NGO sector should be strongly encouraged. NGOs' role in mobilizing and organizing social forces to deal with unexpected events should be brought into full play. They also can play a useful role in maintaining social stability.

• NGOs should be encouraged to cooperate more closely with international professional and volunteer organizations as well as with foreign private foundations.

Examining Personnel Consequences

The attitude and behavior of officials in some departments of the central government and some local governments in fighting against SARS exposed some shortcomings of the norms of cadre selection and appointments. To change the system, the following measures seem to be necessary:

• **The rigid human resource management system should be reformed as soon as possible**. Some senior officials consider GDP growth as the most important measure of their performance. As a consequence, they fail to report detrimental events, such as the spread of SARS, afraid of being fired. Many government officials feel responsibility toward their superiors and less responsibility for the safety of the public.

• **The media and civil organizations should be encouraged to oversee the government and help improve its decisionmaking processes.** If it turns out that a government policy was faulty, it should openly admit so to the public and implement the necessary corrective measures.

• **The law should be brought to bear.** Officials who are found responsible for mismanaging certain issues, causing huge losses to society, as happened in the SARS case, should be brought to justice through open and fair judicial procedures.

• **The government can improve its image and restore its social credibility.** The government has a unique opportunity to achieve this during this period when the general public is keeping a close eye on what the government is doing.

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NEW FINDINGS

A Research Agenda for Development

by Nicholas Stern

To help the development community be more effective in reducing poverty in developing countries, development-oriented research should be derived from a strategy that is based on two pillars: improving the investment climate and empowering and investing in poor people. The research agenda should rely on both empirical surveys and analytical understanding of the dynamics of the investment climate, of preferences, and of political reform. Research and action must reinforce each other.

The World Bank's development strategy can be described in terms of two basic pillars. The first pillar focuses on improving the investment climate. It involves more than just the levels of investment and also includes the environment for entrepreneurship and the investment process itself. The aim is to create a good investment climate, that is, one that encourages private firms to invest, create jobs, and increase productivity through appropriate government policy and behavior. The three important elements of a good investment climate are macroeconomic stability and openness to trade; good governance and institutions, including control of bureaucratic harassment and crime, as well as effective financial and legal institutions; and adequate transportation, power, and communications infrastructure.

The second pillar focuses on empowering and investing in poor people by ensuring that they have opportunities for education and health care, avenues for risk reduction and mitigation, and mechanisms for participating in the key decisions that affect them and their families. Empowerment is both an end in itself and an avenue to development. Indeed, it is key to scaling up to achieve development results because it not only fosters social inclusion and participation in growth, but also promotes growth by mobilizing poor people's assets and energies (box).

Thus the processes embodied in the two pillars are mutually reinforcing in their effects on growth and poverty reduction. This two-pillar strategy suggests a program for research that can take forward both the theoretical and the empirical investigation of public policy.

Appropriate Data

The two-pillar strategy suggests a need to gather and analyze two new types of micro data: first, data from firms to provide detail on the quality of the investment climate (including questions such as "How often are you visited by the authorities and how much management time is spent with them?" "What fraction of your turnover do you spend on bribes?"); and second, data on the functioning of various services that are key elements of empowerment, such as health, education, and social protection. For both datasets going beyond inputs and outputs and asking how processes actually work and how people are

involved is fundamental. In recent years, we have begun to accumulate data on both these important areas. As in the past, we will still need our third major type of micro dataset, information on households and individuals, if we want to assess outcomes.

These three datasets will provide powerful research tools for analyzing development processes. They are far richer and deeper than the cross-country macro datasets that, driven by the aggregate approach to growth, have formed the basis of so many cross-country regression analyses. For example, systematic investigation of the investment climate using firm-level surveys started at the World Bank and the EBRD during the 1990s has gathered pace in the last year or two. We now have comparable surveys completed, under way, or planned for the next year in 30 countries that cover large, random samples of firms, including some 1,200 firms in India and 1,500 in China.

These surveys collect the usual firm information on sales, outputs, inputs, and costs, but they also include specific quantitative questions about the investment climate. The results can be striking. For India we can now compare the investment climate at the state level, for instance, firms in Uttar Pradesh reported twice as many visits from officials as firms in Maharashtra and twice as many firms in Maharashtra than in Uttar Pradesh owned power generating facilities. In Uttar Pradesh, the largest and one of the poorest states in India, the electric power utility is less reliable than in Maharashtra, which explains why—despite the higher capital intensity—the growth rate is lower than in Maharashtra. These findings are strong and easily communicated and can have a powerful impact on policymakers.

The empirical information on empowerment is no less rich, although to date is somewhat less structured. The 2004 *World Development Report*, entitled *Making Services Work for Poor People,* will analyze much of the evidence, drawing on a large number of examples in areas ranging from basic services to economywide issues, such as community involvement in school management in El Salvador and Nicaragua; citizen report cards on services in Ukraine; legal and judicial reform and property rights in slum areas in Ecuador, Guatemala, Peru, and Venezuela; and corruption surveys in Albania, Georgia, and Latvia.

The challenge is to generate more structured data on empowerment so that we can carry out further systematic empirical investigation. The research agenda should be based on both empirical surveys and analytical understanding of the dynamics of the investment climate, of preferences, and of political reform.

Investment Climate

Small beginnings can lead to substantial accelerations of growth. Some changes can generate strong and sustained increases in growth rates and large transformations in such major sectors as education and health. The following are three analytical examples of accelerating and self-reinforcing change in the investment climate:

- Models that involve the diffusion of ideas or knowledge. Griliches demonstrated that the adoption of new technologies like hybrid corn was not a single event, but a series of developments that occurred at different rates across geographical space (Zvi Griliches, *Hybrid Corn: An Exploration in the Economics of Technological Change*, 1957).
- Models that generate multiple equilibria (Kevin Murphy, Andrei Shleifer, and Robert Vishny, *Industrialization and the Big Push,* 1989). A relatively small disturbance (institutional

Scaling-Up: What, How, and Why?

Scaling-up can relate to structures, programs, strategies, and the resource base as follows:

- **Quantitative scaling-up (structure).** A program or an organization expands its size by increasing its membership base, its geographic area, or its budgets. This occurs when participatory organizations draw increasing numbers of people into their realm.
- **Functional scaling-up (programs).** A community-based program or a grassroots organization expands the number and the type of its activities. Starting in agricultural production, for example, participatory organizations move into health, nutrition, credit, training, literacy, and so on, when they add new activities to their operational range.
- **Political scaling-up (strategy).** Participator organizations move beyond service delivery and toward empowerment and change in the structural causes of underdevelopment, that is, its contextual factors and socio-political-economic environment. This will usually involve active political involvement and the development of relationships with the government.
- **Organizational scaling-up (the resource base).** Community-based programs or grassroots organizations can increase their organizational strength so as to improve the effectiveness and efficiency of their activities. They can do so financially by diversifying their sources of support, increasing the degree of self-financing, creating activities that generate income (cooperative enterprises, consultancies), or by assuring the enactment of public legislation earmarking entitlements for the program within annual budgets. They can also do so institutionally by creating external links with other development actors, both public and private, and by improving the internal management capacity of their staff through training or personnel development, which will allow the organization and its programs to grow, be flexible, and be sustainable.

Abstracted from Peter Uvin and David Miller, "Scaling Up: Thinking through the Issues," World Hunger Program Research Report 1994-1, available on: http://www.brown.edu/Departments/World_Hunger_Program/hungerweb/WHP/SCALINGU_ToC.html.

change) improves the investment climate, boosts investment or the productivity of capital, and initiates a movement from a lower-level to a higher-level equilibrium.

• Political economy models that focus on crucial historical turning points (as analyzed in Daron Acemoglu, Simon Johnson, and James A. Robinson, *Reversal of Fortune: Geography and Institutions in the Making of the Modern World Income Distribution,* 2001).

Preferences

Much of economics takes preferences as given and works with a simple model of an optimizing individual who understands the relevant constraints on decisionmaking. This has been a fruitful approach, especially for public economics, that relates social welfare to individual welfare. Increases in the latter can then be associated with a bundle of commodities that the individual prefers. However, some philosophers, including Mill and Keynes, who emphasized objectives in terms of expanded freedoms, also recognized that preferences adapt through development and discussion, and as the following example illustrates, development is in large measure about fundamental changes in behavior driven by shifts in preferences.

Suppose the Pakistani government recognizes the importance of increasing the enrollment of girls in school. How should it go about convincing a girl's parents, particularly her father, to allow her to attend school? The standard economists' answer, which would mention merit goods and externalities, would be to subsidize girls' attendance by eliminating school fees, or even by giving the family a small grant.

However, we could go about expanding attendance in at least two other ways, each supported by a different model of the world. The first of these would take preferences as given, but would recognize that people making decisions do not always have all the relevant information. The policy response to this lack of information would be to provide the parents with good data about the advantages of schooling. These data could be used to point out, for example, that more educated girls are healthier as adults and that their own children will be healthier and better educated, and the father will allow his daughter to attend school even without any change in his preferences. That is, while his objective was always to ensure a good life for his daughter and for his grandchildren, he now understands more clearly that education will increase the chances that will happen.

By contrast, a second policy approach recognizes that preferences are not immutable. Part of the policy challenge is to persuade fathers to think differently about the kind of life they would like their daughters to lead. Note that this preference transformation can happen for reasons other than direct efforts to change preferences and can also result from either of the two policy interventions described earlier. If a subsidy or better information gets the girl into school, then her father's preferences may subsequently change once he sees how valuable education can be for the life of his daughter. Of course, as with most real-world issues, the problem of girls' education in Pakistan has a number of other important dimensions. The point is, preference change is a widespread issue in development and one that bears much further study.

Understanding changes in preferences will require new modeling approaches. The following three examples are intimately linked with empowerment and central to the development process:

• Most aspects of empowering people involve changing attitudes and behaviors.

• Education changes values and preferences in ways that are likely to be hard to predict, yet students and parents make decisions about education in the knowledge—or indeed the hope—that preferences are likely to be changed;

• Values can change in response to examples set by leaders. Many would argue that individual behavior in Russia deteriorated in the 1990s in part because of the example of large-scale looting of the state by individuals and groups close to the sources of political power.

Thus a move toward more systematic analysis of changing preferences is hard to avoid.

Political Reform

Further research seems warranted in three related areas: the political economy of growth, the effective participation of poor people in the growth process, and the role of building constituencies for change in order to advance economic and social reforms.

If economic growth creates large inequalities within a society—as opposed to shared growth—it can undermine the potential for future development. Winners can use their influence with the government to "remove the ladder," that is, to limit competition from other groups in society. In their paper mentioned earlier, Acemoglu, Robinson, and Johnson compare North and South America. Initial features of the political, economic, and physical landscape led to much greater inequality in Latin America, while in North America an improvement in the investment climate favored the establishment of more small and medium firms, thereby creating a constituency for change.

The challenge of ensuring the inclusion and empowerment of poor people is, in large measure, one of assuring the availability, and delivery of basic services as analyzed in the *World Development Report 2004*. In 1513 Machiavelli already saw that "one change leaves the way open for the introduction of others." But he also warned, referring to the relationship between prospects for change and constituencies for change: "There is nothing more difficult to plan, more doubtful of success, nor more dangerous to manage, than the creation of a new system. For the initiator has the enmity of all who would profit by the preservation of the old institutions and merely lukewarm defenders in those who would gain by the new ones." Events in Russia in the 1990s demonstrate Machiavelli's points.

Accordingly, research should investigate how to carry out reforms within some given rules of the political game and what institutions should be created to minimize political opposition to innovation and adaptability, that is, research should find the

best rules of the political game at every given stage of development.

Research and Action

Research and action must reinforce each other. Changing institutions and governance is at the heart of the agenda for action. To translate knowledge into action to promote change means

- Collecting evidence and information and carrying out rigorous analysis of programs and approaches.
- Establishing institutions and building capacity for taking knowledge forward. For example, a World Bank project to build a ring road around Shanghai also helped create local institutions that were then able to apply the techniques for construction, tendering, and finance across the country.
- Encouraging political action by "policy entrepreneurs." Like markets for private goods, markets for policy and institutional innovation are responding to well-chosen combinations of inputs.
- Entrusting the media to goad policymakers to change. Both the *World Development Report, 2002: Building Institutions for Markets,* and the World Bank Institute's recent study, *The Right to Tell: The Role of Mass Media in Economic Development,* include a host of examples of the media's role in catalyzing change, not only of policies, but also of institutions.

Many more examples of how one can trigger institutional change are available. We are beginning to go beyond an understanding of the importance of institutions to an analysis of how to change them, but we have a long way to go. If we researchers want to move forward on a sound basis, then we must have rigorous evidence and well-founded ideas. As academics, it is our responsibility to provide them.

The author is chief economist and senior vice president of the World Bank. This article is based on his presentations at a workshop on Measuring Empowerment: Cross Disciplinary Perspectives in February 2003 and his keynote speech at the World Bank Economic Forum in April 2003. ❊

Improved Business Environment: Joint EBRD—World Bank Survey

by Steven Fries and Sašo Polanec

The business environment in the transition economies improved significantly during the last three years according to the findings of the business environment and enterprise performance survey (BEEPS), which the EBRD and World Bank have conducted jointly first in 1999 and then again last year. BEEPS investigates the extent to which government policies and practices influence business development in CEE countries and the CIS.

Between the time of the two BEEPS surveys, the improvements in the business environment have been most noticeable in the Baltic region and in the CIS-6 countries (Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, and Uzbekistan, albeit from a relatively worse base). The central CIS countries (Belarus, Kazakhstan, Russia, and Ukraine) showed the least improvement, with the CEE countries (Croatia, the Czech Republic, Hungary, Poland, Slovakia, and Slovenia) and southeastern Europe (Albania, Bosnia and Herzegovina, Bulgaria, FYR Macedonia, and Romania) falling in between. To make comparisons over time consistent, the groups include only those countries for which data were available in both 1999 and 2001 (see the table).

A consistent finding in both the 1999 and 2002 BEEPS was the unexpectedly favorable perceptions of the business environment in Belarus and Uzbekistan given the limited extent of market-oriented reforms in these countries, including the liberalization of markets and trade. One interpretation of this finding is that businesses are being sheltered from competitive pressures and therefore have relatively positive perceptions of the business environment because they face relatively little competitive pressure from foreign and domestic rivals. The survey did not cover those enterprises and entrepreneurs that would like to enter these markets, but are prevented from doing so by the countries' restrictive policies. The following are some interesting findings of the surveys:

- In CEE countries, firms in Croatia, the Czech Republic, Hungary, and Slovenia witnessed the most significant improvements in how they perceived the business environment, while those in Poland saw little improvement. In the Baltic region Estonia, which had achieved the most favorable perceptions in 1999, saw less improvement by 2002 compared with Latvia and Lithuania. Nevertheless, in 2002 Estonia, Hungary, Latvia, and Slovenia remained the clear front-runners, with Poland lagging well behind the others.
- In southeastern Europe all the countries except Bosnia and Herzegovina witnessed significant gains in ratings of the business environment between 1999 and 2002. In 2002 Bulgaria, FYR Macedonia, and Serbia and Montenegro achieved the most favorable levels of perception and Albania received the least favorable, with Bosnia and Herzegovina and Romania occupying the middle ground.
- In the CIS Azerbaijan, the Kyrgyz Republic, and Russia saw business environment ratings improve the most, while Kazakhstan and Ukraine made the least improvement. The countries with the most favorable ratings in 2002 were the resource-rich countries of Azerbaijan, Kazakhstan, Russia, and Uzbekistan, as well as Armenia. The business environment

laggards were Georgia, Moldova, and Ukraine, with Belarus, the Kyrgyz Republic, and Tajikistan falling in between.

The gains in perceptions of the business environment between 1999 and 2002 were concentrated in five of the seven areas: inance, infrastructure, taxation, corruption, and crime. These gains were fairly uniformly distributed across the three broad country groups except for finance and crime, where the Baltic states and the CIS-6 countries achieved relatively strong gains. Perceptions of business regulation and the judiciary saw less improvement. Only the Baltic states and the CIS- countries saw significant improvements in business perceptions of the judiciary. Perceptions of business regulation improved only moderately in all five subregions. Notwithstanding these improvements, the aspects of the business environment that continued to pose the most significant obstacles to the operations and growth of firms in 2002 were finance, taxation, the judiciary, and corruption. Many of the persistent obstacles in the business environment may therefore arise because states are still too weak to reign in their own officials or to enforce their own taxes, regulations, and laws.

