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edited by Salvatore Schiavo-Campo

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*by Vikram Goyal*

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At the beginning of the 1980s, the international donor community realized that it is difficult for development projects to succeed in a flawed economic policy context. Adjustment lending to support economic policy reforms was one response to that important realization. By the turn of the 1990s, we have come to recognize that, even with a sound economic policy framework, effective implementation of aid-assisted activities depends crucially on a favorable institutional environment. One response to that recognition is the increased emphasis being given by the Bank to institutional issues, in project design as well as through the work of core staff specialized in these issues.

A separate major trend has been a renewed emphasis on private economic activity as the engines of economic growth. At the same time, it is recognized that there is no dichotomy between the private and public sectors. Reliable public services, an efficient public regulatory framework and accountable governance systems are essential for private sector development and for economic activity as a whole.

The special importance of public sector institutions stems from the convergence between the emphasis on effective implementation and the complementarity between the public and private sectors.

Nowhere else is the importance of efficient public institutions more evident than in Eastern Europe and the new states of the former Soviet Union. In these countries, the regulatory and organizational framework of earlier times is no longer operative. Furthermore, the role of the public sector is undergoing a profound transformation in the direction of market-orientation. Hence, the present volume attempts to set out operationally relevant generalizations, blending the new economics of institutions with the lessons of recent experience. The Technical Department, whose Public Sector Management Team focusses on the institutional dimensions of the transition to a market economy, was pleased to sponsor the meeting near Prague which led to this volume and the reflections herein. I hope that the volume can help improve understanding of the institutional dimension of the current transition.

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Acknowledgments

In March 1993, the Technical Department of the Europe and Central Asia, Middle East and North Africa Regions of the World Bank organized in Prague the Multilateral Workshop on Institutional Change and the Public Sector in Eastern Europe and the Former Soviet Republics. The Editor wishes to thank the participants to that workshop (see Annex to Chapter 8) for the insights produced by their discussions, and the European Studies Center for the use of their excellent conference facilities at Stirin Castle. Certain papers were commissioned as background to those discussions. Following the workshop recommendation, those papers were revised and edited as necessary and, together with other papers and with a summary of the workshop consensus on international cooperation, comprise the present volume. The Editor also wishes to thank the respondents from the various international agencies, who provided the information on assistance for institutional development on which Chapter 7 is based.

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Salvatore Schiavo-Campo

February 1994
Abstract

This collection of eight papers on the transformation of public sector institutions in Eastern Europe and the former Soviet republics blends the new economics of institutions with the lessons of experience and attempts to set out generalizations in the key areas that are both conceptually sound and of direct operational relevance.

In Part I, the first chapter (by Salvatore Schiavo-Campo) derives from the basic concepts and from recent practice a number of strategic and practical suggestions for effective institutional reform. In chapter 2, Thráinn Eggertsson provides a synthesis of the new economics of institutions, geared largely to the search for answers to the problems experienced in transition economies. Part II examines several specific areas. Chapters 3 (by Suphan Andic) and 4 (by Richard Bird and Christine Wallich) deal with issues of organization of public finance — the heart of the economic management challenge — at the central and local government levels, respectively. Chapters 5 (by Geoffrey Lamb) and 6 (by Valery Pivovarov) move beyond the areas where the importation of technical, formal rules is a realistic possibility to consideration of selected governance and conflict-management issues — where informal rules and "cultural" norms are dominant. Part III, on aid coordination and management, comprises a factual report (by Vikram Goyal) on international assistance to institutional development in the region and the concluding Chapter 8 (by Salvatore Schiavo-Campo) makes recommendations on inter-donor cooperation as well as summarizing desirable organizational arrangements for the management of external assistance.

The impulse for this volume came from the Multilateral Workshop on Institutional Change and the Public Sector in Eastern Europe and the Former Soviet Republics, which was held near Prague in March 1993 under the sponsorship of the Technical Department for Europe, Central Asia, Middle East and North Africa of the World Bank.
THE CONCEPTUAL BASIS
INSTITUTIONAL CHANGE AND THE PUBLIC SECTOR: Towards a Strategic Framework

Salvatore Schiavo-Campo

1. INTRODUCTION

The Scope of this Chapter

Based partly on selected experience in the region during the last two years, this chapter suggests some strategic criteria and operational guidelines for institutional reform of the public sector in transition economies. Even if valid, these criteria and guidelines would be, of course, very far from constituting a complete framework. The scale of the institutional transformation in Eastern Europe and the former USSR — at once political and economic — is unprecedented. A blueprint for such transformation, which does not exist (and would be hazardous to attempt), would need to encompass the full range of political and economic insights into organized social systems, from Thomas Hobbes to Ronald Coase. This short paper is therefore intended only to underline the complexity of the issues (whence also the risks of "damn the torpedoes" intervention) while at the same time proposing a few strategic approaches which can assist in the transition without tainting its longer-term outcomes. Its deliberate focus on the public sector — and then mainly in the area of economic management — also helps to keep manageable the scope of the discussion.

Throughout, this paper is guided by three inter-related essential concepts: the understanding of institutions as rules, the importance of transaction costs, and the reality of "path dependence". Thus, through its own attempt at formulating strategic and operational criteria, this first chapter also serves as thematic introduction to the rest of this volume.

The Structure of the Volume

In the next chapter, Thráinn Eggertsson explains these essential concepts in sufficient detail and outlines the new economics of institutions — which is geared largely to the search for answers to the kind of problems currently experienced in the transition economies of Eastern Europe and the former Soviet republics.

The subsequent chapters examine several specific areas of institutional development in the public sector. Chapters 3 and 4 deal with issues of organization of public finance — the heart of the economic management challenge — at the central and local levels. These are among the issues best suited to the adoption/adaptation of "formal", technical rules — although local finance
inevitably also entails an analysis of decentralization possibilities, which must be largely country-specific. Suphan Andic assesses the organizational dimensions of central government finance, as they emerge from the recent literature, and their technical assistance implications; Richard Bird and Christine Wallich explore the scope and limitations of fiscal federalism and the institutional aspects of local finance — with the attendant implications for the appropriate relationship between central and local government. Chapters 5 and 6 move beyond the "technical" areas, where the importation of "standard" procedures is a realistic possibility, to consideration of selected governance and conflict-management issues. By the very complexity of these issues, the discussion here is deliberately selective and illustrative. Geoffrey B. Lamb sketches some governance dimensions of the problem, and Valery Pivovarov describes some ethnic and economic aspects of conflict in the former USSR and suggests a process for managing conflict.

Part III, on aid coordination and management, comprises a factual report on international assistance to institutional development in the region, and, in the concluding Chapter 8, recommendations on interdonor cooperation (arising from the Multilateral Workshop held in Prague in March 1993) as well as a summary of the desirable organizational arrangements for the management of external assistance.

II. SPECIFYING THE PROBLEM CORRECTLY

The Nature of Institutional Change

Colloquially, the term "institution" is often understood as "organization", and the challenge of institutional transformation is mis-specified as consisting of organizational reforms. However, as the 1993 Economics Nobel prize-winner Douglass North has stressed, it is essential to make a clear distinction between "institution" and "organization". Institutions are best understood as a set of formal and informal rules, and are thus distinct from the public organizations which emerge to administer and enforce them. To use a sports analogy, the "institution" of basketball is defined by the rules of the game, and not by the teams of players. The game will be played better or less well depending on the players involved, and enforcement of the rules by a referee is important, but unless its basic rules are modified (e.g., by removing the backboards) the institution of basketball remains the same. Accordingly, players will always try to adapt their behavior — their "play" — to the existing rules.

Naturally, the rules of the economic game can be more or less efficient, in terms of channeling resources to their most productive uses. Thus, institutional "development" can be defined as a move from a less efficient to a more efficient set of rules.

Institutions comprise both formal and informal rules and procedures — which extend to cultural habits and psychological variables, including "commercial morality", which is essential for a well-functioning market economy but is nonexistent or rudimentary in most transition economies. Formal rules can be changed overnight, but informal rules cannot. The implication is that real institutional change is always slower than was foreseen or can be visible on the surface. Rapid institutional change on the surface may go hand-in-hand with a frozen set of informal rules below the surface, yielding little or no behavioral improvement and presenting the agent of change with an apparent paradox. Thus, a "technical" failure to specify the problem correctly in the first place may result in
disillusionment and frustration with the reform process itself.

Institutional Change and Organizational Development

The distinction between institution and organization — and the interplay between the two — is key to understanding the full dimensions of the transformation underway in Eastern Europe and the former Soviet Union. Organizations can be improved — sometimes even created ab nihilo — but economic, social and political behavior will not change unless the rules and procedures change as well. However (and restoring some meaning to the colloquial understanding of "institution"), the reverse is also true: rule modification is unlikely to produce results in an operationally-meaningful timeframe unless organizational improvements proceed apace. And, in the absence of results, institutional reforms are more likely to be reversed. Furthermore, neglect of the organizational requirements of a policy reform is usually lethal for the implementation of the reform. Clearly, then, the massive challenge of institutional transformation in transition economies comprises both institutional (regulatory and procedural) reform and organizational development. Consequently, while the distinction between institution and organization is essential to a clear definition of the problem, it must not be overinterpreted to imply that if institutional change occurs organizational development will follow spontaneously — and in useful time. (As complex and opaque as the Russian situation is after the December 1993 Duma elections, it surely illustrates at least the fallacy of such a proposition.) Furthermore, institutional change does not occur by osmosis: organizations are themselves the agent of institutional change.\(^5\)

The Objective of Institutional Change

It is an oversimplification, but a useful one, to state that the current economic difficulties in many parts of Eastern Europe and the former USSR are the direct result of a temporary extreme increase in transaction costs due to various factors, such as the collapse of trade, increased uncertainty, and the breakdown of supplier networks. In turn, the increase in transaction costs is linked in part (albeit only in part) with the collapse of the old institutions without a corresponding rise in new, market-oriented, institutions. Thus, the objective of institutional reform can be defined as the quickest and largest possible reduction of transaction costs. This can be explained further by noting that transaction costs, as the total cost of doing business, are inversely related to: (i) the efficiency of the institutional framework in terms of defining clear property rights and protecting them; and (ii) the efficiency of the enforcement and organizational arrangements.

This definition is crucial. For, by focussing on areas where transaction costs can be reduced rapidly (and visibly), institutional reform can advance the necessary transformation of the role of the state while at the same time making an important contribution to economic recovery in the short term — thus increasing the political and social sustainability of the transformation itself. In the long term, however, because transaction costs are closely associated with clear and accepted property rights, it is important to keep in mind that a sustainable strategy for institutional reform must also incorporate the needed clarification and/or redefinition of property rights. Among other things, this is essential for the security of planned investments, and thus for the probability that these investments will in fact materialize. (One articulation of this issue is around the strategic choice between a "quick and dirty" and a "slow and clean" reform path — elaborated later.)

The Need for Assistance

The transition countries and the external donors cannot afford to ignore the fact that institutional change is key to a successful
transition to market-oriented economies with accountable governance. As a concrete example, liquidation of unviable public enterprises is a cornerstone of parastatal reform; yet, because of lack of procedures and organizations, enterprises remain in liquidation proceedings for years — at substantial real costs and compromising the credibility of the overall reform effort. As another example, it is impossible to formulate public investment programs adapted to the new role of the state in a market-oriented system unless the project evaluation and monitoring rules are changed and new organizations are created to administer and enforce the new rules.

In general, a simple old proposition has regained acceptance: vigorous and productive private economic activity requires reliable social services, credible public rules and efficient government organizations. Thus, reform of the public sector is itself a key ingredient of an enabling environment for the private sector. In the specific context of transition economies, an equally simple new proposition is also evident: in the wake of the collapse of the old command structures, deliberate promotion of a new set of market-oriented institutions and organizations is essential for economic recovery and a successful transition. These institutions and organizations will not emerge spontaneously — surely not within any kind of realistic timeframe. In turn, because of the lack of local experience with market-oriented rules and organizations, well-focused technical assistance in selected public sector institutional development areas can make a vital contribution.

III. STRATEGIC CONSIDERATIONS

Reform Choices

Institutional reform offers various choices: (i) the strategic choice — "quick and dirty" vs "slow and clean"; (ii) the governance choice — efficiency vs. accountability; and (iii) the operational choice — specific assistance vs. capacity-building; and (iv) the choice of scope — focussing on key institutions vs. broad-based institutional development. There is an implied chronological dimension to these choices. The first term of each is normally associated with urgent problems, which require specific assistance to key institutions, oriented to efficiency and quick results; the second term is associated with long-term institutional development which requires broad-based capacity-building assistance, with a deliberate focus on accountability and clear definition of property rights.

These choices are continua and not polar opposites (as is obvious from the short-term/long-term formulation). The key decision in the design of institutional reforms is therefore when to emphasize one or another term of these choices and how to identify and exploit complementarities among them — and not whether to adopt one or another strategy across the board and regardless of circumstances.

Let's elaborate on this point with reference to the strategic choice. It is obvious that a "quick and clean" reform strategy is optimal and a "slow and dirty" strategy the worst. More often, however, the practical choice revolves around the intermediate options of a "slow and clean" reform strategy or a "quick and dirty" strategy. As a general presumption, the former is preferable because it is more likely to be sustainable. (Recall that a "clean" reform is defined here as one that recognizes the importance of clear property rights and the necessity of their enforcement.) Many statesmen (e.g. Vaclav Havel) and most jurists have expressed the preference for a clean path on moral and legal grounds, respectively. Such a preference, however, does not need a moral or legal
rationale, but can be justified entirely on pragmatic grounds, i.e., by the sustainability of the transition itself. Moral and legal arguments, which are weighty, may be sufficient to opt for a clean reform path but are not necessary for such a choice. Instead, if valid, the pragmatic argument — which rests on sustainability — is sufficient.

The "Torto-hare" Approach to Institutional Change

Most importantly, unlike the moral and legal rationales, a pragmatic justification permits focussing strategic attention on identifying areas where it is feasible to move very fast (with only a slight cost in terms of "cleanliness" or deviations from the optimal long-term path), and areas where it is essential to build slowly and carefully the solid institutional foundation required for sustainable reform. For, despite the general superiority of a slow and clean reform strategy over its alternative, its rigid and dogmatic implementation may paradoxically result in practice in the worst outcome — a slow and dirty outcome.

To the question of what is the "optimal pace of reform," the risk-minimizing, reform-maximizing answer is "it depends" — unsatisfying and demanding as such an answer may be. This answer is especially valid in the fluid and opaque circumstances of the current transition. To use the metaphor of road traffic, optimal driving speed depends on traffic conditions — subject to an overall speed limit and to the need to keep moving. "Torto-hare" was the slogan (tarta-lepre in Italian, combining tortoise — tartaruga — and hare — lepre) coined by the Italian highway authority in the 1960s to describe the optimal driver behavior. To complete the metaphor, the worst approach to driving in heavy and erratic traffic is to set the cruise control.

In this perspective, there is an aura of unreality to the debate between "shock therapy" and "gradualism", joined at the beginning of the transition and currently raging in the aftermath of the January 1994 resignations of key reform advocates from the Russian Government. The underlying, valid, premise of shock therapy is that in the absence of simultaneous rapid policy reforms in complementary areas partial reform measures will have no effect. The underlying, valid, premise of the gradualist approach is that there is only so much change and upheaval a society can stand at any one time, and the attempt to do too much may end up in a failure to accomplish anything.

The difficulty, as always, is that stretching these valid premises to their logical extremes leads to caricature and untenable prescriptions. Thus, the fundamentalist interpretation of shock therapy is tantamount to advocating reform of everything at once; and the fundamentalist interpretation of gradualism becomes a prescription for total immobility. Much of the current "debate" about policy reform strategies shows signs of the manichaen spirit which invariably destroys scientific reasoning. The operational choice is rarely between two extremes. The real challenge is to identify the specific policy areas where "shock therapy" is appropriate and those where "gradualism" is the more effective approach. This harder challenge calls for a lot more homework and interaction with local interlocutors than fundamentalist advocates of either extreme approach are normally willing to undertake. It is time to let go of the "cruise-control" mentality shared by both the shock therapist and the gradualist. Indeed, it is time to shelve the very terminology of shock therapy and gradualism, which has been singularly unhelpful to clear-headed reform design and evaluation, and has been in any event misused and trivialized.

Beyond slogans and metaphors, the argument is in effect a simple cost-benefit argument. It always makes sense to keep circumstances under constant review, and adjust the pace or location of
intervention as needed — because a change in circumstances will by definition entail a change in both the opportunity cost and the benefit sides of the efficiency calculus. Provided that "costs" and "benefits" are correctly specified, such an argument is as relevant to institutional change as it is, say, to investment projects evaluation. Reforms should be pushed very fast wherever and whenever the circumstances warrant, and may need to be postponed in other areas or occasionally slowed down — in order to allow complementary developments to catch up, absorptive capacity to grow, or public tolerance to be rebuilt. Such an obvious point would not deserve being mentioned were it not that it is so often disregarded in practice.9

The Areas of Reform and a Taxonomy of Intervention

The institutional reform choices sketched earlier intersect with the issue of how and where to act to reduce transactions costs. Transaction costs can be reduced, as noted earlier, by either or both institutional change and more effective organizational arrangements. Also, although public sector reforms always have some impact throughout the system, efforts to reduce transaction costs can be focused on the following areas:

- at the external interface between the domestic economy and the outside world (e.g., tariff rationalization);
- within the central government (e.g., improving budgetary procedures);
- between the central government and other components of the public sector (e.g., corporate governance or decentralization); and
- at the internal interface, between the public and private sectors (e.g., private delivery of public services).10

The above distinctions have no conceptual merit, but are simply a convenient way to classify and summarize an institutional reform program — the basis for a "matrix" to be used as a checklist and a tool for a preliminary identification of gaps in the reform program. Such a matrix would cross-classify actions as between institutional or organizational improvements, and among the four areas of intervention listed above. Naturally, because the agents of change differ among these eight categories, such a matrix can also serve to indicate the appropriate interlocutors for the reform dialogue and help the tactics of reform.

Sustainability: The Key Strategic Criterion

As noted, while there is no clearcut choice between one or another avenue of institutional reform, in practice most of the external assistance so far has been focussed on the urgencies of the day. There is a clear need to redress the balance. To recapitulate, a comprehensive institutional reform program must include the following elements without which the program cannot be sustainable — hence it would be a failure even if it had spectacular near-term results:

- attention to the task of clarifying, defining and enforcing property rights;
- consideration of the probable impact of the reforms on accountability and representative governance;
- recognition of the existence of economic, social and, crucial in many countries, ethnic conflict, and of the ensuing need to manage it;
- consideration of the country's absorptive capacity for change and for technical assistance, without which such assistance substitutes for local effort, at best, and creates long-term dependence, at worst;
• a major effort for long-term capacity-building throughout the economy; and

• a potential to include more and more people over time ("the role of hope").

Assuring that these longer-term considerations are incorporated into an institutional reform program requires, in the first place, that an appropriate entity within the government be charged with that function. The function can be entrusted to a Ministry of Economy, or to the Prime Minister’s or President’s office, or to a secretariat of an inter-ministerial group, or to any other organization appropriate to the political landscape and country conditions. Each location has advantages and disadvantages. What is essential is that whatever entity is charged with this function must enjoy a clear and public mandate, unquestioned political support and the material and human resources necessary to carry out its function. It is difficult to overemphasize the importance of this factor — in the midst of an understandable convergence of tendencies to focus on the immediate problems. *Someone must be made responsible for looking out for the long run,* or the dream of a market-oriented economy with accountable governance may turn into a nightmare.

External agents, and especially donor organizations, have a responsibility too. At best, they should actively encourage governments to create such a capacity to look out for the long run and stand ready to support it. At a minimum — following the Aesculapian injunction of “First, Do No Harm” — donors should not press for short-term results without consideration of longer-term repercussions, nor push for technical assistance to facilitate implementation of their own project portfolio regardless of whether such assistance facilitates or suffocates nascent local capacity and initiative.

IV. SOME COROLLARIES

The Futility of "Paper Reforms"

A first corollary of the above conceptual considerations is that institutional reforms are hollow in the absence of effective monitoring and enforcement mechanisms. This point is evident in instances of institutional change with a heavy component of informal rules. But even in instances of change in formal rules (e.g., budget formulation), organizational and human capacity is still essential to administer and enforce the new framework. Administering, monitoring and enforcing mechanisms take time, resources and genuine commitment at several levels in order to become operational. Yet, two very different tendencies often converge in practice to sidestep these requirements. The first tendency is the temptation of foreign donors to declare a problem solved and move on to the next agenda item. The other is the ingrained habit of control-minded central elites in the transition countries themselves to effect behavioral change by *ukase.*

Adopt, Adapt or Create?

A second corollary concerns the question of whether it is possible to "import" foreign institutional arrangements. The answer to that question is often phrased in dichotomous "yes" or "no" terms. Both answers are bad answers. As is generally true in other instances of transfer of technology, once again the better answer is: "it depends". Formal rules can be imported fairly easily, informal ones much less so. It follows that importing foreign institutional practices is a practical proposition only when these practices have a high component of formal rules. This is the case, for example, of the more "technical"
areas, such as central banking or certain public finance functions. It is, on balance, far better and more cost-effective (in institutional terms as well as in terms of resource costs) to import tested, "standard", rules for — say — discount rate setting or direct tax administration, than it would be to try and devise new, country-specific, rules. Furthermore, in such cases, results and function are more important performance criteria than process and form. However, even the most "technical" formal rules do require a minimum of adaptation to country conditions, or at the very least an open-minded assessment that country conditions are amenable to efficient introduction of the new institutions. (Suphan Andic analyzes in Chapter 3 the issue from the viewpoint of central government finance, and Richard Bird and Christine Wallich do likewise in Chapter 4 from the viewpoint of local government finance.)

On the contrary, when the nature of the institution entails a high component of informal rules, as in "social" and "governance" areas, the institution will normally need to be home-grown or, if imported, will require substantial adaptation and changes over time. In such cases, process and form ("ownership", "dissemination", "consensus-building", etc.) are as important as the eventual results. Indeed, it is sometimes true that (pace Frederic Molnar) "the play's the thing": the process is the reform — as in the case of some of the priority reform areas indicated by Geoffrey B. Lamb in Chapter 5 and of the conflict-resolution mechanisms proposed by Valery Pivovarov in Chapter 6.