The business environment was "polluted" by the following factors:

- **Overtaxation and customs delays.** Firms in the institutionally less developed countries use two tax evasion strategies: not reporting actual sales to tax authorities and bribing tax authorities. The countries facing the most severe problems in relation to tax avoidance were Albania, Georgia, the Kyrgyz Republic, and Tajikistan, while the countries with relatively strong tax discipline were Armenia, Estonia, Lithuania, Poland, and Slovenia. For those firms that import, the duties levied on imports and the customs procedures through which these levies are collected are important. Countries with the longest delays at customs were Russia, Tajikistan, and Uzbekistan and those with the shortest were Estonia, Latvia, and Romania.
- **Over-regulation.** BEEPS asked the respondents what proportion of their senior managements' time was spent dealing with public officials about the application and interpretation of laws and regulations ("time tax") and how frequently firms like theirs paid bribes to deal with various aspects of business regulation, including business licenses and permits, health and safety inspections, fire and building inspections, and environmental inspections. The countries with the highest time taxes were Albania, Georgia, and FR Yugoslavia and those with the lowest time taxes were Armenia, Azerbaijan, and the Czech Republic.
- **Crime.** One measure of the cost of crime to businesses is the amount of losses incurred due to crime. The countries with the highest losses caused by theft as a percentage of total sales were Armenia, Azerbaijan, the Kyrgyz Republic, and Uzbekistan and the lowest were Albania, Bosnia and Herzegovina, Estonia, and Hungary.
- **Infrastructure inadequacies.** One indication of the extent to which infrastructure inadequacies create business obstacles is the delays in connections versus the proportion of firms that pay bribes to be connected to services and the number of working days lost because of an interruption in infrastructure services. The number of working days lost was particularly great in Central Asia and the Caucuses, as well as in Albania, Moldova, and Ukraine Countries with the longest connection delays were Belarus, the Kyrgyz Republic, Tajikistan and FR Yugoslavia and the countries with shortest delays were Bosnia and Herzegovina, Croatia, the Czech Republic, and Lithuania.
- **Inefficient finance** One measure of the extent to which finance represents a business obstacle is the length of time required to receive a bank loan after the submission of a successful loan application. Countries with the highest level of banking efficiency were Estonia, Latvia, and Slovenia, and the lowest were Armenia, Azerbaijan, and Uzbekistan.

Nuts and Bolts of the BEEPS Survey

The business environment is multidimensional and includes key aspects of governance provided by the state, such as business regulation and taxation, law and order and the judiciary, infrastructure, and financial services. Firms' ability to function affectively is also affected by the extent of corruption, both administrative corruption, which is often associated with the arbitrary application of laws and regulations, and state capture, whereby firms seek to influence the content of specific laws and regulations to the benefit of narrow private interests rather than broad public interests. The behavior and performance of firms also have many dimensions. In this context BEEPS focuses on the growth of firms, including their decisions to invest and to innovate, and the growth of firms' revenues and productivity.

BEEPS asks firms to assess how their business operations are affected by the functioning of state institutions, physical infrastructure, and financial institutions. The survey assesses seven broad areas: taxation, business regulation, corruption, crime, the judiciary, infrastructure, and finance. Firms were asked to assess how problematic these factors were for their operations and growth on a scale of one to four. A score of one indicates a minor obstacle and a score of four implies a major obstacle.

The first round of the survey was implemented in 1999 and covered 4,104 firms in 25 countries. This latest round covered 6,667 firms in 27 countries, of which 38 percent were industrial companies and 62 percent were service providers. Of the firms surveyed 67 percent were small businesses (2 to 49 employees), 19 percent were of medium size (50 to 249 employees), and 14 percent were large businesses (250 to 9,999 employees). Seventy percent of the firms in the sample were new private firms, 16 percent were privatized, and 14 percent were state-owned.

Qualitative Assessments of the Business Environment
(scale of 1 to 4, with 1 indicating a minor obstacle and 4 a major obstacle)

Country	*Year*	*Finance*	*Infrastructure*	*Taxation*	*Regulation*	*Judiciary*	*Crime*	*Corruption*	*Average*
Albania	1999	3.27	3.01	2.86	2.03	2.99	3.35	3.30	2.97
	2002	2.34	2.61	2.74	2.19	2.85	2.23	3.10	2.58
Armenia	1999	2.46	1.79	3.21	1.54	2.34	2.15	2.34	2.26
	2002	2.42	1.86	2.77	1.78	1.66	1.34	1.85	1.95
Azerbaijan	1999	3.38	2.28	2.96	2.22	2.79	2.47	2.88	2.71
	2002	2.19	1.66	2.29	1.57	1.25	1.15	2.07	1.74
Belarus	1999	2.85	1.55	3.35	2.17	2.30	2.34	2.91	2.50
	2002	2.62	1.24	2.95	2.32	1.98	1.73	2.14	2.14
Bosnia and	1999	3.02	1.83	3.41	2.22	2.12	2.30	2.26	2.45
Herzegovina	2002	2.67	1.64	2.63	2.02	2.52	2.18	2.65	2.33
Bulgaria	1999	3.05	2.30	3.02	2.35	2.37	2.81	2.85	2.68
	2002	2.83	1.51	2.41	1.78	2.23	2.23	2.53	2.22
Croatia	1999	3.56	1.87	3.27	1.94	2.77	2.40	2.79	2.66
	2002	2.23	1.23	2.24	1.81	2.57	1.63	2.29	2.00
Czech Republic	1999	2.88	2.48	3.29	2.40	2.48	2.29	2.52	2.62
	2002	2.49	1.43	2.58	1.86	1.91	1.85	1.95	2.01
Estonia	1999	2.84	1.62	2.70	1.79	2.10	1.99	2.04	2.15
	2002	1.99	1.54	1.99	1.79	1.85	1.70	1.69	1.79
Georgia	1999	3.47	2.22	3.40	2.13	2.33	2.58	3.09	2.74
	2002	2.37	1.98	3.10	1.86	1.91	2.42	2.87	2.36
Hungary	1999	2.86	1.64	3.07	2.18	1.96	2.10	2.14	2.28
	2002	2.26	1.26	2.41	1.74	1.51	1.44	1.77	1.77
Kazakhstan	1999	2.04	1.32	2.33	1.63	1.67	1.73	1.99	1.82
	2002	2.36	1.32	2.27	1.64	1.76	1.71	1.96	1.86
Kyrgyz Republic	1999	3.94	2.20	3.58	2.54	3.29	3.55	3.75	3.26
	2002	2.30	1.59	2.58	1.71	1.98	2.06	2.36	2.08
Latvia	1999	2.84	2.10	3.27	2.19	2.61	2.37	2.64	2.57
	2002	1.91	1.38	2.80	1.95	1.56	1.62	1.94	1.88
Lithuania	1999	3.24	1.87	3.36	2.66	2.71	2.90	2.88	2.80
	2002	1.81	1.55	2.78	1.74	2.16	1.91	2.15	2.01
FYR Macedonia	1999	3.67	1.85	3.18	2.48	2.69	2.41	2.90	2.74
	2002	2.24	1.51	2.32	2.06	2.45	2.17	2.45	2.17
Moldova	1999	3.53	2.53	3.49	2.44	2.80	3.18	3.11	3.01
	2002	2.72	1.39	3.12	2.22	2.10	2.43	2.65	2.37
Poland	1999	2.86	1.70	3.15	2.17	2.35	2.43	2.52	2.46
	2002	2.91	1.55	3.17	2.32	2.47	2.26	2.50	2.45
Romania	1999	3.71	2.51	3.34	2.41	2.66	2.68	3.00	2.90
	2002	2.67	1.61	2.92	2.03	2.45	1.95	2.70	2.33
Russia	1999	3.32	2.10	3.47	2.29	2.38	2.70	2.83	2.73
	2002	2.26	1.43	2.64	1.77	1.88	1.80	1.99	1.97
Slovakia	1999	3.37	1.90	2.96	2.08	2.26	2.59	2.59	2.54
	2002	2.53	1.41	2.43	2.05	2.50	1.93	2.50	2.19
Slovenia	1999	2.73	1.74	2.87	1.92	2.29	1.64	1.71	2.13
	2002	2.00	1.19	1.87	1.60	2.02	1.33	1.67	1.67
Tajikistan	2002	2.65	1.97	2.74	1.97	1.88	1.75	2.27	2.17
Ukraine	1999	2.52	1.47	2.77	2.05	2.13	2.12	2.51	2.22
	2002	2.55	1.48	2.78	2.04	2.23	2.14	2.51	2.25
Uzbekistan	1999	3.04	1.90	2.76	2.07	2.28	2.18	2.76	2.43
	2002	2.41	1.46	2.48	1.66	1.67	1.50	1.71	1.84
FR Yugoslavia	2002	2.60	1.74	2.78	2.02	2.13	1.79	2.02	2.15

Source: Authors

Firms often pay bribes to overcome obstacles in the business environment. Countries in which more than half of firms reported paying at least some bribes included Albania, Azerbaijan, Bulgaria, FYR Macedonia, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, Romania, Russia, Serbia and Montenegro, the Slovak Republic, Tajikistan, and Ukraine. Among those firms in these countries that paid bribes, the average "bribe tax rate" was around 5 percent of their total annual sale, except in FYR Macedonia, where it was significantly lower. Armenia, Croatia, Moldova, and Slovenia appeared to have the lowest incidence of corruption in government procurement.

State capture refers to actions taken by individuals, groups, or firms to influence the formulation of laws, regulations, decrees, and other government policies to their own advantage though illicit or nontransparent means. Public officials can also capture the state if they abuse their authority to shape institutions to further their private interests at the expense of the broader public interest. Firms that succeed in state capture can have a significantly higher investment rate and faster productivity growth than firms that do not engage in such behavior and believe in fair competition. This suggests that state capture is a zero (or negative) sum game for the economy as a whole.

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Emerging Owners, Eclipsing Markets? Corporate Governance in Transition

by Erik Berglöf and Anete Pajuste

In the transition economies, ownership and control will probably remain concentrated for the foreseeable future. Regulatory intervention should focus on eliminating outright fraud while maintaining the incentives for entrepreneurship and large shareholder monitoring. The transparency of emerging control structures—and of what controlling owners do—is of the utmost importance.

New comparable data on ownership, control, and financing patterns show that the emerging capitalist systems in Central and Eastern Europe share many features. While the extent of remaining government ownership differs from one country to another, private ownership dominates everywhere. Ownership and control are becoming increasingly concentrated, with the emergence of corporate groupings and significant foreign owners in most countries. As firms grow, ownership and control are separated. Most firms in the CEE countries are, however, still owner managed, but professional management is becoming more common. Nevertheless, even in those that employ professional managers, controlling shareholders play a critical role. Moreover, for better or worse, large shareholders also play, and most likely will continue to play, a role beyond their immediate mandate and influence the course of politics, in particular, in shaping the rules related to corporate governance and financial sector development.

The emerging ownership and control structures have important implications for corporate governance. In owner-managed firms the fundamental trade-off is between providing incentives for entrepreneurship and protecting minority investors. The data and rich anecdotal evidence from the CEE countries suggest that strengthening minority protection is of paramount importance in combating fraud and bringing down financing costs. This policy priority has its drawbacks, however, when selling companies, because excessive protection of minority shareholders may discourage strategic investors and prevent badly needed restructuring in these countries. The mandatory bid rule that requires new owners who acquire large controlling stakes to buy out remaining shareholders (thereby providing an exit possibility for the minority stakeholders in case they are unhappy with the new owners) could induce firms to withdraw from the stock market, and these de-listings could undermine the sustainability of the fledgling capital markets.

As controlling owners gradually distance themselves from day-to-day management in favor of professional managers, the nature of the corporate governance problem changes. Managers must be monitored, and only controlling owners have sufficient incentives to perform this task. Even in these firms, controlling owners and minority investors could turn against each other, unless controlling owners are provided with sufficient incentives to monitor and protect the latter. In the medium term, the increasing involvement of lending banks may provide some monitoring. Over time, enhanced financing opportunities can increase competition in the market for corporate control and help improve contestability. As countries' legal environments improve, especially with respect to enforcement, litigation could also contribute to better corporate governance.

The regulatory response to the emerging ownership and control structures has largely been determined by the EU accession process. Regulators have emulated existing institutions in current member states, and to some extent have anticipated possible regulation at the EU level. As a result, the CEE countries have adopted regulations that on paper have stronger minority protection than in most EU countries; however, the CEE countries are less forceful when it comes to

implementation. For example, the interpretation of the mandatory bid rule appears to be lax in several countries, leaving more possibilities for a control premium and facilitating block trades.

Regulators must recognize that holders of large blocks of shares are an important feature of the corporate governance system once ownership and management split. Controlling shareholders are a second-best response to weak legal institutions. Efforts to get rid of large holdings would lead to more managerial discretion in an environment where few other disciplining mechanisms exist and where elements of a specific stakeholder culture may obfuscate corporate goals. Moreover, such attempts would most likely lead to further de-listings and increased opaqueness. The market for corporate control is critical to promote transfers of controlling blocks, but given the high ownership concentration, these transactions are unlikely to take place against the wishes of the controlling shareholders and managers. Strict enforcement of mandatory bid rules would essentially shut down the market for corporate control and further entrench incumbent management and controlling owners.

Erik Berglöf is the director of SITE. Anete Pajuste is a Ph.D. candidate at the Stockholm School of Economics. This article is based on their paper "Emerging Owners, Eclipsing Markets? Corporate Governance in Transition," to be published in the forthcoming volume Corporate Governance and Capital Flows in a Global Economy, edited by Peter K. Cornelius and Bruce Kogut (Oxford University Press). ❊

Impact of WTO Accession on the Russian Economy: A Review of Current Findings

by Ksenia Yudaeva

Recent studies on the impact of Russia's WTO accession conclude that the effect of tariff changes alone will be small. The studies expect much stronger effects from accompanying institutional changes and the anticipated liberalization of the service sector, especially from the reform of the electric power utilities.

In 1992 Russia abolished its state monopoly of international trade and introduced a liberal trade regime with virtually no official trade barriers. Responding to the massive decline in production, the Russian government began to re-establish both tariff and nontariff trade barriers in 1993. This process slowed down in 1995 when, as part of the framework agreement with the IMF, Russia was required to abolish all quotas.

Trade Barriers on Both Sides

The last major revision to Russia's tariff schedule was in January 2001, when tariffs in four groups were unified and most tariffs were slashed to 5 to 20 percent. Since then, under increased pressure from protectionist lobbies, Russia has raised its import tariffs for used cars and introduced quotas on imported meat products. Some tariff exemptions exist for goods produced in CIS countries. In 2002-03, however, Russia boosted protection against some imports from CIS countries, such as Ukrainian steel. This growing protection against both CIS and non-CIS goods is expected to continue in 2003.

Because of low administrative capacities and corruption, the revenue from tariffs is lower than the rates would suggest. Nevertheless, tariff collection has improved in recent years, and may improve further after WTO accession. The importation of some goods, such as spirits, sugar, precious metals, and color televisions, is permitted only upon obtaining import licenses, but this requirement is not strictly enforced because of corruption and fraud.

In addition to tariff and nontariff barriers, Russia maintains a number of trade-related distortions that might change after WTO accession. These affect a great many important areas, such as agriculture, intellectual property, telecommunications and other services, government procurement, and markets in which the state is a key or monopoly trader.

In the spring of 2002, the EU and the United States granted Russia market economy status. However, because of state control over domestic energy prices, their rules for antidumping procedures against Russian exporters still allow comparison of costs in third countries. Other protective measures against Russian exports include quotas on Russian steel, envisaged by the Russia-EU agreement on steel, and quotas on Russian grain exports that were recently strengthened.