It is important not to misinterpret this distinction as implying that technical assistance is necessary in the case of "imported" rules but not for informal rule-change. Appropriate technical assistance may be needed in both cases. What will normally differ is the origin of the "experts", the skill-mix, delivery mode and the risks of assistance.

The Risks of Intervention and the Design of Assistance

Societal opaqueness, outsiders' lack of familiarity with rules (especially informal rules), a fluid and unstable situation in many countries, and the high political overtones of institutional reform, make institutional change in Eastern Europe and the former USSR risky territory for external intervention. The country dialogue is complicated further by unprecedented communication difficulties: the very terminology of market-oriented economics is entirely different from the semantics of the command-economy, to which most local interlocutors are accustomed. The risks are heightened by the reality of "path dependence", i.e., that institutional reforms enacted today have inescapable but unpredictable long-term implications — particularly in this unprecedented context of political and economic transformation. The penalty for mistakes, of course, falls almost exclusively on the people of the transition economies themselves. Thus, the moral hazard inherent in all forms of intervention from the outside — however benevolent — is especially severe in the area of institutional change.

These considerations should not be taken as counseling inaction or benign neglect — inaction, too, carries its own brand of moral hazard — but to stress the importance of identifying the risks and minimizing them to the extent possible. The risks can be generally minimized, as noted earlier, by flexible mechanisms of assistance — adjusted periodically in keeping with the dynamic nature of the transition — attention to accountability and governance implications, and a focus on capacity building. More concretely, the risks of intervention can be reduced by interaction with a variety of local interlocutors and optimum use of local expertise. These elements are elaborated below.
The conflict dimension. All institutional change implies winners and losers, and therefore carries implications for the intensity and localization of conflict in society. It is accordingly important to include in the implementation of technical assistance activities, insofar as practical, an element of conflict analysis. In addition, it is important to establish some contact with various relevant groups beyond the official interlocutors (e.g., parliamentary bodies, local public and private entities etc.), seek their views, and try to explain the reasons and probable effects of the reforms. However, whether these efforts should be made by external official agencies is an open question which raises, among other things, troublesome concerns about unwarranted intrusion in internal matters. As suggested below, intervention to facilitate such contacts among the various local groups themselves is less risky and in all probability more constructive. In any event, any such enlargement of the dialogue by external official agents must always be conducted in transparent ways vis-a-vis the official interlocutors.

The role of "local" participation and expertise. Among other things, efficiency in institutional assistance is fostered by encouraging and using local participation and expertise. The well-known advantages of using local expertise — mainly capacity-building, cost-effectiveness, and greater familiarity with the local context — are especially relevant in the institutional domain; the UNDP-sponsored "Umbrella Project" in Poland provides a good recent experience. It is true, however, that the nature and content of local expertise is not uniform; in Russia's privatization program, for example, expertise on the mechanics of asset valuation and privatization vouchers was available, but accounting expertise was lacking.

Some of the advantages of local expertise are shared by experts from neighboring countries as well. These experts might have a special understanding of the nature of conflict in the country in question, and might contribute the lessons of their own experiences with similar problems of adjustment in the recent past. On the other hand, experts from neighboring countries might be unacceptable, because of historical hostilities. Also, rightly or wrongly, there is often in the region a preference for experts from industrial nations, with nationals of countries in similar circumstances to one's own being considered second-best. These attitudes are realities, which need to be recognized but not necessarily accepted. In the first place, to accept a reality always risks reinforcing it. Second, attitudes can and do change over time, and an abandonment of discriminatory attitudes (itself a form of institutional improvement, albeit diffuse and indirect) should be encouraged. Third, a regional expert whose nationality might not be acceptable to one country could be welcome in another country of the region. Fourth, donor agencies should replicate successful applications, and the ensuing demonstration effect could overcome initial prejudice.

More generally, to use local "expertise" also means seeking the views of informed local persons and of the local partners and beneficiaries of technical assistance. In the domain of institutional change, the advantages of doing so are compounded by the key factor of awareness of informal rules, which are the institutional aspect least amenable to rapid change and most important for its sustainability.
V. OPERATIONAL APPROACHES

The search for operational approaches to institutional change in transition economies rests on the above strategic considerations, as well as four premises. First, the information problem is massive. It has rarely been so true as in the current transition that the only thing we know for sure is that we know very little. The fluidity of the economic and political situation interacts with the lack of timely and reliable information to place everybody — insiders almost as much as outsiders — in an equal position of relative ignorance. Second, specific entry points must be identified. On the one hand, it is evident that simultaneous institutional transformation across the board is out of the question; on the other hand, total inaction on the institutional front is a recipe for destroying the transition. Somewhere between these two extremes, intermediate possibilities for constructive entry must be found. Third, path dependence is a reality. Institutional mistakes tend to become evident only years down the line, when they have become irreversible, with potentially severe consequences for the desired scenario of market-oriented economies with accountable governance and effective conflict-management structures. Fourth, countries must, after all, work with what they have. The human resource endowment, the inertia of neodysfunctional institutions and bureaucratic habits, the existence of large numbers of people whose human capital (often even their professional identity) has become obsolete overnight, the predictable bitter resistance and backlash of the losers from change, etc. — all these factors can be altered, combated, utilized, perhaps even deliberately neglected, but cannot be ignored by those who would assist the institutional transformation.

These four premises underpin two interrelated approaches for constructive intervention: (i) strengthening intra-system linkages; and (ii) fostering the creation of "efficient nuclei".

Capacity-Building and Strengthening Internal Linkages

For all the distortions created by the previous command-economy system — in that system intragovernmental communication was rapid; today, it is very feeble virtually everywhere. The absence of systematic lines of inter-agency communication and the lack of incentives to share information (which is often viewed as a personal asset) result in fragmented policy formulation and atomized decision-making. This presents a major problem for the implementation of reforms and for the probability of success of the transition. The challenge is how to restore communications and cooperation within the public sector, although of course within the new aim to implement market-oriented policies and accountable decision-making — rather than to transmit unquestioned central orders as in the command economy.

The current state of institutional confusion at the "core" of economic management apparent in the less developed countries of Eastern Europe and in most of the former Soviet republics (with some possible exceptions) must be remedied. However, the central long-term issue is the building of adequate capacity throughout the system, without which restructuring at the core will accomplish little more than rearranging boxes and titles in tables of organization. Capacity-building must encompass not only training within individual agencies, but the linkages among them — revolving around specific key functions of government.

It is difficult to decide whether to strengthen one particular agency of government or another; the outcome of bureaucratic "turf" disputes is utterly uncertain; and the risks of losing an organizational bet are potentially severe. The guiding operational criterion of technical assistance for sustainable institutional reform in
the public sector should therefore be to strengthen the linkages between the components of the public sector. Not enough is known to pick winners and losers — and today's winners may well be tomorrow's losers anyway. Enough is known, instead, to say that strengthening the institutional and communication linkages within the system: (i) does not prejudge or preempt the appropriate transition path for the system as a whole; (ii) entails a direct reduction in transactions costs; and (iii) is likely to have positive implications for transparency and accountable governance.

Specific linkage-strengthening activities may include: improving information flows; fostering mutually beneficial inter-agency cooperation; clarifying property rights in disputed areas; training in conflict analysis and management; strengthening judicial and contract-enforcement systems; installing user-friendly and standard data-processing capabilities and the associated training; language teaching; assistance to the media; assistance to other information-generating, linkage-strengthening or dissemination entities, etc... None of these activities will eliminate the conflicts of interest that exist between different agencies and entities. They will, however, contribute to limiting the conflict to instances where it does exist — and set the ground for a constructive resolution of it.

Linkage-strengthening activities should, when appropriate, also include creative utilization of elements of the old system. For example, in the former Soviet republics most ministries had no independent analytical capacity, and relied for technical and scientific work on their respective technical "institutes", which either constituted an integral part of the ministry or were highly subsidized although with autonomous status. At present, the institutes which still survive are in financial and legal limbo — cut adrift from the parent ministry and shrunken to a fraction of their earlier size — but several still exist and have substantial technical expertise, equipment and facilities. Imaginative contractual arrangements could be devised, on a competitive and strictly commercial basis, between the government and some of these institutes. This could permit the performance of certain needed analytical tasks without adding to the permanent civil service, and stimulate the growth of a private local consulting capacity using the best of the existing technical expertise — while accelerating the substantial downsizing of the institutes' workforce that is needed.

The linkage criterion points to the need to avoid a "partial equilibrium" mode of assistance for capacity-building, but does not in the least exclude specific technical assistance for capacity-building of specific functions or segments of government. Clearly, today's priorities must be attended to, particularly in areas where the weight of formal rules makes rapid institutional change a realistic possibility. However, even when supporting the reinforcement of one or another agency of government, it is essential to encourage positive interaction with other government agencies. Such encouragement must not be limited to the rhetorical level, but should entail incorporating in the assistance specific incentives for greater information exchange, training and cooperation. This point leads to the second approach suggested here.

Efficient Nuclei

The general notion. Action to strengthen linkages and communication channels facilitates but does not in itself generate the spread of new rules and efficient organizational practices. There must also exist dynamic agents of change that can generate the positive "messages" to be transmitted throughout the system by the improved communication channels. These agents, these "efficient nuclei", must be deliberately created to perform a few key selected public functions.

A guiding criterion for selecting these key functions (and this is where the inter-relation with the previous approach emerges) is their
contribution to maximizing the linkages within the public sector. By analogy with Albert Hirschman’s "unbalanced growth" approach of 30 years ago, efficient nuclei should be selected largely on the basis of their potential for spreading new institutions and organizational practices throughout the system.

Beyond the linkage-maximization general selection criterion, an efficient nucleus should meet the following practical standards:

- be small;
- be fiercely meritocratic, in the initial selection and in the evaluation of staff performance;
- have flexible and simple procedures;
- provide adequate compensation for staff; this may require fixed-term contracts without fringe benefits, to permit adequate salaries without compromising eventual decisions on fiscally sustainable civil service structure and compensation;
- have adequate material and financial resources;
- use local talent, with external advisors only when demonstrably necessary;
- be a transitional arrangement, with a clear sunset clause and advance specification of the procedures for reassignment of its staff throughout the relevant government agencies;
- operate not only to perform specific tasks but also a teaching-by-doing function, in cooperation with other agencies.

A specific illustration. An illustration of the efficient nucleus approach can be given in the area of public investment. Public investment programming based on economic project evaluation and real-cost financing, is key to the transformation of the role of the state towards enabling rather than controlling private economic activity. However, the rules and organizations needed to evaluate economically-sound projects, prepare a coherent public investment program, and formulate the corresponding annual investment budgets, are conspicuous for their absence in many Eastern European economies and, even more so, in the former Soviet republics. Substantial attention has been devoted to this issue by international donor agencies. Yet, improving "core ministry" capacity (e.g., in a ministry of planning, or of finance, or of economy) accomplishes little without sufficient capacity at the sector level to screen out unsound ideas and formulate good projects. It will take a long transition for the sector ministries to build up their own capacity in this respect. In the interim, a mechanism is needed to assure results and speed up the transition as well.