Accession Hurdles

Russia's WTO negotiations are currently wrestling with a number of unresolved problems, and when and under what conditions Russia will become a member of the WTO is unclear. These problems include the following:

- Russia initially proposed that after accession it would increase tariffs, and then during a grace period of five to seven years—would slowly return them to the present or a slightly higher level. While the tariff increase could present some problems for commodity groups, such as agricultural produce and automobiles, the tariff proposal seems to be the least problematic compared with other issues on the table, as for a developing country Russia's tariffs are fairly low.
- Reaching agreement on trade in agriculture turned out to be a significant problem. Frustrated with the high level of

agricultural support in neighboring Europe, Russia insists on significantly increasing its own subsidies. The lack of transparency in agricultural support is making the deal even more difficult, as how much regional governments have offered to local producers in the way of subsidies is not clear.

• Negotiations about unhindered access to services are among the thorniest issues. In the service sector strong vested interests are seeking protection using the infant industry argument, in the banking sector foreign banks are barred from opening fully licensed local branches, and in the insurance sector foreigners are not allowed to become involved in the life insurance business.

• Some of Russia's negotiating partners, particularly the EU, view state control over energy prices as a trade-distorting subsidy and are urging Russia to reform its energy sector. Russia, for its part, argues that its energy prices are lower than in the world market because they reflect Russia's comparative advantage in energy. Russia refuses to tie WTO accession to a reform of its energy policy.

Winners and Losers

Most studies dealing with the possible effects of WTO accession were sponsored by the Russian government or lobbying groups, and therefore focused primarily on the expected short-term increase in unemployment and the need to reallocate labor. Out of 10 quantitative studies analyzed, 6 addressed WTO accession directly, 2 dealt with the effects of the formation of a free trade area between Russia and the EU, and 2 examined the consequences for domestic industry of reforming Russia's electric power utilities. Even those studies that concluded that Russia would gain from WTO accession or the formation of an free trade area with the EU claimed that the gains from the trade policy changes would be fairly modest, and noted that most of the gains would originate from liberalization of the service sector or institutional improvements. One of the papers concluded that changes in tariff policy after Russia's WTO accession would have an almost negligible effect on GDP.

Other findings of the studies include the following:

• WTO accession will have a particularly large effect on the size and composition of Russian imports from non-CIS countries.

• Improvements in the quality of Russian institutions will help to further increase Russia's trade volume.

• In terms of changes in industrial composition, in the long run metal producers would gain the most from WTO accession, while domestic service providers would experience the greatest losses. (This conclusion did not take the probable effects of energy reform, that is, the expected increase in domestic energy prices, into account.)

• The light industry, machine building, and food industries would be the most probable losers from the accession. At the same time, metals and chemicals would likely be the winning industries. If energy prices had to be raised, the machine building industry would likely lose even more, and thus requires immediate restructuring to make it more productive. Other energy guzzlers, such as the food and nonferrous metal industries, could also face huge losses once energy prices went up.

Overall the studies conclude that eventually, Russia will gain or lose little from tariff changes after the accession. Whether the effects will be positive or negative depends on the type of analysis used. The results differ once institutional changes, productivity gains, or liberalization of the service sector are taken into account.

Weakness and Strength

A number of studies believe that Russia wants to see tariffs go up by the time of accession as proposed last year (see http://www.wto.ru). Officials of the Ministry of Economic Development and Trade revealed, however, that the Russian government considers the proposed tariff rates as the top rates, to be used only in a worst case scenario. Therefore the most probable outcome is that current tariffs will be applied right after the accession, followed by a slow decline during the grace period.

None of the studies dealt with possible changes in government subsidies and other support mechanisms. In Russia most subsidies are provided at the regional level, often via price regulation or other nonmonetary means. More information about the future of various subsidies could refine predictions of the probable effects of WTO accession. The effects of accession on poverty and income distribution were also ignored. One study addressed the issue, but did not provide any quantitative assessments. None of the papers analyzed the macroeconomic or sectoral effects of improvements in intellectual property rights protection, even though the consequences of implementing the Agreement on Trade-Related Aspects of Intellectual Property Rights would be significant for such sectors as the pharmaceutical industry and information technology.

None of the macroeconomic models used in the studies considered the large differences in the economic and social structures of the regions. For a country with such regional diversity as Russia, this weakens the reliability of the forecasts. As statistical information on inter-regional trade in Russia is unavailable, constructing such models requires a serious data collection effort. Nevertheless, the surprising similarity of the conclusions of the different papers suggests that these methodological problems may be less important than they appear at first glance.

Ksenia Yudaeva is a senior economist and director of policy programs at CEFIR and a scholar in residence at the Carnegie Moscow Center. This article is based on her report prepared for the OECD Trade Directorate, which hosted an OECD experts' meeting on Developing Governmental Analytical Capacities in the Trade Policy Area in Moscow on June 3-4, 2003. For further information you can email george.holliday@oecd.org or blanka.kalinova@oecd.org. ❊

WORLD BANK/IMF AGENDA

World Bank Doing a Better Job, But Criticisms Remain

According to a recent poll, opinion leaders in developing countries regard the World Bank's influence on their respective countries as generally positive, and many say the Bank has become more useful, relevant, transparent, responsive, visible, and better at communicating. Opinions are particularly positive in Europe, Central Asia, and East Asia, where 8 in 10 opinion leaders say the Bank has a "very" or "somewhat" good influence. Many opinion leaders agree that the Bank's manner and approach to borrowing countries have improved in recent years and that the Bank is more collaborative and willing to work in partnerships with civil society. Many, however, complain that the institution remains too bureaucratic and arrogant. The Bank also gets lower evaluations for its efforts to help developing countries reduce corruption. In addition, opinion leaders see the Bank as closely tied to the United States. On the issue of the benefits of economic reforms recommended by the Bank, opinion is mixed.

This new poll by Princeton Survey Research Associates was one of the largest and most comprehensive ever conducted on international development issues with opinion leaders. Between October 2002 and March 2003 researchers polled more than 2,600 individuals holding high-level positions in government, the media, civil society, academia, the private sector, and labor unions in 48 countries.

World Bank-IMF Annual Meetings 2003: Dubai, United Arab Emirates

The World Bank and IMF annual meetings will be held on September 23–24 in the Dubai World Trade Center in the United Arab Emirates. Topics of the preceding seminar event, scheduled for September 20–22, include

- What Future Role for the World Bank Group in Oil, Gas, and Mining? Findings of a Global Review.
- Roundtable Discussion: Middle East and North Africa's Employment Challenge in the 21st Century.
- Foreign Direct Investment and Developing Country Economies: The Growing Impact of HIV/AIDS and Infectious Diseases.
- The Growing Dollarization of Banking Assets and Liabilities: A Problem or a Solution?
- Foreign Direct Investment to Emerging Markets: Where and Why?
- Water: From Scarcity to Security.
- Adopting a Global Standard? Developing Countries and the New Basel Accord.
- The Role of Effective Public Communications in the Success of Economic and Financial Policies and Reforms.
- Is There a Role for Business in Building Peace and Democracy?

Nick Stern Takes Senior Position at U.K. Treasury, David Dollar Appointed Director

The World Bank announced on June 12 that Nicholas Stern, the Bank's chief economist and senior vice president for development economics since July 2000, is to take up the position of second permanent secretary and managing director, budget and public finances, at the U.K. Treasury. He will also be head of the U.K.'s Government Economic Service. His new appointment will take effect on September 29. A search for his successor will be initiated shortly.

As of June 16, David Dollar has been appointed director, development policy, in the Development Economics Vice Presidency. His most recent assignment was research manager in the Development Research Group of the vice presidency.

Cost of Preserving State-Owned Banks in Transition Countries: New World Bank Report

In May 2003 the World Bank released a new report, *State-Owned Banks in the Transition: Origins, Evolution, and Policy Responses,* by Khaled Sherif, Michael Borish, and Alexandra Gross, which recounts the time consuming, costly restructuring of state banks in European and Central Asian countries from the late 1980s through 2000. A key finding is that governments are better off moving swiftly to privatize or liquidate their remaining state banks rather than rehabilitating them. On average, state banks still hold nearly one-third of banking system assets in the region (46.2 percent in the CIS, 26.4 percent in CEE, and 7.7 percent in the Baltics), and do so at huge costs to the financial system and the economy as a whole. The report includes seven case studies of selected state-owned banks in Azerbaijan, the Czech Republic, Latvia, Romania, Russia, and Ukraine that have been reformed or privatized over the past decade (see http://lnweb18.worldbank.org/eca/eca.nsf/Attachments/State+Banks/$File/State+banks+Final-022803.pdf).

World Bank Supports Romania's Electricity Market . . .

A •74.3 million ($82 million equivalent) loan approved on June 12 to Romania for the Electricity Market Project will support the development of a well-functioning wholesale electricity market and improvement of the transmission system. Transelectrica, Romania's national power grid company, together with the national electricity regulator and the power market operator, will receive assistance to design and implement the regulatory framework for a new electricity trading platform. Since Romania joined the World Bank in 1991, Bank commitments to the country have totaled more than $3 billion for 30 operations.

Serbia's Private and Financial Sector Reform…..

A $80 million IDA credit for Serbia and Montenegro approved on June 10 will support the country's regulatory, institutional, and structural reforms in the private and financial sectors, targeting a better business registration system, a new enterprise law, and improved access to finance by enterprises and will facilitate the exit and redeployment of nonproductive assets.

A Revenue Collection System in Bulgaria…

A •31.9 million loan for the Revenue Administration Reform Project in Bulgaria approved on June 5 will help the country develop a modern and effective revenue collection system that is more transparent and efficient. It will save taxpayers both time and money. Improving and simplifying procedures will drastically reduce the private sector's overhead time: current procedures require up to 30 percent of the time of an accountant in a small company The project will also minimize opportunities for corruption by introducing equal standards for contributors, and will set up clear rules and procedures for compliance with tax payment responsibilities. Since Bulgaria joined the World Bank in 1990, total commitments to the country have reached about $1.7 billion for 32 projects.

and Ukraine's Tax Service Reform

A $40 million loan for the First State Tax Service Modernization Project in Ukraine approved on June 5 is the first of two proposed loans under an adaptable program lending instrument, with an estimated total $114 million in Bank lending out of $202 million in total costs. The program will support a decade-long, comprehensive modernization of tax administration, and will lay the foundation for a sustainable tax system in the country. Ukraine currently has a large shadow economy and a relatively low rate of taxpayer compliance with the tax legislation. As a result, tax authorities take an enforcement-oriented stance in relation to taxpayers, which creates opportunities for administrative abuses. Since Ukraine joined the World Bank in 1992, commitments to the country have totaled more than $3.4 billion for 27 operations.

Record $100 million IFC Loan to Moscow Narodny Bank

On June 9 the International Finance Corporation (IFC), the private sector financing arm of the World Bank Group, signed an agreement to provide a five-year, $100 million loan to Moscow Narodny Bank, majority owned by Russia's central bank. This is IFC's largest loan for Russia to date. The loan will help Russian companies access medium-term financing and will provide Moscow Narodny Bank with additional opportunities for doing business in Russia. The bank is already engaged in talks to pass on that money to companies in the oil and gas, metals, chemicals, and service sectors. Eventually the central bank will sell its 88.9 percent stake in Moscow Narodny Bank, whose total assets stood at $1.8 billion and equity at $440 million at the start of the year. Moscow Narodny Bank is headquartered in London and was established in 1919 to facilitate trade with Russia. Russia joined IFC in 1993. Since then IFC has invested more than $911 million of its own funds to finance about 70 projects in a variety of sectors.

In fiscal year 2003, which ended on June 30, IFC invested $500 million in Russia. In fiscal year 2004 IFC plans to focus on investments in the finance sector, but will also invest in the manufacturing sector, transportation, telecommunications, and technology, said IFC Executive Vice President Peter Woicke during a recent press conference in Moscow.

EBRD Sees New Opportunities in Transition Countries Even After EU Accession

The EEBRD sees opportunities for its business in Central and Eastern Europe after the countries become EU members, nevertheless, it does plan to downsize its operations in the region over time, announced EBRD First Vice President Noreen Doyle. The fields that EBRD is looking at in the region include leasing, mortgage loans, warehousing, and banking. With EU enlargement imminent, the EBRD also envisages working closely with central and local governments to help them obtain money from the EU's structural and aid funds. The region continues to need equity investment funds.

Mixed Results in the War Against Poverty

The war against poverty has made definite progress, but has also encountered setbacks related to the Millennium Development Goals, which aim to halve the extent of severe poverty in the world by 2015. Australia's *Melbourne Age* recently made the following observations:

- Global poverty is declining. The new update of the Bank's *World Development Indicators* estimates that in the 1990s the number of people living in extreme poverty—an income of no more than $1 a day, indexed for inflation since 1990—fell from 1.3 billion to 1. 2 billion, despite rapid population growth. The Bank noted, however, that the fall was concentrated in China and India. Poverty rose—in some cases dramatically—in much of the world, above all in Africa and the former Soviet Union, where real incomes have been halved.
- More developing countries are enjoying real growth. Despite civil wars, AIDS, corruption, and misgovernment, since the mid-1990s average per capita incomes in Africa have risen by about 1 percent a year, reversing a 20-year slide.
- Economists and global institutions are finally grasping the economic importance of education; health care; good, corruption-free government; and a culture that is conducive to business development. The World Bank's own priorities have changed radically to reflect this understanding. It funds infrastructure projects, but also wants to ensure that every child receives a good basic education, that safe water and health care are available to all, that childbirth is not fatal to mothers or children, and that gender equity becomes a reality. Experience shows that these rights not only flow from economic growth, but in a virtuous circle they also generate it. ❊

TOPICS FOR DEBATE

Uncertain Roadmap for Postsocialist Health Care Reforms

The transition countries once had a socialist health care system that, for all its weaknesses and ideological fallacies (it was geared toward keeping workers fit and healthy), offered universal, and—at least on paper—free, outpatient and inpatient treatment. With the fall of communism the challenge became how to apply both the principles of solidarity, (that is, treating the poor for free), and efficiency. Governments are struggling to meet both requirements. The following articles rely heavily on a survey titled "Who Cares? Health Care Reform from the Bering to the Adriatic," published in the Spring 2003 issue of *Local Government Brief*, a quarterly publication of the LGI, Budapest, Hungary (see http://lgi.osi.hu/publications/default.asp?id=236).

Curing Sick Health Care Systems in Transition Countries

by George Shakarishvili

As a result of large-scale economic decline in the former communist states of Central and Eastern Europe and the former Soviet Union, major indicators of the health status of their populations and of their health care systems have shown dramatic deterioration. Health care reform should increase efficiency while simultaneously maintaining health systems' solidarity and universality.

Funding for the heath sector in the Soviet system was derived exclusively from state revenue sources. The state owned and ran health facilities and medical personnel were considered to be civil servants. Funding was provided to health facilities based on fixed norms, and the management of health care institutions had little control over activities and inputs.

Mixed Bag of the Past

Universal entitlement of the entire regional population to a full range of health services was an undeniable achievement of the socialist regime and its health care system. Structurally integrated networks of hospitals, outpatient clinics (polyclinics), and other health facilities provided universal access to curative health services. Outside urban centers outreach facilities, *feldsher* stations (facilities employing medical practitioners who lacked graduate qualifications and were trained to work in rural areas), ambulatory clinics, and rural hospitals provided health services. By the 1970s health sectors across the region were well endowed with basic physical infrastructure, trained staff, and education programs compared with countries with similar per capita incomes, or even with highly industrialized countries.

Over time, however, the system's long-term sustainability faltered as supply-driven development of the medical infrastructure failed to meet demand. From 1980 to 1998 most CIS countries had, on average, 850 hospital beds per 100,000 people, while CEE countries maintained 700 hospital beds per 100,000 people, compared with the EU average of 550. During the same period hospital admission rates varied between 20 and 22 per 100 people in the CEE countries and the CIS, compared with 16 in the EU, and the average length of stay hovered around 14 days in the CIS, compared with 9 in the EU in 1996. Health providers were reimbursed based on the number of hospital beds, therefore local authorities had a strong incentive to build mega-hospitals that had high flows of patients and to bypass the primary care level. [Editor's note: Moreover, hospitals were widely used as hospices.]. The predominant focus on specialist- and subspecialist-based curative care further reduced the use of primary care level services, thereby decreasing the system's cost-efficiency even more.

Deteriorating Health Indexes

The efficiency and quality of care deteriorated, and ultimately the population's health status worsened. Life expectancy, for example, fell significantly throughout the CEE countries and the CIS, with the greatest drop occurring in Hungary: 3.5 years from 1970 to 1990. During the same period age-standardized male mortality rates in Bulgaria, Czechoslovakia, Hungary, and Poland increased by 2 to 13 percent, compared with a decline of 12 to 27 percent in Western European countries. Between 1965 and 1989 death rates for males increased by 7 percent in the German Democratic Republic and by 13.1 percent in Hungary. Similar negative trends occurred throughout the Soviet Union as well. A substantial portion of the high death rates can be attributed to the prevalence of noninfectious diseases, such as cardiovascular and respiratory illnesses, cancer, and accidents. Highly cost-effective interventions, such as promoting healthy lifestyles, launching antitobacco campaigns, implementing anti-alcohol regulations, and so on, could have prevented most of these diseases. This clearly indicates the erroneous approach of a health care system that emphasized curative care and the prevention of infectious diseases, yet ignored the noninfectious diseases to which most of the high death rate was attributable, a typical manifestation of non-needs-based planning.

The high mortality rate, along with the economic crisis and high military spending, aggravated the sharp economic downturn that started in the CEE countries and the CIS in the early 1980s. The mortality rate burdened the region's economy because of the lost investment in human capital, the increased state medical expenditures, and the more general opportunity cost of lost lives. Thus not only were health care reforms essential for improving the population's deteriorating health status, but also for reviving the economy and maintaining international competitiveness.

From 1995 to 2000, total health expenditure as a percentage of GDP shrank to 5.8 percent in the CEE countries and 3.8 percent in the CIS, compared with 8.5 percent of a much higher GDP in the EU. Similarly, total per capita expenditures on health were much lower in the CEE countries and the CIS than in the EU. During 1995-2000 such expenditures increased from $85 to $167 in the CIS, from $415 to $500 in the CEE countries, and from $1,680 to $1,920 in the EU.

No Universal Reform Recipe

Fleshing out the patterns of health care reform across the CEE countries and the CIS is a complicated endeavor. The health sector cannot be reliably regulated by purely bureaucratic, governmental coordination or by purely market coordination, but must employ a combination of the two. Governments' ability to achieve a sustainable balance between multiple health sector objectives depends on the development of an appropriate mix of supply-side interventions at the micro (institutional) and macro (system) levels. This mix should increasingly include a carefully constrained role for certain market-oriented incentives as well as for traditional regulatory instruments.

Viewing the early 1990s as catastrophic for their health care systems, many policymakers have attempted to make too many fundamental changes too quickly. Sometimes new policy decisions have undermined the dependency theory, that is, that every new policy, regardless of how radical a change it is designed to bring about, is nonetheless built on a former system. Attempts to build a new system without taking the ramifications of the old into account tend to prove ineffective.

Different countries in the region are at different stages of implementing health reforms. While many CEE and some CIS countries have switched to a system based on social insurance principles, others, such as Azerbaijan, are still operating within an old, Soviet-type framework. Not only do the countries vary according to how much they have advanced with respect to reforms, but they also vary in relation to the strategies they have chosen. While Bulgaria has privatized almost its entire provider sector, Lithuania has transferred health facilities to local governments, while in Ukraine these facilities still remain the property of the central government. Croatia, which had a fairly decentralized system prior to the 1990s, has attempted to strengthen the central government's role and has therefore centralized certain aspects of health service provision and financing. In still other countries decentralization is one of the key components of the reforms. Thus talking about common policy strategies that are appropriate and applicable across the entire region is premature.

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Paying the Bills: Health Care Funding in Central and Eastern Europe

by Martin McKee

By the late 1960s the Soviet model of health care clearly could not maintain its initial successes. While health care advanced rapidly in the West, with new pharmaceuticals and surgical practices, the Soviet Union, and to a somewhat lesser extent its Central European satellites, suffered from the dual challenges of isolation from Western scientific developments and a reduction in funding for the so-called nonproductive sectors, including health care, largely because of the diversion of resources to military spending. The number of deaths that could be avoided by effective and timely medical care began to fall rapidly in Western countries, but remained high in the Soviet Union.

By the end of the 1980s, dissatisfaction with the Soviet model of health care was widespread. The gap with the West became ever more apparent, largely as a result of *glasnost*, which helped reveal that the system was much less equitable than official statements suggested. Those fortunate to work in politically privileged jobs or in successful enterprises that could cross-subsidize their facilities fared much better than those reliant on often very basic facilities. In many countries the use of connections or informal payments became widespread as a means of obtaining better quality treatment.

Consequently, when communism collapsed, changes in health care financing were inevitable and health policymakers turned to examples from Western countries. Several factors influenced their decisions. One was the priority placed on transparency. Decades of the government siphoning money from health care to transfer to sectors such as defense convinced them of the need for a transparent arrangement that would protect health care funds. Physicians, who were often politically influential, wanted a system that would reward them adequately for the work they did. However, the general public was interested in a system that maintained universal coverage and did not support the U.S. model, which left many poor people without care.

Inevitably, this steered many policymakers toward a model based loosely on the social insurance systems of Western Europe. In reality, these systems could not be replicated, because they had evolved in different ways in each of the Western European countries over a period of a century or more, neither could they be grafted onto existing institutional

structures of employers' associations and trade unions. Nevertheless, a variety of health insurance models did emerge. These varied considerably, with some countries, such as the Czech Republic, introducing multiple, competing funds, while others, such as Hungary and Romania, adopted a single fund. Similarly some countries have combined health and social insurance funds while others have separated them.

Even though aspirations to introduce health insurance have been almost universal, in reality perhaps the greatest diversity lies in the degree of success achieved.

In part this reflects countries' varied success in building institutions and in achieving economic development. Those countries soon to join the EU have largely succeeded in developing workable systems, with sustainable revenue collection and increasingly sophisticated methods of purchasing health care. Others, such as Albania, Russia, and Ukraine, still depend heavily on budgetary support from central or local government revenues. Meanwhile some countries, most notably those in the Caucasus, which have not only suffered severe economic decline, but have also been beset by war, have experienced effective collapse of the previous system, and their citizens must make out-of-pocket payments for most health care.

We can learn several lessons from these varied experiences in relation to raising funds, pooling and allocating resources, and purchasing care as follows:

• **A poor country will be unable to afford a system that is comparable to that in a wealthy one, no matter what system it uses to raise funds.** Several countries in the region have suffered economic declines to such an extent that they are now among the world's most destitute, the so-called Highly Indebted Poor Countries. In these countries, while not a substitute for eventual nationwide systems of social protection, they can achieve a good deal through small-scale community financing schemes that will at least avoid some of the risks of impoverishment in the event of illness.

• **Health insurance based on payroll contributions is unlikely to succeed in countries that still have a large informal economy and high unemployment.** Indeed, through their effect on labor costs high payroll contributions may actually be an incentive for informal employment. Governments have many ways of raising funds, not only from payroll contributions, but also from sales taxes, import tariffs, and so on. Health insurance systems face particular problems in assessing and obtaining contributions for those not working, especially because they are likely to be especially heavy users of services. Different countries have taken different approaches. For example, in Russia municipalities are responsible for these contributions, but transfers are often late and insufficient.

• **Western European countries have all developed systems of collective funding based on solidarity.** Those most in need of health care are often those least likely to be able to pay for it. Thus for most people or health care providers to promote a private financing system with no risk sharing makes no sense. Similarly, competition between insurance funds is rarely a good idea unless a country has a sophisticated system of regulation, the costs of which will almost inevitably outweigh any gains resulting from competition. Funds tend to find increasingly sophisticated ways to exclude those who are likely to cost them money.

• **General taxation is the most equitable system, while health insurance tends to be more regressive.** Out-of-pocket payments are the most inequitable, and systems in which they are widespread often create impoverishment among those who develop a serious disease.

• **Health care funds are required not only for revenue, to keep the system going, but also for investment in people, facilities, and equipment.** Often such investment falls to the bottom of the list of priorities, leading to a steady decline in the infrastructure needed to provide health care.

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Dealing with Four Elements of Postcommunist Health Care Systems

by Hernan Luis Fuenzalida-Puelma

To implement effective reform in postcommunist health systems, the authorities must recognize that in addition to the public and private health sectors, an informal sector and a public-private mix also exist and their particular situation requires unique solutions

After more than a decade of health care reforms in Central and Eastern Europe, it is common to read about the duality of health systems divided between underfunded public (state) sectors and financially exclusive private sectors. State sectors are characterized by oversupplies of hospital beds, poor infrastructure, a focus on inpatient care, low-quality and limited primary and preventive health care, disincentives for health care staff at all levels, and customer dissatisfaction. By contrast, the private sectors cater almost solely to the affluent; cooperate with large, usually foreign corporations; allow patients to choose among qualified physicians; provide services and consultations promptly, obtain modern medical equipment; and, under special arrangements, enjoy access to public hospitals and clinics.

In reality, however, the region's health care systems do not exhibit any duality. Even during the socialist period there was a "triality" that consisted of the formal public system for the

population at large, the formal public system for the apparatchiks, and the-under-the-table system within the public system.

Today the sectors have become even more complicated, exhibiting a "tetrality" as follows:

- A public health care sector that continues to serve most of the population and to do so badly
- An incipient, but growing, private health care financing and delivery sector aimed mainly at the middle and upper classes
- A persisting informal public-private mix consisting of an unregulated secondary market within the public health care system in which mostly public resources are used privately
- A formal (through contracts) public-private mix whereby the financial and delivery resources of the public and private sectors interact in a search for efficiency and mutual benefits.

Public Health Care

The public health care sector continues to bear the responsibility of financing and providing health care to the majority of the population. This colossal task—particularly if properly carried out—requires many adjustments carried out over several years. These adjustments must represent a visible redesign of the larger health care system to incorporate fewer beds and hospitals and integrated polyclinics with larger outpatient services. Polyclinics need to be restructured, merged, and reorganized to focus on primary and preventive care. Regional and municipal-based networks should be redesigned to provide services locally and avoid the overuse of regional and central hospitals. The number of physicians must be reduced, but with due coordination between health and education to avoid, for example, what occurred in Georgia, where the Ministry of Education unilaterally approved dozens of private medical schools in a country already oversaturated with physicians. Primary health care training for physicians and nurses also needs to be improved.

The hopes for social health insurance to finance basic public packages of health care goods and services have not panned out as expected. Conceiving an employment-based social health insurance system in the midst of a transition that curtailed formal employment and fomented unemployment does not seem to have been a good or an opportune idea. Revenues have been inadequate, and the burden still rests with public treasuries, which are incapable of making the required transfers to sustain the systems financially and to subsidize those not in the formal employment sector. Voluntary health insurance, which is supposed to complement social health insurance, has developed slowly, mainly because of consumers' lack of interest.

Costs have increasingly been passed on to consumers in the form of copayments and user fees, with disastrous results for the poor. This has heightened people's distrust of public systems and consumer dissatisfaction, particularly among socially and economically vulnerable groups.

Instead of establishing a single social health fund most countries have created several health funds, leading to fragmentation in relation to resources, high administrative and transaction costs, administrative duplication, and inefficiencies. Elsewhere the process of re-centralization has been inevitable, but when adopted early on, as in Estonia, it has prevented the problem of excessive enlargement. Overall, public health care systems remain underfunded and largely unrationalized, and provide low-quality services to most of the population.

Despite recent accomplishments, including a reduction in the number of hospital beds (many of which existed only on paper and not in reality), the public health care infrastructure generally remains in relatively bad shape, with low-quality care and shortages of equipment, medications, and even basic medial supplies, particularly in rural areas. The decentralization of health care services has also been disappointing. Regional and local governments simply do not have enough resources.

Private Health Care

Every CEE country possesses an openly operating private health care sector that is linked to some formal sources of financing, such as banks and insurance companies, and various packages of health care goods and services provided by insurance companies and through prepayment schemes. In Bulgaria these schemes involve service packages offered by private financiers in association with groups of physicians for a fixed fee. Growth of the private sector is generally proceeding in an unregulated manner.

Health care delivery in the emerging private sector is generally good, but tends to be limited to certain specialists, such as gynecologists, pediatricians, dentists, pharmacists, cardiologists, and ophthalmologists. Such practices are evident everywhere, but especially in those countries where the polyclinics were broken up. The emphasis on the development of primary health care has also given rise to the emergence of general practitioners in private practice.

The main constraints facing private health care delivery are legal, because it is difficult for physicians to create their own practices in the form of separate legal persons, and financial, because of limited access to capital and operational credit. In addition, the lack of proper regulations on accreditation, licensing, and certification contribute to the emergence of mediocre professionals in the private market. The absence of patient's rights, appropriate claims procedures, and malpractice laws foster the uneven development of private health care delivery.

Informal Public-Private Health Care

Informal payments made to individuals or institutions, in kind or in cash, outside official channels can be found in health care, the courts, customs, the traffic and tax police, various inspection services, and virtually all public services. Regardless of the field, this important issue, which is embedded in the current institutional system from the socialist period, is detrimental to any rational effort toward development and governance. In health care the problem directly affects the well-being of individuals and families, as informal payments

represent a significant proportion of household income. As such, they affect the poor the most. Often such payments are indicative of corruption and have increasingly become the usual form for paying and remunerating public health care providers. The logic of informal payments seems to be that they ensure quality, priority, or a certain treatment, and constitute a regular under-the-table business for many health care providers. Regrettably, they have become almost mandatory because of the financial and institutional breakdown of public health care systems. Providers feel entitled to receive these payments and patients believe they are obliged to pay.

Formal Public-Private Mix

The formal public-private mix is slowly developing. As public hospitals and polyclinics gain some legal and institutional autonomy, they are able to enter into contracts with private financial sources. In turn, they can spend these incomes on their own, outside the restrictions of budgetary lines. Public establishments therefore have a powerful incentive to enter into such contracts. In some cases, for example, in Lithuania, private health care businesses lease space in public hospitals to operate private clinics. These arrangements can include the use of some hospital facilities, such as laboratories, operating rooms, and rehabilitation premises. Often such arrangements take place between the private sector and military hospitals with spare capacity. Meanwhile, social health insurance sometimes pays for services rendered in private facilities, but this is typically confined to important public officials. The system is becoming more complex, and contracts stipulate details of the relationships.

Financing derives mainly from private sources, namely, health insurance companies. Large prepayment schemes also have contracts with public and private providers, both individual and institutional, for example, in Bulgaria. In some cases social health insurance funds purchase services in the private sector, mostly in more modern and better-equipped private health care facilities. Delivery appears to be of relatively good quality. Regulation is typically accounted for in contracts, listing the types of services to be delivered as well as quality standards.

Impact of Health Care Reforms to Date

Health care reforms that focus on financing and payment mechanisms have produced mixed results. The reasons for this include a weak macroeconomic context, low levels of formal employment, low compliance with social contributions and a lack of fiscal transfers, and overgenerous basic benefits packages. Likewise, the expectation that health insurance would result in greater and more stable revenues and allow health care professionals to earn more has not been the case. For the most part the situation of public health care workers has not improved.

Social health funds have not been given full and adequate legal and institutional structures to ensure their financial, managerial, and contractual autonomy. Meanwhile ministries of health fight social health funds, because they feel that they no longer have control over the financing of the public health care sector and are reluctant to accept that their role needs to change to one of policy and regulation and that they need to concentrate on public health. Multiple social health funds have proven to be a bad idea.

Legal and institutional impediments to payment mechanisms, complex contracting procedures, and a lack of enforcement of contracts have challenged the efficacy of some financial reforms. Accumulated deficits in the public health care sector result in public systems not honoring contracts with suppliers, thereby contributing to increasing mistrust of public systems and the consolidation of public health systems that are financially unreliable. In essence, while private sectors have benefited from the opening of markets, public health care infrastructure has not changed substantially even after a decade. Without renovating the legal and institutional settings, labor markets, and medical education systems, and without rationalizing public health care infrastructure and enhancing primary and preventive care, any attempted reform is piecemeal.