By the efficient nucleus approach, such a mechanism could consist of creating a "visiting team" unit, in the core ministry which is charged with public investment responsibility. The unit would comprise a small number of highly-qualified, newly-trained local analysts and an experienced external advisor — all with excellent communication skills in addition to economic competence. The unit would provide ad hoc assistance to sector ministries — at the right points in the PIP cycle — by sending a visiting team "in residence" for a brief period of time. This would combine knowledge of economic methodology with the specific technical knowledge and sectoral familiarity of ministries' staff. The team would visit each sector ministry in turn, and interact with its staff to produce better-quality decisions as well as some "teaching-by-doing". The relationship would be one of cooperation and mutual assistance — because decisions on actual approval of projects for funding would be entrusted to an entirely different core entity. Such relationship would therefore encourage informal exchanges of information and advice as and when needed. When, helped by this mechanism (and, of course, their own specific training programs), sector ministries have
acquired sufficient project preparation capacity, the visiting team unit would disband — and its personnel would be reassigned to take care of PIP matters within the core ministry as well as lead the work in sector ministries.

The visiting team suggestion is only one of many possible applications of the efficient nucleus approach. For example, in Algeria (which, although not in the region, shares similar transition problems) institutional modernization of the public works sector is underway — led by a small group of senior staff in the Ministry of Public Works in cooperation with provincial authorities and the state School of Public Administration. The activities are facilitated by local and external advisors financed through the World Bank’s Institutional Development Fund. This process, too, is cooperative, emulative, and interactive — with a plus-sum outcome and thus a potential gain for all concerned. The strong support of the present Minister provides the political backing essential for any such institutional change process to succeed. Even in the current extremely difficult political and security situation, the process has already produced some organizational and regulatory improvements.

The Role of Hope

There are two essential differences between the "efficient nuclei" approach and the notion of "enclave projects." First, an efficient nucleus is aimed at spreading institutional improvements throughout the system. Second, efficient nuclei should be encouraged to emerge within an existing organization, to reform it from the inside — a benign mutation rather than a threat. By contrast, enclave projects normally either ignore or bypass the existing organizations. Experience with enclave projects and with other attempts at bypassing the existing dysfunctional organizational arrangements has been generally negative. The organizational strongholds being bypassed refuse to wither away, and actively resist and subvert the reform process. (Brazil is a case in point.) One major reason for this negative experience is that the enclave approach gives the people in the existing organizations no prospects for participating in the institutional transformation.

It is important that institutional reforms incorporate positive incentives for all who are still "inside" the system. In traditional welfare economics, so long as the reform has a positive impact on overall income, the winner-loser problem is "solved" by assuming that losers are compensated. The assumption is the sort of cop-out that gives economic theory a bad name. In the transition countries, this assumption is particularly surrealistic, as transfer mechanisms do not exist and overall income has been contracting sharply from the general economic crises associated with the sharp increase in transaction costs. If, then, actual compensation is out of the question, the reform must at least incorporate a potential benefit for individuals in the system — the hope to become part of the new institution, the chance of turning themselves from losers to winners. The individual's average probability of access to the new system is by definition very low — because public employment in the transition economies is contracting quite substantially. However, a non-zero average probability combined with the individuals' capacity to raise their chances through personal effort with the help of appropriate training, may suffice to motivate enough people into supporting the reform. The key proviso is that there must be absolute confidence in the equality of opportunity of access to the new system — hence the meritocratic imperative if an efficient nucleus is to work in the right direction. (The implications for governance are, of course, far reaching.)

There is no illusion here that incorporating the "role of hope" can remove, or even substantially reduce, resistance to change in general. It can, however, turn many opponents into supporters for the reform process; at the margin, this may make the difference between
success and failure of a particular institutional or organizational improvement. Also, well-designed and fairly-administered training-for-access programs can have an important demonstration effect in terms of one "informal institution" which is essential for a market-economy with accountable governance: that is, the principle of reward for effort and performance, rather than for political or ideological loyalty. In any event, equal opportunity of access is the right thing to do.

The Four S's: Sensitivity, Selectivity, Stamina and Staff

Whether the dialogue on reforming public institutions is between external donors and the government, or between the agents of change within the government and other interested parties, certain requirements are essential to the success of the dialogue on reforming the public institutions. These requirements stem directly from the conceptual and strategic considerations advanced earlier in this paper, and are recapitulated here for readers’ convenience and easier reference.

First — under the heading of "sensitivity" — understanding of the circumstances of the other parties, mutual respect and open mindedness are even more important for the "ownership" of institutional change than they are in the general economic policy dialogue. With particular reference to the transition countries (vide the unusual semantic difficulties mentioned earlier), one must pay attention not only to the clarity of the message as it is "broadcast", but also to its clarity as it is "received". This point leads, among other things, to the practical suggestion of asking the interlocutors to articulate their interpretation of the message being delivered — a simple but effective way to insure against misunderstandings.

Second, as implied by the earlier discussion of strategic criteria and efficient nuclei, institutional change should focus in areas where it can make a difference. The three main selectivity criteria are: importance of the area for the transition; feasibility of significant and identifiable regulatory or organizational change; and, as noted, positive impact on intra-system linkages as well as a potential for generalizing the change to other areas.

Third, as emphasized at the outset, institutional change is slow by its very nature, and the concomitant organizational capacity can only grow over time. Assistance to institutional and organizational development, consequently, must be viewed as a long-term investment of time, imagination and resources. Delusions of institutional grandeur produce only disappointment and frustration. The long-haul nature of institutional development requires commensurate commitment and stamina to stay the course. In general, this is true whether the intervention is by external donors or by the core government agencies vis-a-vis other public sector entities. It is possible, however, to conceive of external assistance as a catalyst — in the original and literal sense of the term — that can spark or facilitate an internal process of a potentially self-sustaining character. It does not follow, therefore, that external agencies necessarily need to remain directly involved beyond the initial phase.

The fourth "S", staff, is shorthand for resources. It is not worth elaborating on this obvious requirement, except for underlying the inverse correlation between the soundness of the design of intervention and the resources required for its implementation and supervision. Nevertheless, the best-designed assistance mechanism will still require sufficient material and human resources to be implemented. External assistance can help with the material side; it can also help somewhat with the human side, by providing competent advisors who understand their primary responsibility as including training of their local counterparts. External assistance cannot, however, provide the core staff charged with implementing and
facilitating the process. In turn, that core staff must have appropriate incentives. New-found patriotism may last a long while but not indefinitely.

The implications of the fourth "S" for the required skill-mix of civil servants and their compensation are thus inescapable. We cannot discuss these implications here. But we can stress the following conclusion. Without adequate and early attention to civil service issues — that is, without considering the capabilities and incentives of the human beings in the public sector who are charged with fostering reform of the public sector itself — the best operational recipes are just words and the "soundest" institutional development program is a waste of resources.

NOTES

1. I am grateful for valuable comments from Yves de San, Thráinn Eggertsson, Costas Michalopoulou, Geoffrey Lamb and Sarwar Lateef and for the insights from the discussion at the Prague Workshop (see Chapter 8).

2. The term, associated mainly with Douglass North, was first used by historians of technological change. North uses "path dependence" in the following sense: the stock of social capital is immense; it can be changed only at the margin; therefore, the immediate future is largely predetermined. Path dependence is used in this paper in a different (although entirely consistent) sense: institutional change alters the stock of social capital, albeit at the margin; thus, it has a lasting, rippling impact; one must be careful not to embark on a new, inefficient path.

3. Alongside public finance, monetary institutions are the other key area of macroeconomic management. The International Monetary Fund traditionally has primary responsibility in these areas, and has been active in assisting countries of the region develop the new institutions and organizations. Unfortunately, an overview paper could not be made available for this volume.

4. In the public sector, that is. In the private sector, business organizations do not emerge to administer the rules, but to do business within the existing regulatory and incentive framework.

5. This is the basic rationale underlying many external assistance efforts in the region. As one example, the EC-Phare has financed a legal advice facility to the Baltic States which interacts with the World Bank's studies of governmental organization for economic management.

6. It is true that with perfect institutions the right organizations would spring up instantly and spontaneously; and, if they do not, it "merely" indicates that institutions are imperfect. However, this is analogous to the neoclassical argument that with perfect competition (implying, inter alia, costless information) there cannot be a divergence between public and private optima. It would be paradoxical for the economics of institutions — which has emerged largely to correct the unreality of the frictionless neoclassical system — to itself argue that there is no independent organizational problem if only one assumes perfect institutions. For all practical purposes — and economics, as a social science, must somehow be concerned with practical purposes — even under the most optimistic institutional scenario, time, resources and policy attention will still be needed to facilitate the growth of the organizations that give practical meaning to the new rules.

7. In addition, the reality of external diseconomies, manifested most dramatically in the extraordinary environmental problems of the region, calls for appropriate public action. It is of course true that the environmental damage had itself been caused by the perverse state policies and incentives of the past.

8. A macroeconomic example of such a mistake would be an attempt to reduce the fiscal deficit by improving the tax effort without concomitantly strengthening expenditure control mechanisms. A microeconomic example would be the liberalization of public enterprise
pricing without the complementary measures to place the enterprise on a commercial footing.

9. An important connection, which is not explored in this paper, is that between the appropriate reform strategy and the governance system. For example, "shock therapy" may be more or less viable as a strategy depending on the degree of legitimacy and popular support enjoyed by the regime.

10. The last logical possibility — reducing transaction costs within the private sector — is very much part of institutional development but is normally less well suited for constructive external assistance. Possibilities do exist, however — from the financing of "site and services" for commercial marketing complexes, or assisting the creation of chambers of commerce or the growth of private information networks. In any event, all these fall outside the scope of this paper, which is concerned with the public sector.

11. Furthermore, interdonor cooperation is important to prevent tunnel-vision actions by each individual donor. (Chapter 8 discusses this question at some length).

12. Thus, both the EC-Phare (which coordinates European Commission aid to Eastern Europe and the Baltics) and the EC-Tacis (with the same role for the CIS) have large programs of assistance in public investment programming. The World Bank, of course, has a major concern in this area as well.

13. This is certainly true of the public sector as a whole, because of the bloated parastatals. Except for Russia, however, it is not necessarily true of government employment in most former Soviet republics, where — because all major decisions were made by Moscow, and implemented by the local Communist Party bureaucracy — government itself had few real functions and a fairly small workforce. Indeed, central governments from the Baltic to Central Asia tend to be understaffed, especially when netting out holdovers with no skills relevant to governmental functions in a market-oriented economy.

14. This section takes its lead partly from the U.S.A.I.D. Policy Paper Approaches to the Policy Dialogue (Washington; December 1982), which was drafted by this writer.
I. INTRODUCTION

This paper is a survey of the new economics of institutions with an emphasis on its potential contribution to institutional change in Eastern Europe and the former Soviet economies. The purpose of the paper is twofold: to provide persons who are directly or indirectly involved with institutional change in the region with new tools and concepts that may help in their work; and to encourage people in the field to provide empirical insights needed for the further development of the economics of institutions.

Reformers who turn to economics to guide the transition from plan to market, find sophisticated theories designed to explain economic relationships and results in full-fledged market economies, particularly in terms of prices and quantities at the micro and macro levels. In some cases, the strength of the theory is not seriously affected by substantial variation in the institutional structure; for example, the long-run relationship between money and inflation has been established in diverse economic systems. In other cases, application of standard theory may produce disastrous results, when the appropriate institutions are not in place: witness the debate over the proper sequencing of reform measures. In all cases, however, the main point is that the reformers need a theory of organization, institutions, and institutional change. It is not likely that the lifting of price controls and the liberalization of trade will automatically and swiftly call forth the required economic and social institutions—in other words, that the demand for efficient institutions creates its own supply on a timely basis. Specific efforts are needed; some theoretical guidance is provided below.