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Fighting Corruption in Health Care Services

by David Hayhurst

Governments in CEE countries and the former Soviet Union meet with resistance on many fronts when tackling corruption within their health care systems. Even when state authorities possess the will and resources needed to take on the various, and often endemic, types of corruption, they confront a common, major obstacle: the attitudes of the public and of many politicians are as difficult to change as those of health care professionals.

In-depth, OECD-funded studies carried out in 2002 that dealt specifically with corruption in the health care system in Latvia and Lithuania shed light on problems common to some extent in all the post-Soviet states. While the two Baltic nations are far from being the worst off in the region in terms of either systemic fraud or budgetary constraints, the reports describe how hospital cleaning staffs are routinely paid better than nurses, while factory workers can earn more than even some senior doctors. Meanwhile, throughout the CEE countries and the former Soviet Union poorly implemented systemic reforms, often explosive increases in operational costs, and decentralization of accountability and decisionmaking capacities have unwittingly helped to promulgate environments where corruption can thrive.

A major challenge to governments wishing to reduce corruption is that what international bodies invariably view as improper conduct is not frowned upon nearly as much by the public at large. The most common form of "unethical" conduct—the acceptance of so-called out-of-pocket payments by patients to doctors and nurses—is still widely tolerated by the public. This is particularly true among older people, who often tend to view such informal charges both as expressions of gratitude and as the surest way of assuring that they receive the best medicines and treatment. A 1998 World Bank survey on corruption in Latvia found that despite households' direct experience with corruption in the health sector, they gave health-related organizations relatively high marks in terms of honesty and integrity, on average well above what they gave the mass media or local NGOs.

Indeed, it is difficult to see how governments that cannot afford to pay the meager salaries of medical professionals for months on end can expect them even to survive by honest means. Some governments have allegedly given up on trying to curb the practice to the point of using estimates of out-of-pocket payments to determine physicians' wages. Recent estimates for Azerbaijan, Georgia, and Moldova, where public financing for any forms of social services have all but collapsed, indicate that such payments now account for 50 to 80 percent of total national health revenues.

The introduction of mainly market-based reforms in health care systems has been fraught with danger for governments worldwide. This is perhaps doubly so in the former socialist states, where unfettered and free access to health care was seen by all as a citizen's birthright. Medical professionals in these countries have not been overly accepting of their governments' usually scattershot approaches toward installing such foreign concepts as performance benchmarks and peer reviews for their managerial prowess. Much of the so-called private care increasingly being implemented to help ease the insufferable burden on state budgets is currently either financed partly by government or uses public infrastructure and equipment to treat private patients. Clearly such policies can leave systems wide open to abuse.

According to a comprehensive 2002 study ("*Corruption as a Challenge to Effective Regulation of the Health Care Systems*," by Tim Ensor et al published by the Open University Press, Buckingham, United Kingdom): "Staff in public medical institutions have the opportunity to deliver private care using public resources. This includes the use of equipment, supplies and, perhaps most importantly, time. Sometimes known as creeping privatization or privatizations from within…services offered to patients may include simple additions to the treatment already provided as part of the official state package of care. Alternatively, a doctor may provide treatment entirely on a private basis during the time he should be spending on public duties and/or using public supplies and equipment. Another possibility is for a public doctor who also has a private practice to spend less time than contracted for in public facilities to extend the amount of time in private practice."

Such workaday abuses obviously stem in part from the failure of alternative methods of budget financing to supplement massive jumps in expenditures adequately. In particular, the introduction of payroll-based mandatory health insurance funds is, in the view of many experts, being regarded as a panacea by governments unwilling to admit that extra funds have to come from somewhere if public systems are going to function even remotely in accordance with official guidelines.

In such environments, it is not difficult to see how senior doctors and hospital managers can be tempted to take illicit measures to make ends meet. Most, after all, received little or no training as managers before being required to run hospitals in a suddenly semi-autonomous environment. Under the Soviet model, successful hospitals were seen as those with the most occupied beds. This mentality has often died hard: hospital-based concerns still completely dominate health care policymaking rationales in the CEE countries. A 2001 study describing the abundance of changes still taking place in the Hungarian hospital sector found that patients were more likely to be willing to pay gratuities the longer they stayed in hospitals, and particularly just before surgery. This has led to a rise in the number of hospital inpatients—completely the opposite of the expressed desires of almost all national and regional politicians—with a concomitant rise in what are described as interventionist operations. ("*Coping with Environmental Change: The Hospital Perspective in Hungary*," Eurohealth, Dublin, Ireland, Vol. 7, No. 3, 2001).

Nevertheless, the anticorruption battle has had some success stories. In recent years the Czech government has managed quite successfully to circumvent some of the often well-entrenched vested interests that have stymied effective reforms in many of its regional neighbors. Most Czech hospitals are now owned and governed under a public-private mix involving the national government, district and regional authorities, and private for-profit and not-for-profit bodies. The country is almost unique in the region in that the number of physicians has declined and their earnings have exceeded the national wage growth average in recent years. Partially as a result, out-of-pocket payments are the exception. Poland has also seen health care professionals in general receiving higher wages than the national average.

Perversely, however, many health care workers in Poland and elsewhere have voiced their concern that joining the EU will lead to at least an initial drop in wages, while intensifying what has already been a dramatic brain drain of the youngest and often most gifted professionals. (CEE countries' health care systems, perhaps somewhat surprisingly, are not specifically part of the EU's accession criteria.) With the sudden heavy inflow of capital that EU membership will in all likelihood bring to the health care networks overall, whether new and equally insidious forms of both blatant and tacit corruption will emerge within CEE countries' and the former Soviet Union's medical networks remains to be seen.

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Hungary's Medical Profession's Game with the Government

by Pavel Ovseiko

This articles uses game theory to conceptualize the challenges Hungary's health sector currently faces in relation to effective governance. The prisoner's dilemma game can illustrate the structure of the interaction between the medical profession and the government. To optimize the health sector's performance these two actors must cooperate. The article considers two problems causing ineffectiveness, inefficiency, and inequality—"gratitude money" and adverse incentives—and suggests how cooperation between the medical profession and the government could address these problems.

In Hungary, doctors and pharmaceutical and medical equipment manufacturers took advantage of the state's loss of control over the health sector and the introduction of market mechanisms in the public health system. Patients pay doctors gratitude money in the hope of receiving better prescriptions, securing attention, jumping a line, obtaining a referral to a hospital so as not to have to pay for prescribed drugs, taking sick leave, and being treated in a high-profile hospital or by a leading specialist. Similarly, to sell more drugs pharmaceutical companies pay doctors "in gratitude" for prescribing their products with up to 10 percent of the cost of the prescribed drugs, gifts, or invitations to "conferences" in exotic places. (Note that it was only in 2000 that the government introduced a law banning doctors from accepting gifts from pharmaceutical companies.) In addition, to boost sales the manufacturers of medical equipment and commercial health care providers offer premium deals to doctors with negotiating power.

Adverse Incentives and Gratitude Money

In terms of adverse incentives, nonpurposeful mismanagement and incompetence on the part of reformers account for considerable efficiency losses. For example, instead of providing a definitive course of treatment, general practitioners, who receive salaries according to the number of patients they serve, are enticed to quickly prescribe drugs and refer problematic patients to specialized inpatient clinics. The cost of inpatient care is much higher than that of outpatient care. Moreover, in inpatient clinics doctors' salaries are performance based. Thus doctors have incentives to keep patients as long as possible and to prescribe expensive treatments.

Rooting out the problems of gratitude money and adverse incentives is extremely difficult, as both result from maximizing behavior on the part of patients, doctors, and the medical industry. Minimizing the effects of these problems requires either changing the incentive system or finding ways to eliminate these problems within the context of existing health sector arrangements. Because changing these arrangements is difficult and expensive, finding new options that will improve efficiency is desirable.

In my opinion, for the time being the authorities must refrain from pursuing costly, radical changes and from following blind hopes that liberalization, democratization, and decentralization policies by themselves can put things right. Such policies can bring about effectiveness and efficiency in the long run, and society will eventually regulate the free market through civic groups, political parties, trade unions, patient rights groups, and professional organizations of doctors. In the meantime, however, policymakers should focus on finding practical solutions for problems that reduce the effectiveness, efficiency, and equity of existing health sector arrangements.

Short-Term Solution

The phenomena of gratitude money and adverse incentives persist because of medical professionals' low salaries. Under pressure to reduce public expenditure, the government cannot devote sufficient resources to finance the health sector. This was also true under the socialist system. The communist government took gratitude money into consideration and set salaries and wages in the health sector lower than it might have done in the absence of such payments, allowing patients to top up doctors' salaries and the wages of auxiliary staff. Another consideration concerns the interests of the medical profession. Clearly if gratitude money constitutes up to 90 percent of doctors' incomes, even a tripling or quadrupling of their official salaries will not create a sufficient incentive for them to abstain from accepting gratitude money. Similarly, if doctors continue to have incentives to prescribe expensive drugs, they will do so. Thus an effective system of penalties and policing is needed.

The problems result from interaction between the government and the medical profession. The government's strategy of accusing the medical profession of corruption serves to manipulate public opinion. The public knows firsthand about corruption in the health sector, but corruption in the government is less apparent. Meanwhile the medical profession's attempts to preserve the publicly funded health system are not solely altruistic, and are often motivated by the self-serving interests of the current medical elite.

Thus as concerns the "game" the medical profession and the government play, the current situation of gratitude money and adverse incentives represents equilibrium. As such, no player can gain by unilaterally switching to another strategy. The government's dominant strategy is to accuse the medical profession of corruption and to make doctors responsible for the problems of the health service, thereby absolving itself from its own responsibility for public health. As for the medical profession, the current situation allows senior doctors (who represent the medical profession in political circles) to earn high incomes and preserve their top positions in the medical hierarchy. Obviously such an equilibrium is suboptimal.

The government can no longer control the medical profession, and therefore requires its cooperation to establish and enforce a set of cost-contained and effective treatment

The Prisoner's Dilemma Game

Even though the word "game" suggests light situations and peaceful behavior, game theory is usually applied to rather serious situations. Investigators use game theory in politics and economics to model interactions that involve strong conflicts of interest and competition. To them a game is an interaction between two or more actors, where players try to optimize their pay-offs and make their decisions separately from other players, but anticipate others' moves.

In game theory, the problem of cooperation is usually analyzed by means of the prisoner's dilemma game, whereby two suspects in a crime are put into separate cells and are given the option of confessing to or denying an allegation. If they both confess, each will be sentenced to three years. If only one confesses, he or she will be freed and used as a witness against the other, who will receive a sentence of 10 years. If neither confesses, they will both charged with a minor offence and jailed for a year. Obviously a dominant strategy for each prisoner is to confess. As such, trying to maximize their pay-offs separately and, in doing so, competing against each other, together they will produce a suboptimal outcome. To minimize the total punishment for the system consisting of two prisoners, the prisoners should not pursue their dominant strategies but accept a common strategy of rejecting the allegation. When they manage to cooperate in denying the allegation, they can both produce an optimal outcome. The unique equilibrium of this game—a situation when no player can gain from unilaterally switching to another strategy—highlights the principle of suboptimization, when optimization of outcomes for every subsystem does not optimize the outcome for the system as a whole.

procedures that doctors should follow, penalties for deviation from these procedures, and an enforcement system. The medical profession has no reason to regulate and restrict its activities as long as such measures neither ensure high incomes for doctors nor contribute toward the profession's development. Thus to promote cooperation, the government must increase official salaries in the health sector. If doctors receive high official incomes, they would be interested in excluding colleagues who are incompetent and/or violate professional norms and procedures from their profession (though the possibility of negative solidarity among doctors should not be excluded). Therefore the medical profession should delegate a certain amount of control and policing functions to the state. In return the state should delegate some powers to the medical profession to participate in health policymaking in relation to doctors' salaries, costs and content of medical procedures, organizational reforms, and so on.

Is Cooperation Possible?

In the prisoner's dilemma game, cooperation is beneficial for players, even though it can be viewed as irrational. The expectations of players who consider taking a cooperative strategy that their counterparts will inevitably cheat them determines that both players stick to a competitive strategy. A great deal of trust between the players is needed to allow them to abandon rational strategies of competition and to "irrationally" choose a cooperative strategy. This trust can be generated between the government and the medical profession only through personal relationship building. If leaders of the medical profession and the government achieve this, then they can agree on an unbiased framework that would facilitate the medical profession's participation in health policymaking with a view to enhancing overall efficacy. To have an effective, efficient, and equitable health system, the government needs to introduce reform in cooperation with the medical profession, but whether it can achieve this in practice remains an open question.

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"You need this operation soon! It is time that your daughter-in-law brought us some anesthetics and other necessities."

From the Hungarian daily *Népszabadság*

World Bank Health Projects in Eastern Europe: An Evaluation

According to the World Bank's Operations Evaluation Department (OED), most early Bank-financed health projects in Eastern Europe underestimated the political and institutional difficulties and were unduly optimistic about the pace of and prospects for reform. The outcomes of completed projects also varied, ranging from highly satisfactory in Estonia, to moderately satisfactory in Romania, and moderately unsatisfactory in Hungary.

As Eastern European countries undertook the difficult transition to a market economy they found that they needed to radically reform their health sectors. Most sought to decentralize care, increase private sector involvement in service delivery, rationalize or downsize hospital services, and strengthen the role of family practice physicians. Many introduced forms of national health insurance. Some took steps to strengthen public health programs and regulations, for examples, by restricting smoking in public places and tobacco advertisements. Others sought to improve reproductive health services for women. The World Bank encouraged these reforms

OED completed its reviews of six projects in six transition countries (Albania, Croatia, Estonia, Hungary, the Kyrgyz Republic, and Romania) by the end of fiscal year 2002. Five of these projects—the Albania Health Services Rehabilitation Project, the Croatia Health Project, the Estonia Health Project, the Hungary Health Services and Management Project, and the Romania Health Services Rehabilitation Project—became the basis for a broader OED review of the Bank's reform experience in Eastern Europe. OED also conducted in-depth field assessments of completed projects in Estonia, Hungary, and Romania.

Health reform is a slow and contentious process. Reform in transition countries has been especially difficult, because most have had to reform inefficient systems with excessive hospital capacity. This required downsizing, which was resisted by health workers, consumers, and local politicians. Furthermore, many countries lacked the knowledge and capacity needed for health policymaking, planning, and management. A long tradition of specialist medical training contributed to resistance to family medicine and to cost-effective treatment protocols. In addition, the economic transition itself impeded reforms when GDP and health sector budgets were stagnant or declining, as was the case in most transition countries, particularly in the early 1990s.

As the World Bank's financial contribution is typically small relative to total health sector financing, the Bank's influence depends on catalyzing wider reforms, which it tries to achieve through policy dialogue, investments in training and capacity building, and policy conditions associated with lending. The health projects in Estonia, Hungary, and Romania illustrate the range of difficulties encountered when attempting to reform the health sector in transition countries. Estonia has been among the most advanced countries in the region in reforming both its economy and its health sector, while Romania has lagged on both fronts. Hungary has progressed in terms of economic reform, and is positioning itself for accession to the EU, but has been slow to tackle the health sector.

The outcomes of completed projects varied, ranging from highly satisfactory in Estonia, to moderately satisfactory in Romania, and moderately unsatisfactory in Hungary. The Bank-sponsored Estonia Health Project effectively integrated investment and reform activities and served as an overall framework for the government's reform program. The Romania Health Sector Rehabilitation Project helped rehabilitate health infrastructure and catalyze health reforms, but the outcome of project investment activities varied considerably. The Hungary Health Services and Management Project had low government ownership and, even though several project components were successful, most project investments had only a limited impact on the sector and their sustainability is uncertain.

The Bank's most successful project investments resulted from lending and nonlending support for strengthening capacity and building consensus for reform. However, most of the early Bank-financed health projects in the region underestimated the political and institutional difficulties of health sector reforms and were unduly optimistic about the pace of and prospects for reform. OED found that several other major factors also influenced the outcome of these early projects as follows:

- Project design and sequencing needs to take the degree of political consensus for reform and the capacity for implementing projects and reform programs into account. Given the regular turnover of governments and ministers, engagement with a wide range of stakeholders, including parliament and opposition parties, is essential.
- Structural reforms, including the introduction of compulsory national health insurance or the privatization of family doctors, depend on progress in complementary reforms, as well as on training and capacity development for health managers and providers.
- Bank studies and analyses were often influential, as in Albania, Hungary, and Romania, but their impact depended on the extent of local involvement and dissemination and on the government's absorptive capacity for technical analysis.
- Capital investments can complement and reinforce the reform process, but only if used properly. For most of the completed projects, capital investments were only modestly successful in bringing about reforms or in significantly improving the quality or efficiency of the health service.
- Project investment activities were more successful when carried out in partnership with other donors, NGOs, or research institutes.
- Remarkably little evidence is available regarding the impact of various reforms on service quality and efficiency, health behaviors, or health outcomes, despite 10 years of

reform experience. The lack of priority given to monitoring and evaluation has reduced the Bank's contribution to consensus building and social learning.

The agenda for health sector reform has been remarkably similar across the region. Experience with three areas—implementing national health insurance, strengthening family medicine and privatizing general practitioners, and strengthening health promotion and public health programs—illustrates some of the challenges.

• **Implementing national health insurance: great expectations, mixed results.** Most Eastern European countries have established some form of compulsory national health insurance financed through a payroll tax. Outcomes have been mixed. In advanced reformers, such as Estonia, the new insurance system is well established and is beginning to yield benefits. In Hungary cost containment remains a challenge. In countries whose economic and institutional context is weak, such as Romania, the reforms remain fragile, with continued shortcomings in the legal framework. Insurance and payment reform alone are insufficient to significantly rationalize or improve the efficiency of the hospital sector.

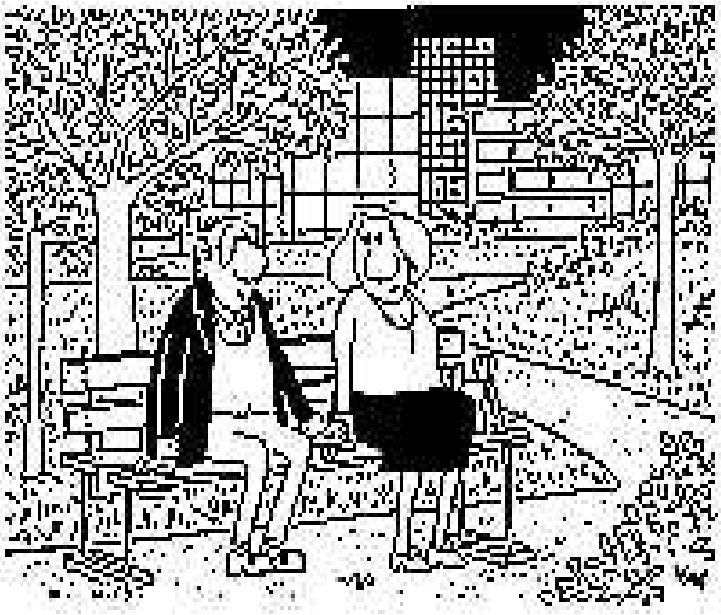
• **Strengthening family practice: the importance of sequencing training and reforms**. To strengthen primary care, countries throughout the region have either piloted or implemented reforms to establish family medicine as a distinct specialty and to contract family doctors as independent practitioners. Estonia, a leader in these reforms, established the Department of Family Medicine at its medical school in the early 1990s (and expanded it with project support). By the time the reforms were fully implemented in 1997, a critical mass of well-qualified family doctors had been trained, increasing acceptance among the public and the medical community. In Romania, a project-sponsored pilot tested family doctor reforms in eight districts. The pilot built support and helped refine legislation, but reforms were implemented nationally before family doctors had been trained in their new roles.

• **Strengthening health promotion programs: limited progress.** Strengthening health promotion and preventing noncommunicable diseases, including reducing tobacco and alcohol consumption and improving diets, requires efforts to influence individual behavior through information, education, and communication as well as changes in policies, laws, and taxes. However, progress has been limited because most governments in the region initially assigned health promotion a low priority. Project-sponsored health promotion components were relatively successful in Croatia and Estonia, where the governments were generally supportive, but were unsatisfactory in Hungary and Romania, where support was weak. The Bank needs to give greater emphasis to building capacity for and commitment to health promotion activities in project design, supervision, and policy dialogue, particularly when government commitment is weak.

How can the Bank use its lending and nonlending activities to help strengthen local capacity and build consensus for reform among stakeholders? It has supported health management institutes in Hungary and Romania, schools of public health in Estonia and Hungary, and a department of family medicine in Estonia. Reforming existing organizations, such as ministries of health or Soviet-era sanitary and epidemiological agencies, has proven more difficult than establishing new ones in Estonia and Hungary.

The Bank will need to address several important questions. Do the benefits of compulsory national insurance outweigh the opportunity cost of establishing new private institutions, particularly in low-capacity settings? Even if compulsory national health insurance is not ideal, how can countries that have made a political commitment to national health insurance best adapt to this system? Should governments introduce competition among public and private insurance providers, along with the even greater regulatory burden required by this approach? Should payroll taxes continue to be the primary source of revenue for national health insurance given their potential to increase labor costs and tax evasion? If not, what mix of revenue sources might reduce negative side-effects for the economy? Countries themselves will make these decisions, but increasing their knowledge base and advising client governments on such questions is an important priority for the Bank and its partners.

This article is excerpted from "Supporting Health Reform in Eastern Europe," published in the OED newsletter Précis, no. 223, Summer 2002; available on http://lnweb18.worldbank.org/oed/oeddoclib.nsf/DocUNIDViewForJavaSearch/B2014A3F9E44C54F85256C0600719E82/$file/Precis_223.pdf.



"We have so many things in common: neither of us have jobs, neither of us can afford to travel or go to the theater."

From the Hungarian daily *Népszabadság*

EVENTS

Educating Russians in Modern Economics: New Economic School Enters Second Decade

by Sergei Guriev and Gur Ofer

Since its inception in 1992, hundreds of graduates, dozens of research projects, and several international conferences and workshops have proven the viability of Russia's New Economic School (NES). Established soon after the regime change in Russia, it started to teach modern economics as distinct from the Marxist theory prevailing for 70 years. The NES also has a research center for training students and conducting economic research, as well as an active outreach center that disseminates information about modern economics to faculties and hundreds of researchers across the country. In December, in recognition of the school's distinguished role, leading economists from around the world attended a conference to commemorate 10 years of the NES.

The December conference, titled The State of Economics and of Transition—Honoring 10 years of the New Economic School, provided an excellent opportunity to showcase the NES and its capabilities to the large community of economists and policymakers in Russia. The NES was established in 1992 in partnership with the Central Economic Mathematics Institute of the Russian Academy of Sciences and the Hebrew University in Jerusalem, plus the involvement of a group of Western economics professors. The aim was to replace the Marxist economic paradigm and the way economics had been taught under the old regime with modern, Western economics.

The NES offers a two-year graduate program in economics, similar to programs at the top Western institutions. Through its Research Center, the NES provides training in modern research methods and how to apply economic analysis to transition issues and the Russian economy. Through its Outreach Center, the NES brings modern economics training to economists outside Moscow. In this way, the NES is engaged in training a new generation of professional, academic, and research economists for Russia who are familiar with the concepts of a market economy. The NES has already become the model for a similar school in Ukraine and for new institutions planned elsewhere in the former Soviet Union.

During the school's early years visiting professors from the West, who adapted complete Western curricula, provided most of the instruction. Over time, however, an increasing number of Russian teachers trained at the school and abroad have participated. The top graduating students were sent to leading Western universities for their PhD, studies in order to gradually build an indigenous academic base for modern economics in Russia. At present, the NES's economics faculty is the only such faculty in Russia where most staff is Western educated.

During the NES's first decade more than 140 of the 320 graduates have pursed PhD, studies at the best universities in

The Founding of the NES

by Gur Ofer

After the failed coup of August 1991, the Soviet Union was falling apart. The political upheaval was only slightly more severe than the state of the economy, which was suffering from acute shortages, a breakdown of supply networks, and emerging inflation. At that time a leading Sovietologist, a professor of economics and the guest of a prestigious Moscow institute, visited a number of Russian economic institutes. During a meeting with George Soros on the Sovietologist's return to Moscow, he expressed surprise about the lack of concern with teaching modern economics as a natural companion to reforms. Soros was skeptical, but offered to help if the Sovietologist came up with any practical ideas. He knew, however, that the Sovietologist was the typical absent-minded, "egg-head" academic, who spent most of his life in his academic ivory tower and rarely had any practical solutions.

But just a few weeks later, through common friends, the professor—who happened to be me—was able to meet Valery Makarov, head of the Central Economic Mathematics Institute (CEMI) of the Russian Academy of Sciences. He was thinking along similar lines. The meeting took place in Archangelskoye, the location of the advisory group headed by Yegor Gaidar, whose team was preparing the reform program for the emerging independent Russia. Gaidar took me to meet Makarov and then rushed to Moscow to accept his appointment as prime minister from Boris Yeltsin.

Whatever I had in my head at the time, Makarov already had in writing. He handed me a one-page document titled "The CEMI Econometric School—CES," which suggested that such a school be organized by the joint efforts of CEMI, an American or European university, and the Lomonosov Moscow State University. The document also suggested three areas of teaching: modern economic theory, econometrics, and business. I invited Makarov for a visit to Jerusalem, where the idea received the blessing of the Hebrew University. We prepared a draft plan and a budget and sent it to Soros. Soros had the idea checked out and gave NES the green light, backed by a dollar grant.

The first class of 52 students started at the NES in September 1992.

the West. Many have returned to Russia to carry out research and to teach at the NES. Approximately 170 NES graduates are pursuing professional careers in Russia and most are already working as professional economists in the public and private sectors, primarily in Moscow. Together with those who returned from Western universities, the graduates of NES and a few other schools and think tanks have begun to form the core of an emerging, modern, high-level, policymaking community in Moscow:

The NES's Research Center was established in 1995 to encourage modern economics research in Russia. Research projects include such topics as pension reform in Russia, health in transition, foreign direct investment in the Russian economy, financial markets, fiscal federalism, tax reform, political economy of economic reform, corruption, and barter in Russia. Since 1995 the Research Center has organized more than 48 different research projects and has hosted two research conferences each year.

The NES also contributes to the upgrading of economics teaching and research in the rest of Russia through an active outreach program. It runs workshops for teachers of economics at various Russian universities in econometrics, microeconomics, and macroeconomics, and has entered into partnerships with economics faculties at Voronezh State University and the Urals State University in Yekaterinburg.

Over the years the NES has been supported by the Soros Foundation, the Eurasia Foundation, the Ford Foundation, the MacArthur Foundation, the World Bank, and Citibank, and in Russia by the National Training Foundation, the Institute for Financial Studies, Peter Aven, the Troika Dialog, the electricity giant RAO-UES, Lusine Construction, and others.

NES graduates teach in other Russian universities and work in government agencies and the central bank. One NES graduate, Arkady Dvorkovich, is deputy minister of economic development and trade, and other graduates in the Ministry of Finance provide the minister with professional advice. Another group established CEFIR, an independent think tank that advises the government. Others are employed by international organizations in Moscow and by the private sector, including YUKOS, Alfa Bank, Troika Dialog, and KMPG. The NES hopes

Birthday Celebrations of the New Economic School

The two-day international conference entitled The State of Economics and of Transition held in December 2002 was hosted by the New Economic School in cooperation with CEFIR, SITE, and the William Davidson Institute. The NES received a congratulatory letter from President Putin acknowledging its accomplishments since its inception in 1992. More than 500 people attended the conference, one of the largest in the history of the new Russia, and 42 research papers were presented.

Stanley Fischer gave the keynote speech: "Globalization and Its Challenges." In his keynote speech he enumerated some of the challenges facing economic globalization. Primarily, he said, it has to make the global system deliver economic growth more consistently and more equitably to further reduce global poverty and inequality. According to Fisher, the policy challenges include the following:

- Implementing the right policies. The outward-oriented policies described in the 1990 Washington Consensus remain an important component of the right approach to economic policy. That policy approach needs to be enhanced by
- Greater emphasis on social justice, to be implemented through health and education spending, social safety nets adapted to the country's economic structure, and infrastructure spending
- Increased attention to developing the institutions of effective economic governance, including efficient judicial systems, civil service, tax system, and other elements of an enabling environment for private sector activity
- More attention to crisis proofing the economy, especially by strengthening the financial system and macroeconomic policies
- Increased attention to labor market reform to allow a greater proportion of the workforce to enter the formal labor market.
- Delivering on trade and aid. The industrial countries should liberalize their agricultural trade and end the massive subsidies to agriculture that impair the exports of so many developing countries. The Doha development round also needs to succeed. At the same time, the developing countries could achieve major gains by opening up their trade to each other. However, the problems of the poorest countries are unlikely to be solved without significant increases in aid.
- Making the international financial system less prone to crises. The system is still disturbingly crisis-prone for the emerging market countries. Despite the shift to exchange rate flexibility, crises can erupt for other reasons, particularly market fears of unstable debt dynamics. The strengthening of domestic policies and institutions is essential.
- Dealing with migration. Labor migration and temporary labor flows are a potentially powerful force in the global economy. If the unskilled migrate, they can be an advantage by helping produce a convergence of income levels among countries; however, they can be a disadvantage because of possible brain drain effects. This is an area where national economic, social, and cultural preferences are bound to take a front seat.
- Improving governance. Ordinary people everywhere want to improve their lives, but corrupt governments do not necessarily respond to their desires. This is why the trend toward democracy is so important. While countries are primarily responsible for their own fates, outsiders from both the public and private sectors can help influence the outcome by promoting democracy, investing in the economy, and supporting projects in the social sectors.

to deepen its cooperation and interaction with other Russian institutions and society at large through its graduates, its research and policy work, and its outreach to other universities and institutions, as well as through the recently established Russian Advisory Board.

Sergei Guriev is vice president for strategic development at the NES and Gur Ofer is the NES's international advisory board coordinator. For more information about the NES conference go to http://www.nes.ru/NES10/conf-materials.htm. ❊

BEST PRACTICE

Vietnam's Experiment with Block Grant Budgeting: "Crossing the River by Feeling the Stones"

by Ann Bartholomew, Stephen Lister, Edward Mountfield, and Nguyen Van Minh

Ho Chi Minh City is piloting a remarkable budget management reform. Launched in January 2000 and now entering its fourth year, the experiment allows local authorities considerable discretion over budget spending. A evaluation on behalf of the World Bank carried out in 2002 reported a significant increase in productivity: staffing and operational expenditures were reduced, while services maintained both their quality and quantity. This local experiment is now being extended to other parts of Vietnam.

Budget management in Vietnam was already decentralized before the Ho Chi Minh City experiment was launched. The share of local administrations in total budget expenditure reached 43 percent in 1998, up from 26 percent in 1992. Formally, provincial finance departments are required to allocate their budgets according to normative guidelines, specified by central line ministries. In practice, however, the budgets allocated to provinces were insufficient to finance all the tasks assigned by the central government. Thus out of necessity, the provinces used their own judgment in allocating between sectors and spending units. The spending units themselves, however, were subject to strict control by the provincial finance departments. The units were not allowed to reallocate spending from one item to another without the formal approval of their superiors.

This control proved to be both inefficient and ineffective. It created excessive rigidity in the allocation of resources and encouraged an approach to public service delivery that was focused on compliance with rules and red tape rather than on responsiveness and the quality of service outputs and outcomes. Detailed line item budgeting rests on the assumption that finance department officials in provincial capitals have better information than frontline service providers, or at least symmetrical information, about how best to achieve operational efficiency. Line item budgeting takes away service providers' incentives to find savings, because savings made within items or subitems of expenditure cannot be transferred to other categories of expenditure, but must be forfeited to the treasury. Above all, micromanagement and "second guessing" of this kind blurs the lines of accountability for results between the finance function and the spending unit.