The modern economic theory of institutions is in its infancy, although in the last two decades important contributions have accumulated.1 The new approach is slowly transforming economic theory by explicitly introducing the notion of costly information and the related concept of transaction costs. In the new approach, it is the encounter between rational, non-altruistic individuals and information problems that makes organizations and institutions critically important for explaining economic results. The study of transaction costs and their implications has found an outlet in a vigorous new field, the economics of law (or law and economics); it has also brought new life to the theory of economic history and transformed the field of industrial organization.2

In the area of economic development and Soviet studies, however, the influence of the new
Eggertsson

approach has been somewhat limited. Furthermore, in its current stage the strength of the new theory is the study of outcomes and structures at the market or micro level, and the studies of life within organizations at the so-called micro-micro level. There have been few attempts to merge macro-economics and the economics of institutions and develop a theory of macro-economic relationships centered on transaction costs and allowing for variations in institutional arrangements. Such a theory is necessary for understanding the macro-economics of the transition.

The remainder of the paper consists of five sections. The next section introduces the basic tools and concepts of the economics of institutions and summarizes the strengths and weaknesses of the approach. The third section looks at a world of positive transaction costs and examines how the institutional framework affects economic results. The fourth section examines the influence of transaction costs on the choice of economic organization within a given institutional framework. The fifth section reports on attempts to explain various aspects of the institutional framework and the choice of economic policy. The final section contains some concluding thoughts on the economics of institutions and the transition.

II. THE NATURE OF INSTITUTIONS AND THE CREATION OF WEALTH

The Puzzle

Albania is the poorest country in Europe with GNP per capita of about US$1,250 in 1990. Yet Albania, which has a population of about 3.3 million, is endowed with rich reserves of chrome, nickel, copper, natural gas, iron, coal, lignite, and oil. Other countries, such as Japan or Singapore, that are not endowed with abundant natural resources, have managed to prosper. What accounts for this discrepancy in performance?

The economics of institutions is concerned with the ultimate puzzle of economics: why some nations are able to organize their economic life effectively while other economies fail to grow and even suffer poverty amidst plenty. The failure of the potentially rich to act is particularly baffling from the viewpoint of economic theory where it is assumed that individuals take every opportunity to augment their wealth and welfare. We believe that the answer to the riddle is rooted in information problems and in the role of institutions in economic life.

In this section we introduce a theoretical framework for exploring the link between institutions and the creation of wealth. We begin by defining some key concepts — institutions, property rights, transaction costs, contracts, and organizations — and their relationships. We emphasize the interaction between property rights, transaction costs, and contracts in the process of production, and distinguish external from internal property rights. Finally, there is a brief look at the role of organizations in institutional change and the concept of institutional rigidity or inertia.

Institutions

Institutions are rules, both formal rules (such as statutes) and informal rules (such as norms), that constrain behavior. As the theory is concerned with behavior, institutions are defined as effective rules, rather than nominal rules, with
emphasis on enforcement. Institutions are external to decision makers and define their ultimate choice set and structure of incentives, for instance, when they exchange commodities, invest, or design organizations. Institutions determine whether budget constraints are soft or hard, or whether rivalry among organizations gives rise to competition that selects low-cost enterprises for survival. The institutions that individuals confront vary with their position in society. For instance, in the old Soviet system an enterprise manager, a central plan bureaucrat, and a Politburo member confronted overlapping but different sets of institutions.

The relationship between institutions and wealth is complex and multi-dimensional as can be seen from the following assertions, some of which are elaborated elsewhere in the paper:

- Formal institutions are designed to maximize the wealth of those who control institutional change. However, rational individual efforts of the players to better their position may have undesired effects in the aggregate. In the extreme (and using the language of game theory), the players engage in a negative-sum game (the sum of their payoffs is negative), which for instance was probably the case toward the end of the Soviet system.

- Social institutions that fill spiritual needs often have side-effects on economic behavior. Attempts by the state to manipulate social institutions, such as norms, for its own ends have not been particularly successful. For instance, attempts to create socialist man in the U.S.S.R. and imbue him or her with altruism favoring the state were unsuccessful.

- Institutions can be seen as a stock of social capital. The stock changes through depreciation and new investments, but changes that occur in the span of a few years tend to be marginal. Although formal rules may change rapidly, enforcement and informal rules tend to change slowly. Many informal rules, such as norms and customs, are not explicitly designed by some authority but evolve spontaneously.

- As they adjust slowly to changes in the environment, institutions that formerly were functional often become dysfunctional and remain so for a long time. Societies are often unable to leave the path that was set much earlier in their past.

**Transaction Costs and Property Rights**

The concept of transaction costs is essential for explaining the link between institutions and productive efficiency. Transaction costs are best understood in the context of property rights, and, in our definition, property rights refer to the effective power of individuals to control scarce resources and enjoy their valuable attributes. Consider an individual who is registered as the owner of a building. A building has many valuable uses or margins, but an owner may not have control of all of them. The owner may, for instance, legitimately rent her building and collect the rent, but the building can only be used for commercial purposes and the rent is subject to an official ceiling. Also, the owner is free to alter the appearance of the building in minor ways, but major changes require official permission, as the building is on a list of historical landmarks.

In addition to putting certain uses or attributes off-limits, the state protects the owner's legitimate rights. The owner has residual control of the building: she has a right to those attributes that are not put off limits by the state or by social custom. In general, the building becomes more valuable to the owner the larger the set of residual rights and the stronger the public enforcement of residual rights. However, the degree of effective control of an asset is not solely determined by external authority; rights or control is also established internally by the owner's effort and resources. For instance, the owner may
employ a watchman to fend off intruders, invest in an alarm system, employ a credit bureau to check the financial worth of a prospective tenant, and monitor the tenant's treatment of the property.

Therefore, we distinguish between external and internal property rights. External property rights are the manifestation of the institutional structure that the individual faces, but her costs of enforcing internal property rights is what we call transaction costs. The transaction costs incurred by an individual to achieve a particular level of control of an asset depend on the institutional structure of society. For instance, one would expect the property rights of the owner of an informal firm in Lima to be internal to a larger degree than the rights of the owner of a registered firm in a comparable line of production in Germany, which suggests that transaction costs are relatively high in the Lima case. High transaction costs are often associated with weak institutions (weak public enforcement of rules), but high transaction costs can also be associated with strong institutions that leave the agent with few rights. In voluntary exchange, for instance when our owner rents her building, valuable rights are at risk because the other party may have a propensity to cheat under the cover of high monitoring and enforcement costs.

In sum, the institutional framework of society determines the cost of controlling assets, which influences both how resources are used and the willingness of individuals to acquire and invest in assets.

We have talked only about the relationship between institutions and transaction costs, but the costs of transacting are affected by several other factors, such as the technology of measurement and monitoring, the physical characteristics of assets, and the nature of the exchange. Other things being equal, transactions costs are relatively high when:

- assets with complex attributes are exchanged, as in the sale of a large commercial aircraft or an ocean freighter;
- the exchange involves time, as when the owners of a coal mine make a long-term agreement with a railway company to carry the coal to market;
- the exchange is between unrelated individuals and is not expected to be repeated, as when street vendors in Hong Kong sell watches to passing tourists;
- assets depreciate in a way that is hard to measure, and the transfer is not permanent, as when certain pieces of machinery are leased and it is costly to establish whether a breakdown of the equipment is due to an original mechanical fault, natural wear and tear, or abusive treatment;
- assets are specific and depend on particular uses, as in the case of a pipeline that an oil refinery leases to move its output or the plant that makes body parts for an unrelated car maker. Specific assets and dependence invite hold-ups, attempts to capture the return on the specific assets of the dependent party.

Contracts

Individuals have an incentive to seek ways to lower their transaction costs. Contracts are perhaps the most important empirical manifestation of investments undertaken by traders to protect their property rights in exchange. Contracts include, in addition to the usual provisions for price and quantity, various stipulations that are intended to protect the rights of the traders. These stipulations either make no sense or seem to be wasteful unless we allow for information problems and transaction costs. Consider a landowner who contracts with her tenants to provide them with fertilizer at a price...
below the market price. Such a contract clause may appear senseless or irrational until it is realized that the landlord fears that the tenants will otherwise use less fertilizers than is required to maximize the value of the land, and, further, that the subsidy is less costly than other methods such as direct monitoring of the tenants.12

Traders do not fully control the structure of their contracts, as the structure is partly determined by the institutional framework: the community restricts the set of legitimate contracts. Formerly in the Soviet economies, private entrepreneurs could contract with only a small number of employees, often only 10-15; they were compelled to restrict their activities to particular economic sectors, such as certain services, and various other contractual terms were mandatory. Likewise in these economies, contracting over residential housing tended to be illegal. Contracts between central planners and enterprises dominated the economy.

By severely restricting contractual choice for political reasons, the state is likely to exclude efficient arrangements from the choice set. On the other hand, the state can make vital contributions toward efficient contracts, for instance, with an efficient commercial code and a fair and effective court system, because of economies of scale in designing and enforcing (and disrupting) contracts.

The economics of transaction costs give important insights into the logic of contracting as the following observations suggest:

- High transaction costs can prevent contracting among individuals, for instance over the right to pass a railway line across a region over thousands of individual properties, or the right to fly airplanes across a continent over privately owned land. In these instances, resources may not find their most valuable use unless the state intervenes and directly allocates rights. However, when exclusive rights are clearly defined, the exchange of rights is legitimate, and transaction costs are low, resources tend to find their most valued use through decentralized contracting. In these cases the initial allocation of rights is important for the distribution of wealth but not for the efficient use of resources.

- All contracts are incomplete, as it is costly to contract over all potential states of the world and fully enforce agreements at all margins. Incomplete contracts are unavoidable in a world of costly information and consistent with economic rationality. According to contract theory, each step in contracting is evaluated in terms of marginal costs and benefits, and frequently valuable margins are left in the public domain. A movie theater that has one price for all seats and leaves the extra value of good seats in the public domain is a common, if trivial, example of incomplete contracts. When assets are left in the public domain, people make costly and wasteful efforts to capture these free values. To get a good seat, moviegoers may waste time by coming either early or at an inconvenient time of day or week.

- In an economic system, where the choice set for contractual arrangements is relatively unrestricted, competition among contractual arrangements gradually weeds out arrangements that involve high transaction costs. In systems where the set of legitimate contracts is narrowly prescribed by the state, there is less scope for competition among contracts. In the U.S.S.R. contractual arrangements between planners and enterprises remained relatively stationary for decades in spite of high transaction costs, vast resources entering the public domain, and wasteful behavior by enterprise managers.13
Organizations

Whether formal or informal, all organizations are groups of individuals who pool their assets in production. There are economic, political, and social organizations with boundaries and structures defined by networks of contracts, and with output ranging from commodities, to production. Whether formal or informal, all organizations concern the autonomy of political and social needs. They are groups of individuals who pool their assets in organizations and the rules they generate: whether these phenomena merely reflect economic forces or have a life of their own and independently influence economic development. The new theory of institutions makes it clear that information costs give at least partial independence to political and social institutions. For instance, information costs make direct democracy impractical and give rise to representative democracy; they isolate and enable representative political bodies to go against the interests of a large majority of their constituency (at least in the short run) and influence the way political organizations reach their conclusions.

In fact, the full implications of costly information for economic and social studies have not been worked out. With costly information, the choice set and preferences of the consumer in the long run, the causation between institutions and organizations runs both ways, as players in the various organizations strive to reach their goals not only within the existing set of institutions but also by investing in institutional change. North (1989) has emphasized how the stock of institutions casts a long shadow on the future by defining in the present which investments are gainful for organizations to undertake. In that way, institutions influence the long-run direction of all forms of investments in a community, including investment in knowledge and investment in institutional change.

One of the great questions in social science concerns the autonomy of political and social organizations and the rules they generate: whether these phenomena merely reflect economic forces or have a life of their own and independently influence economic development.
III. ECONOMIC CONSEQUENCES OF ALTERNATIVE INSTITUTIONAL ARRANGEMENTS

The Theory

Wealth and Ideal Institutions

Institutions influence outcomes in an economic system by specifying the basic structure of incentives for the players. In the short run, the line of causation passes from institutions, through organizations, to economic outcomes. Although the new theory of institutions cannot precisely spell out the details of optimal institutional arrangements for maximizing wealth, the theory offers important insights.

We begin with a definition of ideal institutions for maximizing wealth (given the initial distribution of resources): institutions are said to be ideal, when all individuals have an incentive to account for the full (or social) marginal costs and benefits of their actions. With ideal institutions owners of factories consider the full cost of pollution to the consumers of clean air before they decide to release waste into the atmosphere. Similarly, a farmer who drains the village meadows allows for all benefits accruing to neighboring farmers when deciding the scope of his efforts. In short, with ideal institutions, so called technical externalities, both positive and negative, disappear as they are allowed for or internalized by each decision maker.

Unfortunately, ideal institutions are only a theoretical benchmark. The perfect outcome just described requires not only free trade in property rights, but also perfect delineation and enforcement of property rights to all valuable resources, which only occur in a world of zero transaction costs. With positive transaction costs, marginal costs would exceed marginal benefits before complete property rights are achieved on all margins.6

Dissipation of Wealth and Institutions

Institutions dissipate wealth in various ways. First, weak institutions fail to provide economic agents with strong exogenous property rights. When exogenous property rights are weak, it is costly for individuals to protect and exchange rights, and, other things being equal, high transaction costs limit the incentive to invest, specialize, exchange, and expand the market.

Weak institutions are usually associated with a weak state. In some circumstances various decentralized groups (trading companies, guilds) have taken over the role of the state and succeeded in providing stable property rights, but a system based entirely on decentralized property rights is unlikely to provide a foundation for a modern industrial economy.17

Second, dissipation of wealth also occurs when a strong state explicitly decides not to permit exclusive rights in certain activities and thus introduces open access and the classic tragedy of the commons.18 For instance, U.S. federal and state governments have created and enforced institutions for maintaining open access in the country’s ocean fisheries. Attempts by individuals and their organizations to control entry or effort by other citizens are judged to be in violation of the country’s antitrust legislation.19

Third, the state can create open access indirectly through regulations that leave values in the public domain, even as an unintended side effect. Rent controls, involving a ceiling on rents, leave in the public domain the differential value between the maximum price that prospective renters are willing to pay and the price ceiling. Value left in the public domain creates incentives for capture, which is an unproductive and wasteful activity. Technically, the authorities can
prevent wasteful investments in capture by substituting new forms of rationing for price rationing, for instance by using a lottery to allocate inexpensive housing directly to specific individuals. Note that wasteful behavior is not avoided, if valuable rights are allocated on the basis of individual characteristics (location, education, rank in an organization) which people can often acquire by investing.

Finally, the state can create institutions that dissipate wealth by supplying individual actors with overly detailed exogenous rights, rather than presenting them with a general framework for guiding economic behavior. Although excessively detailed exogenous rights are associated with centrally managed systems, they are also found in relatively decentralized economies, for instance in Ethiopia after the revolution of 1975, and even to some extent in many western economies.

When the state specifies in detail the structure of property rights, such as contractual relations within economic organizations, the outcome is likely to be relatively inefficient for several reasons. First, those who control the state may prefer arrangements that give them a large slice from a small pie, rather than a smaller slice from a large pie. Second, the center may be preoccupied with survival and (even correctly) see efficient structures as threatening their position. Third, the rulers may hold irrational ideologies and entertain incorrect models of economic relationships, but, unlike decentralized agents, decision makers at the center receive weak feedback from erroneous decisions: information is often garbled after filtering through several levels of authority, and wrong decisions usually do not strongly affect the welfare of the central decision makers. Therefore, the cost of indulging in ideological fantasies or political games is relatively low.

**Second-Best Institutions**

By second-best institutions we refer to arrangements that fail to generate complete (ideal) property rights, but maximize the value of output subject to information (and other) constraints. The term second-best is not a fully satisfactory term because first-best institutions are solely a theoretical ideal. The common practice of referring to institutions as inefficient, if they fail to provide results that only exist in a theoretical world of full information, is a source of serious confusion as Demsetz has convincingly argued. Information costs are real costs that cannot be avoided, and the introduction of information problems has caused an unresolved dilemma for welfare economics.

The impossibility of wholesale institutional change is an important obstacle in the path of economic reforms. Historical evidence suggests that institutional change can only be marginal, because various institutions, especially norms and customs, resist rapid change. Therefore, the reformer is constrained by the past in making recommendations for institutional change, which suggests, for instance, that in the transition to markets the second-best path in China need not be the same as the second-best path in the former socialist economies of Europe.

To reach the goal of wealth maximization, given all the constraints, the influence of the state on the formation of property rights must be direct in some instances and indirect in other cases. In situations where transaction costs are low, trade flows smoothly, the state's second best policy is to provide the players with a general framework for supporting property rights. If A has a garage that is coveted by his neighbor, B, who uninvited parks his car in A's garage, the state should (take advantage of scale economics in enforcement and) provide A with a general mechanism for protecting his rights, because the exchange of rights to a garage generally does not involve high transaction costs. If B values the garage more than A, he can contract with A to rent or buy it.

In other instances, high transaction costs may block or limit trade, even when the state provides a general framework of property rights. We have
already mentioned the high cost for individuals to negotiate the right of passage for trains and aircraft. With high transaction costs, resources may not find their most valuable use, and the state can contribute to the creation of wealth by assigning rights directly to a specific category of users.21

**Direct Assignment of Property Rights**

In general, political organizations are not well placed to assign property rights directly to individual users, which suggests that the practice should be used sparingly.22 A major reason for leaving the assignment of property rights to economic organizations, whenever possible, is that the information requirements may overtax the capacity of political organizations. For instance, in order to maximize the value of a resource, property rights may have to be subtly partitioned, and an efficient partitioning of rights is information intensive. Alchian (1965) uses the example of land to illustrate the multidimensional nature of efficient property rights:

"By this [partitioning] I refer to the fact that at the same time several people may each possess some portion of the rights to use the land. A may possess the right to grow wheat on it. B may possess the right to walk across it. C may possess the right to dump ashes and smoke on it. D may possess the right to fly an airplane over it. E may have the right to subject it to vibrations consequent to the use of some neighboring equipment. And each of these rights may be transferable. In sum, private property rights to various partitioned uses of land are "owned" by different persons."23

The problem of finding an efficient solution to conflicting uses of airspace is another example of the multiple dimensions involved. Consider a case where the interests of owners of residential units and owners of an airport conflict. The noise from low-flying airplanes imposes costs on people living nearby, and restrictions of flights will impose costs on the airport. The joint maximization of the value of the airport and the resources in the neighborhood may require a sophisticated balance on several margins. The adjustments could include a ban on evening and night flights, but permitting particularly valuable night flights (for instance, allowing planes to land and take off at night in emergencies), the installation of noise-abatement equipment on airplanes, limits on the type of aircraft allowed, the installation of double windows and other forms of soundproofing in the residential units, the transformation of the residential units into office space, the use of the land around the airport for agriculture rather than housing, and so on. In our particular case, the owners of the surrounding land and buildings and the owners of the airport may not be able to negotiate an efficient solution because of high transaction costs. In that event it is up to political organizations to assign efficient property rights, but they are seriously constrained by a lack of information.

Political organizations usually do not partition rights in a subtle manner when they assign property rights directly to specific categories of users, and they are often slow to adjust the rules to major changes in the economic environment.24 Judge-made law or Common Law, which evolves over time with the judges arbitrating between conflicting uses of resources, appears to be more flexible, presumably partly because the judges are supplied with abundance of relevant information at low cost, and important changes in the environment are constantly brought to their attention. The rules emerging in the common law process tend to be subtle and sophisticated; some scholars in the field of law and economics have argued that Anglo-Saxon Common Law tends to be efficient in the sense of neoclassical economics, but that assertion has been contested.25
In a world of incomplete information, the state can choose between establishing a general framework that lowers the cost to individuals of exchanging rights or attempting to assign specific rights directly to various categories of users, and then discouraging attempts to exchange these rights. Both approaches are plagued by information and transaction problems, and a choice must be based on the nature of individual cases.

Implications for Policy

Ideal Institutions and Policy

The notions of ideal institutions, perfect property rights, and first-best economic outcomes have profoundly influenced both critics and supporters of decentralized market economies and centrally managed economic systems. Only recently has it been recognized that much of the discussion has been based implicitly or explicitly on models of reality that assume free information or underestimate the information constraint. For instance, it has been common to argue that the centrally-managed economies would eventually be able to use computers to mimic the economic outcomes associated with perfect competition. In welfare economics, it has been customary to use outcomes from models that assume zero transaction costs to judge the efficiency of outcomes from models that (often implicitly) allow for information and transaction costs, for instance in studies of so-called market imperfections or failures. However, comparative institutional analysis is concerned with contrasting outcomes associated with alternative practical institutional arrangements.

The Legacy of the Soviet System

The transition to markets in Eastern Europe and in the former Soviet Union is constrained by the initial stock of institutions: institutional change tends to be incremental. In order to gain some understanding of how the past shapes the future, we now briefly analyze the structure of the former Soviet system in terms of the economics of institutions.

The Soviet system was distinguished by an attempt by political organizations to directly control not only the general institutional framework, but also the structure of economic organizations and the composition and nature of the output of the economy. In its most austere form, the Soviet system treated general living standards as a constraint rather than a goal — the workers' productive consumption was an investment required to maintain the quality of the labor input — but instead the system was geared to meet various objectives of the rulers.

Attempts to control an entire economy from the center invite gigantic problems of organization, monitoring, and enforcement. The response by Soviet rulers to these information problems created structures that today haunt the transition to market.

Essentially, there were two types of responses. One involved the selection of production technology, economic organization, and outputs that minimized the monitoring and enforcement problem. As it was more effective for the center to control one large production unit than several small ones, the size of enterprises tended to be large. In some instances, one enterprise was the sole supplier of a basic commodity. Similarly, the variety of commodities and qualitative margins were kept to a minimum.

The other response to the information problem was a major innovation in organization, namely the introduction of the communist party as a monitoring organization. The classic Soviet system has a unique feature: branching from the center are two organizational trees populated by party apparatchiks and agents of the multilevel management bureaucracy. In this scheme, party agents monitor agents of the management bureaucracy and report back to the center. The party functionaries also have the important role of
selecting managers at all levels. As the system's overriding concern is with monitoring and enforcement, the primary criterion for selection is loyalty to the principals and the party rather than entrepreneurial skills.\textsuperscript{28}

Therefore, the human capital of mid-level agents of the two bureaucracies is system specific, which implies that the agents suffer a major capital loss when the Soviet system is abandoned. The state relies also on two other agencies, the police and the military, but these functionaries have general skills that would fit relatively comfortably in a market-oriented dictatorship or even a democracy.