Snapshot of Vietnam's Economy

Vietnam's real GDP growth in the first quarter of 2003 reached 6.9 percent, slightly below the government target of 7 to 7.5 percent for the year as a whole and the 7 percent growth rate in 2002, reports Oxford Analytica, the U.K.-based international research group. Boosted by export growth, Vietnam's economy has been performing well given the uncertain global economic climate following the war in Iraq. In the first four months of 2003, the value of exports increased by more than 35 percent, levels not achieved since the mid-1990s. In particular, textile and garment exports showed the strongest growth rate. An expansion of exports to the U.S. market accounted for the majority of this growth. Export earnings were also boosted by the higher international oil price.

Low levels of private investment are, however, likely to limit the growth rate over the next three years. In the first four months of 2003 the Ministry of Planning and Investment approved $677 million of new foreign investment, below the level achieved in 2001. Foreign investors remain cautious for many reasons. These include high nonlabor costs, poor infrastructure, red tape and a lack of transparent policymaking, low purchasing power, nonconvertibility of the currency, lack of skilled labor, and high levels of protection. Investment approvals from Japan, the country's largest foreign investor, fell by 40 percent year-on-year in 2002. Japanese companies have preferred the Chinese, Thai, Malaysian, and Indonesian markets.

However, replacing line item control with a more flexible regime may have its own risks. Alternative checks and balances need to be in place if the move away from line item budgeting is not simply to replace one form of inefficiency with another. As external and ex ante line item controls are lifted, alternative mechanisms—such as stronger internal controls and greater ex post accountability for the use of resources and for service performance—need to be built up. Strong financial management systems are necessary if aggregate fiscal discipline is to be preserved in the absence of detailed line item controls.

Aware of the need to move cautiously with reform in this area, Vietnam chose Ho Chi Minh City as the location for conducting a small-scale pilot of the block grant approach. Vietnam's largest city has a population of 5.27 million. It is both the richest and the fastest growing province in Vietnam. In 2001 its GDP accounted for an estimated 19 percent of national GDP, compared with less than 14 percent a decade earlier. The

Interview with Vietnam's Prime Minister Phan Van Khai

Recently editors of the *Wall Street Journal* and the *Far Eastern Economic Review* in Hanoi interviewed Phan Van Khai, Vietnam's prime minister, who talked about the country's prospects for enhanced trade and investment. Excerpts from the interview follow:

What are the key areas that you wish to target for investment in Vietnam?

We hope to attract a lot of investment in high-tech areas, so that various industries can be more competitive with foreign companies. We will also focus on infrastructure development. In the electricity sector, for example, during the last few years demand has grown annually by about 10 to 15 percent. This year we'll have to build a number of hydropower plants and thermal power plants, and gas-powered plants as well. Another important area is the cement industry. Also important is oil and gas sector exploration, exploitation, as well as processing activities. And we hope for better cooperation with foreign partners in agricultural production and food processing.

What comes after the Bilateral Trade Agreement [with the United States]?

Vietnam's next major step will be to prepare for membership in theWTO. Our target is 2005. We submitted our application in January 1995. We have also undergone four rounds of negotiations with the WTO working party. Negotiations on Vietnam's trade regime have been completed.

What are the biggest problems facing foreign investors in Vietnam?

Number one, our administrative procedures are still cumbersome. You can get approval at the central level, but you still have problems at the local level with issues like land. The government would like to pursue the policy of a one-stop system, with all foreign investment projects only having to work with the Ministry of Planning and Investment. The second major complaint we receive from investors is about unequal services [dual pricing systems]. Telephone tariffs are still high, with discrimination between foreign and domestic firms. Air fares and electricity rates are also different for foreigners. Reductions have been made several times toward a single-price system, but our country has recently emerged from war and a centrally planned economy. Therefore we have to take it step by step. Otherwise, if we go too fast, it would lead to collapse.

Have you been influenced by China's experiences in joining the WTO and attracting foreign investment?

In the past, the two countries had a similar economic policy. So the experience and lessons from China are useful for Vietnam, including policies to attract foreign investment, tap internal resources better, develop the private sector, and improve the competitiveness and efficiency of state-owned enterprises. But each country has its own historical circumstances. Our lesson is that if we just copy one foreign model, there's a chance of failure. Therefore our policy is to study and learn from selected cases.

Do you worry that China's rapid growth might draw potential investment away?

China is a big market for Vietnamese products. Vietnam's exports to China have recently increased significantly. Two-way trade by value is estimated to reach $5 billion in 2005. Vietnam needs to identify the products where we have the best advantage. Something I always tell Vietnamese enterprises is to aim for high quality and low prices to be competitive.

Unlike in China, private Vietnamese entrepreneurs are not welcome to join the Communist Party, but party members can do business. How do you explain this split policy?

We have different conditions from China. We do something on the basis of our conditions. Party members in Vietnam are still allowed to run their own business, but I don't think up to the same extent as capitalists. For example, in rural areas our party members still have their own farms, they run their own businesses. The successful party member/entrepreneur will be in a better position to help the poor.

province is unique in Vietnam in terms of its high levels of economic activity, low levels of unemployment, and high standards of living.

Under the pilot scheme, 10 spending units were given a block grant that is fixed for a three-year period. Within these fixed budgets, spending units may choose to reallocate expenditure between line items without having to seek special permission. Spending units are free to reduce staff numbers and to prioritize between categories of administrative expenditures (with a few limited exceptions). Any savings that are made either on administrative or salary costs can be retained and used to increase staff incomes through additional salary or bonuses. Thus spending units can choose how to reduce material expenditures and can also eliminate unproductive staff, and the direct link between cost reductions and pay increases provides a powerful incentive to do both. However, spending units are required to maintain previously specified levels and standards of service.

All the spending units reported considerable reductions in expenditure on administrative items. Most of these arose from savings on communication expenses, utility bills, routine repairs and maintenance, purchases of goods and services, and printing and production of documents. Nearly all spending units also reduced their staff numbers below the official quota, with most of the surplus staff being transferred or retiring. The resulting flexibility was valuable, particularly if unexpected spending was needed. In addition, the scope for corruption was reduced. As everyone stood to gain from cost savings, there was an incentive to check that no one else was abusing the system for individual benefit.

The government is confident with pressing ahead to authorize 164 additional spending units in 19 more provinces to participate in similar experiments. The further wave of pilots will be more extensive, as it involves provinces more typical of Vietnam as a whole, and it also covers revenue-raising spending units, including key service delivery units such as hospitals and schools, whereas the initial pilots were limited to administrative units. The potential for operational efficiency gains may be greater at the front line of service delivery. Spending units will have also greater discretion in charging user fees.

This pilot program is illustrating an approach favored in East Asia, whereby many reforms are first experimented with locally, and if successful, are applied at the national level, an approach characterized by Deng Xiaoping as "crossing the river by feeling the stones." Vietnam has embarked on a path that could transform its public sector.

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Michael Haney and Maria Shkaratan

Mine Closure and Its Impact on the Community: Five Years after Mine Closure in Romania, Russia, and Ukraine

WPS 3083, June 2003, 73 pp.

In recent years Romania, Russia, and Ukraine have undertaken major reforms of their coal sectors, burdened by obsolete equipment, years of inefficient investments, poor sector management, inauspicious geological conditions in many basins, excessive employment with productivity levels among the lowest in the world, wretched health and safety conditions, and acute levels of accounts payable. Restructuring entails the closure of uneconomic mines and an extensive downsizing of the industry workforce.

The authors examine the impact of mine closure on the entire community five years after mine closure in the three countries. They conclude that the social safety net for laid-off workers and their families should be strengthened, including wider eligibility for participation in microcredit programs, and that jobs should be created in other sectors of the local economy.

Roumeen Islam

Do More Transparent Governments Govern Better?

WPS 3077, May 2003, 41 pp.

The author explores the link between information flows and governance or institutional quality. Economic theory expounds on the importance of information to economic outcomes either through its direct effect on prices and quantities or through its effect on other factors such as institutions and the quality of governance. Functioning freedom of information countries with better information flows also govern better.

Philippe Auffret

Trade Reform in Vietnam: Opportunities with Emerging Challenges

WPS 3076, May 2003, 19 pp.

In 1986 Vietnam initiated its renovation policy, that is, its transition from a centrally planned economy to a market-oriented one. The transition policy generated economic growth and reduced poverty. To reach the targets of the 10-year socioeconomic strategy approved by the Communist Party in 2001, the government indicated that it would change Vietnam's trade and financial policies, liberalize the climate for private investment, increase the efficiency of public enterprises, and improve governance.

Vietnam would benefit greatly from rapid implementation of trade reform, and particularly from fast accession to the WTO, especially after China's recent WTO accession. However, the author argues that rapid liberalization of trade may soon conflict with the slow pace of implementation of other reforms, including the restructuring of state-owned enterprises and state-owned commercial banks.

Elena Ianchovichina and Will Martin
Economic Impacts of China's Accession to the World Trade Organization
WPS 3053, May 2003

WTO accession will boost the labor-intensive manufacturing sectors in China, especially the textiles and apparel sector, which will benefit directly from the removal of quotas on textile and apparel exports to North America and Western Europe. The wages of skilled workers and unskilled nonfarm workers should rise in real terms and relative to farm incomes. Diminishing agricultural protection may hurt some farmers. Possible policy changes being considered to offset these impacts include reducing barriers to labor mobility and improving education in rural areas. The removal of the *hukou* system (which prevents those living in rural areas from moving to the cities) would raise farm wages and allow 28 million workers to migrate to nonfarm jobs. If, through increased education spending, the pool of skilled labor grows, approximately 32 million farm workers could leave their jobs for jobs in the nonfarm sectors.

Elena Ianchovichina, Kym Anderson, and Jikun Huang
Long-Run Impacts of China's WTO Accession on Farm-Nonfarm Income Inequality and Rural Poverty
WPS 3052, May 2003, 33 pp.

Many fear that China's accession to the WTO will impoverish its rural people because of greater import competition in its agricultural markets. According to the paper's findings, even if the producer prices of some land-intensive farm products fall, the prices of other, labor-intensive farm products could rise. Also the removal of restrictions on exports of textiles and clothing could boost town and village enterprises, and thus demand for unskilled labor for nonfarm work in rural areas may grow even if demand for farm labor falls in aggregate. Farm-nonfarm and Western-Eastern income inequality may well rise in China, but rural-urban income inequality need not.

Thomas Novotny, Dominic Haazen, and Olusoji Adeyi
HIV/AIDS in Southeastern Europe: Case Studies from Bulgaria, Croatia, and Romania
Working Paper no. 4, May 2003, 48 pp.

The countries of Southeastern Europe (Bulgaria, Croatia, and Romania) share several social conditions that have led to an alarming increase in HIV infection, including increasing unemployment and poverty, rapid social changes, decreased accessibility and quality of services and educational opportunities, psychological stress from postconflict situations, increased substance abuse, and increased trafficking in women for sexual exploitation. The study evaluates the approaches and strategies currently being used in the three countries, and makes recommendation both for government strategies and for the World Bank's current and potential future involvement.

Other World Bank Publications

Boris Pleskovic and Nicholas Stern, eds.
The New Reform Agenda (Annual World Bank Conference on Development Economics—2003)
World Bank and Oxford University Press, 2003, 313 pp.

World Development Indicators 2003
April 2003, 416 pp. (also available on CD)

This publication, the World Bank's premier annual compilation of data about development, provides 600 indicators for 152 economies and 14 country groups in more than 87 tables. The print edition provides a current overview of the most recent data available and important regional data and income group analysis in six thematic chapters: World View, People, Environment, Economy, States and Markets, and Global Links.

The *World Development Indicators 2003* CD-ROM contains more than 550 time series indicators for 208 countries and 18 country groups covering 1960 to 2001, and offers mapping, charting, and data export formats. The tables function presents a number of sets of country tables covering such specialized topics as social indicators, economic indicators, education, and population projections. In addition, it provides the full contents of the print edition and some quick reference tables.

Alain Mingat, Jee-Peng Tan, and Shobhana Sosale, eds.
Tools for Education Policy Analysis
April 2003, 320 pp.

Breaking the Conflict Trap: Civil War and Development Policy: A World Bank Policy Research Report
World Bank and Oxford University Press, May 2003, 240 pp.

Geeta Batra, Daniel Kaufmann, and Andrew H. W. Stone
Investment Climate Around the World: Voices of the Firms from the World Business Environment Survey, Directions in Development
May 2003, 176 pp.

The World Business Environment Survey, carried out in 1998-2000, presents enterprise data from more than 10,000 firms in 80 countries. In addition to the general findings, this volume provides detailed explanations and the core questionnaire and presents the key findings across regions and firm size. The results suggest that country conditions with regard to taxes, regulations, financing, governance, and other business constraints matter significantly in explaining firms' performance and behavior.

Reforming Public Institutions and Strengthening Governance: A World Bank Strategy Implementation Update
May 2003, 180 pp.

Bernard Funck and Lodovico Pizzati, eds.
European Integration, Regional Policy, and Growth
May 2003, 292 pp.

The current enlargement of the EU to include less affluent new members gives rise to a number of questions, namely:

• How can the cohesion objective best be advanced if initial income disparities will now be greater?

• Will the accession process help the poorer regions to converge their income toward EU standards or will prevailing disparities be exacerbated in the process?

• What, if anything, can the new members do about this? What help can they expect from the EU structural funds and how should the funds be applied to maximize the cohesion?

Drawing on the experience of existing EU members and on the latest developments in growth theory and economic geography, the authors highlight several issues, including the trade-off between promoting national growth and reducing relative disparities within countries and the two "growth poles" of regional income convergence: investment climate and labor market flexibility. Are EU structural funds merely income transfer mechanisms or are they key ingredients of growth-enhancing fiscal strategies? Enlargement, and the ever deeper integration of EU factor and product markets, can bring new challenges to EU regional policy.

Michael U. Klein and Bita Hadjimichael
The Private Sector in Development: Entrepreneurship, Regulation, and Competitive Disciplines
June 2003, 232 pp.

Land Policies for Growth and Poverty Reduction: A World Bank Policy Research Report
World Bank and Oxford University Press, June 2003, 250 pp.

Property rights to land are one of the cornerstones for the functioning of modern economies. Once secure in their land rights, rural households invest to increase productivity. Moreover, the use of land as a primary investment vehicle allows households to accumulate and transfer wealth between generations. The ability to use land rights as collateral for credit helps create a stronger investment climate and at the level of the economy, land rights are therefore a precondition for the emergence and operation of financial markets. This book looks at the historical, conceptual, and legal contexts of property rights to land, and also considers aspects of land transactions, including the key factors affecting the functioning of rural land markets. It explores the scope and role of governments and land policy formation and discusses ways in which developing countries can establish land policy frameworks that maximize social benefits.

Global Development Finance 2003: Striving for Stability in Development Finance, Analysis and Statistical Appendix
2003, 250 pp. (also available on CD)

Foreign direct investment and migrant workers sending part of their paychecks back home have become more important sources of finance for developing countries than private lending. The boom and bust in private lending was a crucial element in a series of financial crises that started with the 1997-98 East Asia crisis and continued in a new round of Latin American debt problems in 2002. The lower volatility of foreign direct investment and remittances is, however, fostering a more stable environment for those developing countries that have learned to live with less external debt.

Global Development Finance 2003 is also available on CD, with more than 200 historical time series from 1970 to 2001 and country group estimates for 2002. The CD-ROM contains all the information found in both print volumes. It lets the user work interactively with data, display maps and graphs, and export data into many popular formats.

The Brookings Institution Publications

Ngaire Woods
Unelected Government: Making the IMF and the World Bank More Accountable
Brookings Review, Spring 2003

Accused of being secretive, unaccountable, and ineffective, both the IMF and the World Bank are seeking to become more transparent, more participatory, and more accountable. Critics have emphasized the following four major elements:

• Unequal representation of member states. Originally members were mutually assisting and each had a vote proportional to its stake. Now the traditional voting structure looks anachronistic and inadequate as a formal mechanism of accountability.

• Inadequate oversight of staff and management through the Executive Board. Executive directors are paid by and housed within each institution and have a dual role as officials of the organization as well as representatives of countries. Many flit from Board to staff and back again.