**The Institutional Economics of Decline**

The system, which originated in the Soviet Union in the late 1920s and the early 1930s, initially functioned rather well both for improving the quality of the labor input and meeting various goals of the state. However, the early success was partly due to the limited information intensity of the production technology and the input-output relationships of the first stages of industrialization, which made these processes relatively well suited for central management: there were substantial economies of scale at the enterprise level, which coincided with the planners' preferences for large units; the vertical phases of processing commodities were few; the final output was not complex with many quality dimensions; and the technology did not require extensive horizontal linkages between enterprises with each unit acting both as a supplier and purchaser of inputs.\textsuperscript{29} Another reason for the early success was that agency problems had not yet accumulated.\textsuperscript{30}

The decline of the Soviet economies was due to mounting transaction costs and agency problems. An important cause of the decline is associated with new technology and new input-output relationships. The production process in the new growth industries, such as electrical and other engineering, instrument making, and fine chemicals, was more costly to monitor than steel, cement, and bulk chemicals, and the new industries involved complicated intra- and inter-industry linkages. Effects of decades of building an inferior infrastructure and a capital stock were increasingly felt, and so were agency problems between planners and managers, and managers and workers. Also, adverse selection eventually spread to the pinnacle of the regime.\textsuperscript{31} The original leaders of the Soviet Union (and the other Soviet states of the region) relied heavily on a loyalty criterion in selecting mid-level leadership for the party, the economic bureaucracy, and the state. It has been argued that these individuals were less qualified as innovative leaders than their predecessors, but with the passage of time they rose to the top of the Soviet system.

**Why the Earlier Reforms Failed**

The structural flaws of the Soviet system were evident to the rulers early in the post-World War II period, and in the Soviet Union attempts to reform the economy began early in the 1950s. Although the reforms differed in nature, they had a common core: the replacement of commands with parameters of the market, which threatened to devalue the system-specific human capital of the mid-level functionaries of the system. Winiecki (1990) has documented how for thirty years the functionaries successfully used subtle means to sabotage a series of reforms that originated with the top leadership.\textsuperscript{32}

**The Transition to Markets and the Soviet Legacy**

The past constrains the transition to markets in the region in several ways. First, it is not clear for all the countries in the region whether mid-level agents of the old system still have the inclination and the power to derail the reforms. For instance, Shatalov (1991) reports how the ministerial apparatus in Moscow thwarted attempts to abolish Agroprom, the huge and
inefficient State Committee for Agriculture, by setting up Agrokhim that exerted the same level of control over fertilizer, pesticides, and other enterprises as had its predecessor. Second, even if resistance from system-specific agents is overcome, the systems are path-dependent, and possibly it may take decades to transform the economies in the region. Consider four intermediate goals that are frequently put forward:

- Macroeconomic stability;
- Provision of suitable property rights;
- Privatization of capital assets; and
- Effective social safety net.

These goals are difficult to reach rapidly and simultaneously. Macroeconomic stability requires both new rules and new political organizations, and effective operations by inexperienced operators in an exceptionally fluid situation with random supply shocks. Further, macroeconomic stability implies reasonably full employment, which is an unrealistic goal during a period of a drastic structural change.

The provision of exogenous property rights for market organizations is not easy to accomplish in the short-run, as we will discuss in some detail in the following section. Little is know about the dynamics of institutional change, such as the optimal path from one regime to another or the necessary time element, but our limited knowledge does indicate that rapid changes (measured in years rather than decades) are not feasible. Rapid transfer of the means of production to private owners is difficult, not only because the former socialist countries lack mature financial systems, but also because of the obsolete structure of industry and organization. The existing structure of economic organizations was rational in the Soviet context, as it was designed to minimize transaction costs associated with central management, but, generally, the structure is unsuitable for minimizing costs in a modern market economy. The structure of industry, the product mix, and quality only vaguely reflects consumer demand and the relative advantage of the former Soviet economies, but mirrors instead the preferences and constraints of the previous rulers. One such preference was the emphasis on self-sufficiency rather than specialization, which was intended to protect the regimes from outside pressures. Therefore, in many instances the transfer of ownership of existing state enterprises to private individuals may be a poor strategy. New owners of industrial dinosaurs of the past are likely to use their political influence to preserve their newly acquired but outmoded assets. However, a clean break with the past requires an unprecedented renewal of the capital stock and the building of new industries. In the meantime, the region must find employment for a large industrial labor force.

Most programs of reform include the rapid introduction of an extensive system of social services or a social safety net. There is also a dilemma here. In the past, the countries of the region provided more extensive social services than did the Western market economies when they were at a comparable level of development, but a lower level of general consumption goods (which is consistent with a policy aimed at protecting the quality of the labor input). In the transition the public is likely to demand from the state social services at least comparable to those it is used to, and a much more generous supply of general consumption goods. However, the immediate exposure of the former socialist economies to international competition, the collapse of intra-regional trade, and obsolete industrial structure is unlikely to give rise to rapid economic growth in the near future. Initially, national output levels have fallen sharply, although official figures may exaggerate the plunge. It is also clear that it will take considerable time to install effective systems of money and banking, and public finance.

All of these factors suggest that rapid transition to a fully functioning market systems is impractical and that the transition is likely to be painful.
IV. EXPLAINING ECONOMIC ORGANIZATION

The Theory

The Dependence of Organizations on Institutions

The structure of organizations is determined jointly by institutions (external property rights) and by internal contractual arrangements and private enforcement. Therefore, the logic of organization must be explained in terms of the relevant institutional framework. We have already seen how the institutional framework of the Soviet system was designed to specify the structure of economic organization in great detail. However, the center was only partly able to enforce its property rights over economic resources, which gave various agents of the state an opportunity to capture valuable rights and establish informal or underground networks of contractual relations. It fact, the notion of a centrally planned economy was a persistent myth, and the system depended on a complex network of informal exchanges that are not well understood.34

The informal firm, for instance in Lima, Peru, is another instance of the dependence of organizations on institutions.35 In many countries, especially in the Third World, entrepreneurs must make costly investments in a tortuous bureaucratic process, which may take months or years, and sometimes pay bribes, in order to acquire the rights to establish a legitimate firm. In the informal economy the enforcement of exclusive property rights is largely internal, and the transaction costs of the informal firm are high. As property rights are not subsidized by the state, they tend to be relatively incomplete, and, when entrepreneurs have insecure control of their assets, it is reflected in the choice of assets, technologies, and organization.

However, it is conceivable that the enforcement of property rights by individual entrepreneurs and informal groups of entrepreneurs may be more effective than property rights supplied by a corrupt and inefficient state. The question is essentially empirical, and of considerable practical interest both for developing countries and the former Soviet economies.

The Modern Theory of Organization

The transaction-cost theory of organizations mainly originated in North America, and the theory is set against the backdrop of the modern industrial state.36 Only a small number of studies have applied the approach to economic organization in history, in the socialist countries, or in the developing countries but fortunately many of the theoretical insights have general application.

The modern practice of explaining the logic of organization in terms of transaction costs originates with Coase (1937).37 Coase was stimulated by the notion, popular in the period following the Bolshevik revolution in Russia, that a national economy could be run as a single firm. He also contemplated why the firm, which essentially is a coalition of resource owners, survives in the market place and does not come apart when tested by the forces of competition. Coase's (1937) answer was that the firm emerges and survives because it is costly to use the price mechanism, and the size of the firm is curtailed because it is costly to use the firm's internal allocation mechanism. Competition selects the combination of firms and markets that minimizes costs. In equilibrium, the cost of allocating resources in the firm and across markets is balanced at the margin.
Incentive Contracts

Recent studies have explored the logic of diverse mechanisms, found in the market economy, for facilitating transactions both inside firms and across markets. Particular attention has been given to the use of contracts for aligning incentives. The incentive problem arises because people’s interests do not coincide, and persons who cheat are protected because it is costly to establish their intentions and actions. For instance, while employees are fully aware of their behavior, their employer usually is not. The situation is one of information asymmetry, and the opportunity to cheat often is reinforced by the high cost of extensive monitoring.

If high costs make careful monitoring impractical, parties to a contract are likely to take advantage of asymmetric information and incomplete contracts to capture value — for instance, a person who has hired his services to a firm may use his time and the assets of the firm for private purposes. Such attempts to capture value are wasteful activities and produce inefficient results, because the gains of the cheating party are less than the overall loss of value he causes.

We now turn to two kinds of incentive problems that have a central role in the theory of institutions: adverse selection that arises prior to contracting and moral hazard that occurs in the course of contractual relationships.

Adverse Selection

Adverse selection occurs when a party to a contract is unable to measure accurately certain valued human qualities or attributes of non-human resources that he or she seeks to acquire. The situation is likely to attract disproportionate offers of assets and service of low quality or of undesirable attributes, which cannot be measured by the buyer. The anticipation of adverse selection may reduce the volume of trade or eliminate it altogether and restrict potential gains from specialization. In big cities, used cars of high quality are rarely sold on informal markets that operate through advertisements in newspapers, and, in the insurance industry of the United States, adverse selection has eliminated the market for individual health insurance coverage for the cost of pregnancy and delivery.

Adverse selection can sometimes be reduced by signaling. With signaling, those who offer attributes of high quality that cannot be directly measured are evaluated on their signals, which are proxies for quality. The proxies can be measured at relatively low cost, and ideally should be uniquely related to the valued attributes. For instance, it is difficult for patients to measure directly the quality of physicians, but a degree from a good medical school is a fairly reliable signal that an individual is qualified.

Moreover, contracts and regulations can be used to compensate people for receiving lower quality than they anticipated, and government standards and inspection are used to guarantee (minimum) quality, for instance in the drug industry. Competition can constrain cheating, when firms have invested in reputation, which will be lost if the firms deliver inferior quality.

Moral Hazard

The problem of moral hazard is also due to high costs of measurement but the term refers to opportunistic behavior during the contract period: a person who has taken insurance against fire may become less cautious than before. Moral hazard is found in virtually all types of contractual relations, the contract between Soviet planners and enterprise managers being a classic example. The propensity of individuals to cheat when unobserved can be decreased by changing their incentives. When output is measured more easily than inputs, incentives can sometimes be aligned by basing rewards on results rather than inputs — for instance, by linking the pay of top managers to the price of shares in their company or giving workers a piece-rate contract.
In addition to contracts that align incentives, various other measures have evolved to reduce moral hazard in economic organizations. The type of expertise that is employed on boards of directors is varied systematically depending on monitoring problems in each field, and sophisticated accounting and monitoring systems deal with opportunistic behavior. In addition, various forms of competition constrain agents and provide monitors with inexpensive information. Competition among managers, even within an organization, may reveal information about the quality of their service, and competition in the market for financial assets such as bonds and shares provides inexpensive information to outsiders about the performance of economic organizations. Alchian (1950) has argued that competition will select contracts and structures that maximize the joint value of cooperating assets — or, more accurately, select arrangements that yield more value than any other known arrangement.