• Flawed appointment process. Neither the Bank nor the IMF has an open and transparent process by which to appoint its head, to whom all staff are accountable. Rather, according to

a 50-year-old political compromise, the head of the World Bank is an American and the head of the IMF is a non-American, in practice always a Western European.

• Broad conditionality, narrow accountability. Although both organizations now consult with civil society and a broader range of stakeholders, their formal accountability remains unchanged. Their official interlocutors, as set out in their Articles of Agreement, are the treasury, finance ministry, central bank, or equivalent agency of a borrowing country.

Therefore each institution needs a representation structure that better reflects the stakes of all member states; a stronger, more independent role for the Executive Board in overseeing the work of the staff and management; a transparent set of operating rules that enables others to monitor how they do their work; and an open and participatory process for appointing the heads of each organization. Powerful members of each institution must restrain their urge to have the IMF and Bank engage in conditionality across a wide range of issues. The scope of the IMF's and Bank's activities should not exceed the scope of their accountability. Rather than impose strong external accountability on weak national systems, they should look for and strengthen local kinds of accountability. In the longer term, people need to hold their own governments to account regardless of IMF and World Bank strictures. (This summary is based on an article published in *International Affairs* in January 2001).

BOFIT Publications

Email: bofit@bof.fi, URL: http://www.bof.fi/bofit

Marja Nissinen
Information Technology Industry in the Baltic States
Baltic Economies—Bimonthly Review, May 2003
(available on: http://www.vtt.fi/ttr)

Latvia has set the goal of becoming a leading software service exporter in Eastern Europe by 2010, Estonia is the most advanced in mobile technologies and wireless solutions, and Lithuania offers the best availability of programmers as well as some interesting software products. The contribution of the information technology sector to national economies is still relatively modest in the Baltics. In 2001 the sector's ratio of value added to GDP accounted for around 4 to 5 percent in each country, but this share is growing gradually. Some estimates suggest that the Baltic states might have 12,000 competent software developers, but a shortage of the highest-level specialists with postgraduate degrees constitutes a challenge. The main export markets are the Nordic countries, Germany, and the United States, although the Baltic countries' neighbors and Russia are also among the target regions.

Laura Solanko
Why Russia Favors Incumbent Firms
Russian Economy—The Month in Review, June 2003

New domestic companies and foreign-owned firms are still rarities in Russia. Small and medium enterprises employ only about 10 percent of the workforce, compared with an average of 50 to 60 percent in advanced industrial countries. At the regional level in particular, large formerly state-owned enterprises (incumbents) nurture close connections with politicians and an uneven economic playing field develops.

Empirical results from transition economies suggest that high barriers to new business entry and soft budget constraints on incumbent firms are significant institutional factors engendering corruption. The strong rule of law, democracy, and civil society are efficient factors limiting politicians from pursuing their private benefit. Furthermore, as seen in China, linking regional tax revenues to the success of new firms can create powerful incentives for favoring such firms. Even if incumbents continue to lobby, the emergence of a new small and medium enterprise sector as an important regional revenue source could greatly level the economic playing field.

CEPR Discussion Papers

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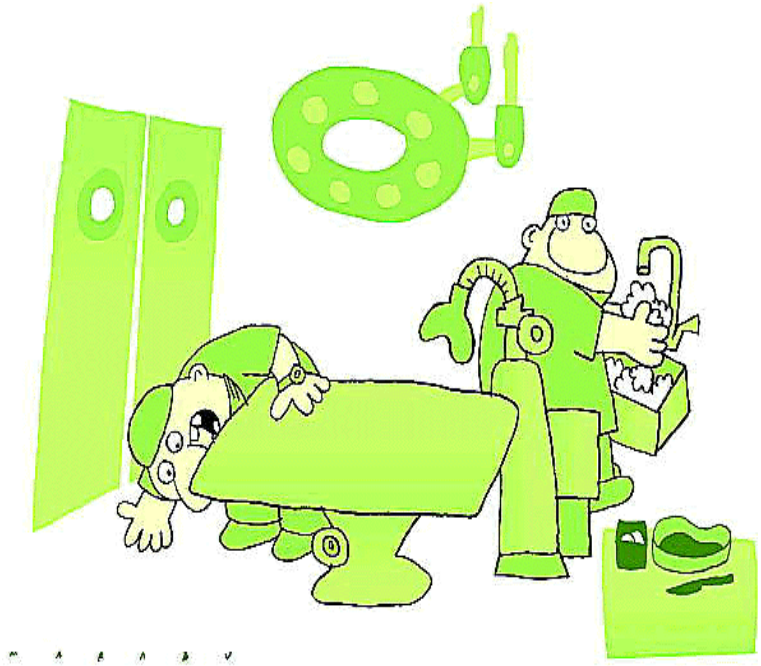
Carl B Hamilton
Russia's European Economic Integration: Escapism and Realities
Discussion Paper (DP) no. 3840, March 2003

Absent-Minded Doctor



"I cannot find it. This time I left not only the scalpel in the patient's abdomen, but the honorarium as well."

From the Hungarian daily *Népszabadság*

Oxana Koukhartchouk and Mathilde Maurel
Accession to the WTO and EU Enlargement: What Potential for trade Increase?
DP no. 3944, June 2003

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Twin Towns on the [National] Border as Laboratories of European Integration
Arbeitsberichte Discussion Paper no. 4/02, 74 pp.

Willfried Spohn
European East-West Integration, Nation Building, and National Identities: The Reconstruction of German-Polish Relations
Arbeitsberichte Discussion Paper no. 5/02, 24 pp.

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Attracting Private Investment, Putting the Policy Frameworks in Place: Experience from Slovenia and South East Europe
Investment Compact for East Europe, December 2002

Andreja Jakliè and Marjan Svetlièiè
Enhanced Transition by Outward Interrationalization: Outward FDI by Slovene Firms
Ashgate Publishing, Ltd., April 2003

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Keith Suter
Global Order and Global Disorder: Globalization and the Nation State
Praeger Publishers, May 2003, 216 pp.

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Yang Zhong
Local Government and Politics in China: Challenges from Below
M. E. Sharpe, United States, April 2003, 240 pp.

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Ronald E. Seavoy
Origins and Growth of the Global Economy: From the Fifteenth Century Onward
Praeger Publishers, May 2003, 312 pp.

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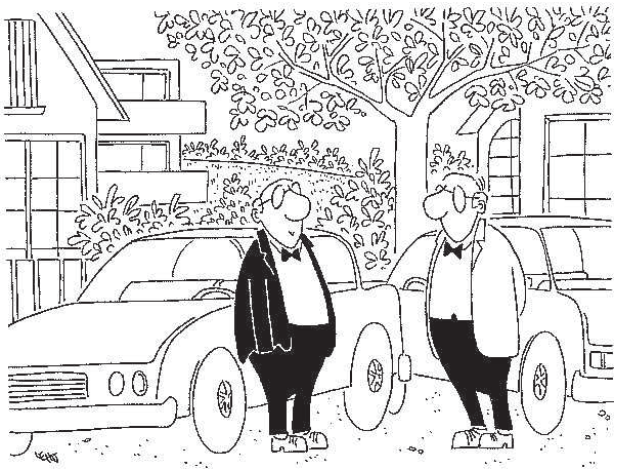
At the Gate of the European Union



"I am fed up buying up castles and forests—now I am buying whole regions"

From the Hungarian daily *Népszabadság*

For the Record

Accounting and Finance in Transition: European and Asian Experiences and Public Policy Considerations
July 10-12, 2003, London, United Kingdom

The University of Greenwich, in collaboration with the Shanghai University of Finance and Economics, Beijing Renmin University of China, and Jinan University, is organizing an international conference devoted to current issues facing accounting and finance during periods of rapid economic and social change.

The conference will examine issues related to the transition from a command to a market-oriented economy and its implications for accounting and finance, as well as all other aspects of accounting and finance in times of rapid social and economic change. Papers are welcome, especially those that address such issues as the failure of classical models and methodologies to grasp the nuances of emerging markets. Privatization is also a natural topic for consideration, particularly if the authors relate the influence of privatization to the development of the accounting and finance profession and its processes and procedures. Papers on accounting and finance issues in the EU may address the role of the EU as a major regulatory player, and also issues related to the EU's influence on the development of accounting frameworks throughout Europe in both EU member countries and those countries that are current and prospective candidate for entry to the EU. Papers on international business (international finance and financial strategy) are also welcome, as are those dealing with the future of the accounting and finance professions. Comparative studies on the development of the accounting profession in emerging markets are of particular interest for one of the conference tracks. Papers dealing with issues facing the accounting and finance professions in the 21st century will find a positive response from the International Program Committee.

Authors are invited to submit a full paper, in triplicate and electronically, by April 15, 2003, although it would be desirable if they could contact the Organizing Committee regarding their intention to submit a paper prior to this date.

The conference will have a number of tracks, including (tentatively): the EU and its influence, Central and Eastern Europe, public finance and public policy, the future of the profession and accounting methodology, China and Asia, and young scholars. One track may be organized and presented in Chinese (Mandarin).

I*nformation and registration: 2003 Conference, Department of Accounting and Finance, The Business School, University of Greenwich, Old Royal Naval College, Maritime Greenwich Campus, 30 Park Row, Greenwich, London SE10 9LS, United Kingdom; fax.: 44-(0)20-8331-9005, email: Acc-Conf.2003@gre.ac.uk (preferred mode of communication), URL: http://www.gre.ac.uk/schools/business/Events/Account%20and%20finance.html.*

Forthcoming

Investment Climate, Growth, and Poverty
September 4-5, 2003, Berlin, Germany

This workshop is organized by the World Bank in partnership with the Development Policy Forum/ Organization for International Cooperation, Advanced Training and Dialogue and Germany's Ministry for Economic Cooperation and Development. The workshop forms an important part of the *World Development Report 2005*, to be published in September 2004. The participants will be European and other economists and key policymakers. They will discuss issues related to the investment climate, such as the security of property rights, business regulation and taxation, finance and labor markets, governance and corruption, and the ways in which reforms can

Masters on Local Development for the Balkans

The Masters Program on Local Development for the Balkans offers 16 months of training for a postgraduate second-level masters degree. It has been designed for 25 young, high-level professionals holding positions of responsibility in or in connection with Southeastern Europe. Its main objective is to provide participants with the necessary knowledge and skills for introducing, supporting, and coordinating processes of change and transformation at the local level. The program focuses on local development that involves public, private, and nongovernmental agents and that furthers social stability and economic prosperity according to the *acquis comunautaire* standards in European/European Community law. The general approach is interdisciplinary and comparative.

The program includes courses on economics, law, sociology and political sciences, and project cycle management and workshops, skills training, internships, language courses, and distance learning. Courses are taught at the universities of Trento and Bolzano/Bozen by Italian and international experts. Given the focus on local development, most of the internships will take place in local organizations in Trentino Alto Adige/Südtirol and northeastern Italy.

Information: Dr. Martina Cvajner, Coordinator, University of Trento, Department of Economics, Masters for Local Development in the Balkans; tel.: 39-0461-882280, email: balkans@gelso.unitn.it, URL: http://www.didatticaonline.unitn.it/master.asp.

be implemented. The discussion will help integrate various new ideas and proposals into the final version of the report.

Information: Deena Philage, Partnership Advisor, tel. : 202-473-6941, email: dphilage@worldbank.org, and Boris Pleskovic, Research Manager, tel. 202- 473-1062, email: bpleskovic@worldbank.org.

The International Society for New Institutional Economics Seventh Annual Conference
September 11-13, 2003, Budapest, Hungary

In addition to economics, the conference program will include sessions on the application of institutional analysis to political science, law, and organizational behavior. The theme of the conference is institutions and change, and the conference will focus on examining institutional change, as well as the effects of institutions on development, transitions, and growth. Douglass North and Vernon Smith will give keynote addresses.

Information: http://www.isnie.org. Note that to register you must be a member of the International Society for New Institutional Economics. Conference participants must make their own travel and hotel arrangements.

Essential Consulting Skills International Training Event
October 26-November 1, 2003, Berlin, Germany

Topics: Consulting skills, process, customer demand, defining objectives, contracting and roles, thinking styles, bringing the whole system into one room—introduction to large stakeholder interventions, the systemic context, and creativity.

Information: http://www.change-management-toolbook.com.

The Middle East and Globalization for the Common Good—Integrity, Spirituality, Ethics, and Accountability: Transforming Business, Corporate Social Responsibility, and Globalization for the Common Good
March 26-31, 2004, Dubai, United Arab Emirates

Papers, panels, and roundtable submissions are invited from observers, commentators, academics, postgraduate students, and NGOs to address issues related to globalization within the identified theme of the conference. Specifically welcome would be papers from economists, business people, philosophers, theologians, historians, political scientists and those working in the field of international relations, peace researchers, conflict resolution specialists, lawyers, sociologists, psychologists, and environmentalists, as well as those engaged in interfaith action projects. You are invited to send a one-page abstract, which should include a working title and the authors' discipline and field, address, institutional affiliation, and email address by December 15, 2003, to either of the conference convenors. Should your proposal be accepted, you will be notified by mid-January 2004 about the conference program, registration, social and cultural activities, costs, and other particulars.

Information: Dr. Kamran Mofid and Dr. Raymond H. Hamden, Directors, 3 St. Martins Rd., Comprehensive Medical Centre, Coventry, United Kingdom, or P.O. Box 11806, Dubai, U.A.E., CV3 6ET; email: k.mofid@btopenworld.com and rhhamden@hotmail.com. For frequently updated information on the conference please visit the web site: http://commongood.info. ❊

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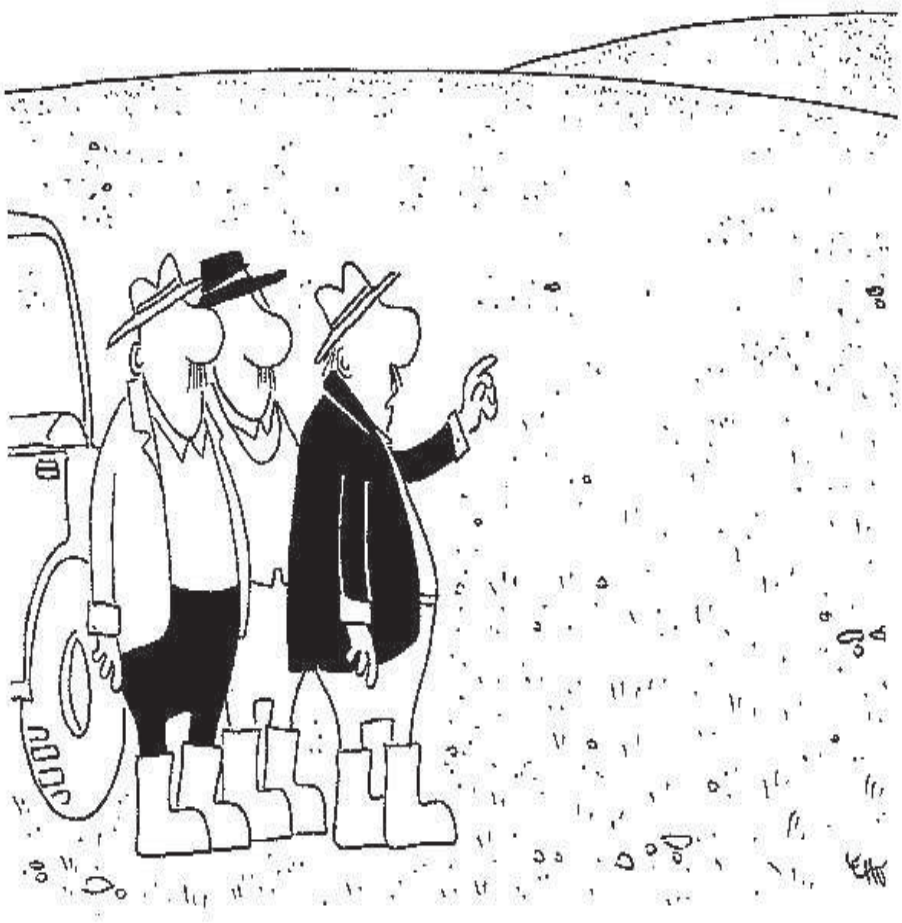
EU Membership Prospects



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