Residual Claims

We noted above that sometimes it is easier to measure output than inputs, but there are also situations where it is impractical to use output to judge the quality of an input. In particular it is difficult to measure the quality of entrepreneurial activities, such as selecting a team, a product, and dealing with outsiders because the outcome depends both on performance and exogenous random effects that often cannot be measured separately. In the case of a farmer, it may be impossible to measure whether a bad crop was due to an unavoidable plant disease, effects of a drought, or poor performance by the farmer.

When measurement is impractical, the potential for moral hazard can often be reduced by making individuals the residual claimants of an economic organization. As residual claimants receive what is left when others have received their fixed payments or shares, their rewards depend on the joint value of the assets of the organization. Studies have revealed how the structure of residual ownership in a market economy differs systematically with the measurement problems in each line of activity. Forms of organization, such as partnerships, the corporate form, and non-profit organization, are appropriate in specific circumstances.

Risk Sharing

In contract theory it is frequently assumed that contracts are used not only to solve transaction problems but also to allocate risk in order to reduce the cost of risk bearing. It is customary to assume that wealthy individuals and legal entities such as firms are risk neutral, but workers and ordinary households are said to be risk averse and ready to pay for avoiding risk. A risk averse individual may prefer a fixed monthly salary to a somewhat higher but variable income that depends on the fortunes of the firm. However, a fixed-income contract may give the individual an incentive to shirk and be costly for the firm. The equilibrium contract minimizes costs by balancing the gains of less shirking against a higher wage bill.

Efficient Suppression of Information

The measurement of quality is a costly activity. Ideally, attributes of commodities should be measured only once and by the party that is in a position to measure them most cheaply, but the ideal solution is impractical if the parties do not trust the measurements. Trust is established when the other side expects that the party that measures would lose more than it gains from reporting false measurements, for instance because valuable reputation is at stake or deception is severely punished by the state. When the parties can trust measurements by others, it can be efficient to suppress information and discourage further measurement. Barzel (1982) cites several market practices that involve the suppression of information, such as sealing commodities before the transaction takes place.
Credible Commitments

The capacity of individuals to make credible commitments is essential for building a decentralized, capital-intensive economy. All advanced economies rely extensively on specific investments, which are made for a particular use and have less value in alternative uses. An economic organization that possesses specific assets, which depend on continued exchange with an outside party, is vulnerable to attempts by that party to appropriate the difference in value of the assets between their first-best and second-best use (which may be their scrap value). Think of a firm that makes an intermediate product that is used as an input by another firm. The threat of a hold-up reduces the expected return on specific capital and obstructs economic development.

In the literature, credible commitments have been examined extensively by Oliver Williamson and others. It is now recognized that vertical mergers can in some instances be justified as an efficient solution to the hold-up problem. Long-term contracts is another solution to the problem, especially if the state provides reliable third-party enforcement through the courts. In an uncertain world it is impossible to specify all future contingencies in detail, and the chief role of long-term contracts is often to provide processes and procedures for dealing with future developments. The phenomenon is referred to as relational contracting.50

Implications for Policy

We have reviewed briefly diverse theoretical contributions concerned with the logic of contracts and organizations in an exchange economy. Although the array of insights may look bewildering, there is a common theme: all the arrangements are designed to cope with opportunism and costly information. The economics of organization explores ways to lower the cost of contracting and offers useful lessons for what the transformation of former socialist economies would involve, rather than a blueprint for a new system. Below we consider six such lessons.

Static versus Dynamic Theory

The modern theory of organization is mostly static: the usual approach is to compare equilibrium organizations before and after a marginal change in technologies or the institutional framework. Although a few studies have a historical perspective and consider a fundamental change in institutions and organizations, they are concerned with the slow evolution from an initial point that is very different from the starting point of the former socialist economies. The transformation of the economies in Eastern Europe and Central Asia is a unique event, and economists can offer only indirect lessons and have much to learn from future developments.

Country-Specific Economic Organizations

In the advanced industrial countries, trial and error and competition have produced an intricate web of relatively efficient economic organizations. The former socialist countries can benefit from the accumulated knowledge in the outside world: the transaction technology for designing (incentive) contracts, monitoring agents, and coordinating activities might be imported to the region just as production technology is imported. However, there is an important difference. Unlike production technologies, transaction technologies are often strongly complementary to a country's "culture" and stock of institutions.51 For instance, there is a distinct difference in the way the United States, Japan, and Germany limit agency problems in their large-scale corporations. As organizations are partly country specific (in a way that is little understood), it is not possible to import techniques of organization as easily as production technology.
Endogenous Organizations

Economic organization in the socialist countries was designed to solve transaction problems in a system of central management. Specific features of the Soviet system include not only large production units but various subtle business practices that have not been extensively reported and analyzed. The new system that is being built is partly constrained by previous practices. Path dependence is one more reason why outside experts are not able to design in detail successful new forms of organization for the region. To believe otherwise reflects a failure to recognize the nature of the information problem, which is a lack of comprehension comparable to the old notion that the outcomes of the model of perfect competition could be simulated by government bureaucrats.

Entry and Exit

In an uncertain changing world, the evolution of satisfactory economic organization depends on an unceasing search, and trial and error. The most important contribution of the states in the region to encourage the search process is to rigorously ensure free entry and exit in all industries. In the long run, large firms are seldom able to contain the forces of competition without relying on the coercive power of the state. The greatest barriers to entry are not private monopolies operating alone, but government laws, regulations and other measures. Similarly, it is the state that usually obstructs exit by providing subsidies to firms that are unable to make profits. The state can make its greatest contribution toward efficient industrial organization by guaranteeing free entry, refraining from subsidizing failing firms and industries, and providing efficient bankruptcy laws and procedures.

Openness

It is generally recognized that the most effective way of rapidly introducing modern production technology in the region is by opening it to international trade and direct foreign investment. The economics of institutions adds another reason for openness: it is also the most effective way of introducing new methods of organization. The introduction of a new organization at the grassroots, jointly by foreign and domestic entrepreneurs, is a sound way to adjust new forms to the existing institutional framework, and also to initiate a creative interaction between economic and political organizations for making required marginal changes in the institutional framework.

Subsidies for Innovations in Organization

New forms of organization are essentially a public good. Once discovered, new arrangements can be used by any interested party at no additional social cost. As forms of organization cannot easily be sold, private individuals are likely to undersupply organizational innovations, and governments in the region and international agencies should subsidize education and experiments with alternative forms of organization.
Figure 1 shows the maximum production capacity of an imaginary economy with two commodities. The production frontier is the traditional concept from the economics text that assumes transactions without any frictions. The transaction frontier is a concept from the economics of organization literature where it is assumed that the state has provided an ideal institutional framework, and economic organizations have used incentive contracts and other means to minimize costs, subject to the constraints of transaction costs. Finally, on the social frontier, where an actual economy would be found, information problems, widely defined, cultural factors and the struggle over the distribution of wealth lead political organization to provide an institutional framework that is less than optimal in terms of the maximization of output.
V. THE POSITIVE THEORY OF INSTITUTIONS AND INSTITUTIONAL CHANGE

The Theory

Frontiers of the Economic System

The current section deals with theories that explain the behavior and the structure of political organizations, and various elements of the institutional framework. The relationship between the current and the previous sections is explained in Figure 1, using a well-known concept, the production frontier of an economy. The figure portrays the capacity of an imaginary economy that produces two commodities. The production frontier shows the maximum capacity of the economy on the assumption that production takes place without any friction in a world of full information.

The transaction frontier corresponds to the common assumption in the literature on economics of organization that political organizations provide an ideal institutional framework for maximizing output. Economic organizations, for their part, use incentive contracts, monitoring, and other methods for ameliorating various information problems.

Finally, there is the social frontier that is located below the two other curves. The paper's current section is concerned with the determinants of the social frontier. In the real world all economic systems are on the social frontier below the transaction frontier, because political and social organizations, like economic organizations, are constrained by transaction costs. Cultural factors and the struggle over the distribution of wealth prompt political organizations to provide a set of rules that are sub-optimal in terms of the wealth criterion. The former Soviet system is a prominent case of such sub-optimality, but so is every known economic system.

Non-Democratic Institutions

The modern analyses of political organizations and institutions in terms of information problems have a common theme: the puzzle is how actions of rational individuals seeking their self-interest can give rise to outcomes that are collectively irrational. We report briefly on five lines of investigation and begin with studies of the non-democratic state.

The pre-democratic state can be analyzed in terms of the modern theory of the firm. The ruler of the regime is a monopolist who maximizes her net revenue but is constrained by transaction costs and potential competition. The ruler contracts with the subjects to provide protection (property rights) in return for taxes. Although the power lies with the ruler, the price she can charge for property rights is constrained by the expectation that very high taxes may invite entry by competitors for power. Therefore, it is rational for the ruler to practice price discrimination and tax members of powerful groups (the nobility or the army) less than politically weak and scattered subjects (farmers).

A network of agents is employed to provide government services and collect taxes, but the ruler is plagued by agency problems, which she tries to mediate with incentive contracts, monitoring, and other means. The ruler is also limited in her ability to measure the tax base and control evasive actions by the subjects.

The model helps explain various practices in non-democratic (and semi-democratic) states that appear to be irrational, such as forms of taxation (tax farming, the sale of monopoly rights, predatory public finance) that eventually shrink the tax base. The model can also be used to
explain the overall logic of the former Soviet system and its inherent resistance to reforms. 54

Rent-Seeking in Democratic Societies

Another conflict between individual rationality and collective rationality is found in democratic societies where small groups have been able to obtain rules, such as import restrictions, that benefit small special interest groups but hurt the majority of voters. Usually the gains of the minority are smaller than the aggregate loss of the majority.

The main lines of the explanation of this phenomenon are widely known and point to asymmetries in information and in costs and benefits between small interest groups and the general public. 55 Further, the special interest groups (for example, local manufacturers of some product) may already be organized, whereas the general public (consumers) usually are not organized and are hit relatively hard by the problems of collective action, such as free riding and rational ignorance. The final part of the story are politicians who maximize their wealth (or votes) and whose support can be bought directly or indirectly. 56

Voting and Structure-Induced Equilibrium

Theories of outcomes in voting contain some of the most pessimistic findings on the conflict between individual and collective rationality. In the wake of a classic study by Arrow (1951) and his impossibility theorem, a large number of studies in the field of Public Choice demonstrated logically that the outcomes of majority-rule voting depend not on the preferences of voters but on the sequence of votes: how and in what order the alternatives are compared. 57 These studies show that almost any outcome is possible. In other words, there are no equilibrium outcomes of the electoral system if the agents are free to manipulate the sequence of votes.

These discouraging findings of formal political theory are at odds with empirical studies which do not reveal evidence of the massive disequilibrium that the theory associates with majority rule. Recently, attempts have been made to solve the voting paradox by introducing institutions that constrain the voters and yield stable outcomes. Structure-induced equilibrium is a term that has been used in this context.

In reality, the operation of political organizations is guided by a maze of rules, such as the rules that form the committee system of the U.S. congress, which create equilibrium and reflect power relationships. Very much like economic organizations, the whole range of democratic organizations is shaped by various contractual arrangements and monitoring systems that help lower the cost of transacting. The study of the structure of political organizations has reached beyond legislatures to examine contractual arrangements, along with monitoring and enforcement mechanisms in a whole range of democratic political organizations. 58 However, so far most of this work looks only at the U.S. system of government.

Studies applying the theory of institutions to political organizations have revealed the general applicability of the transaction costs approach. Agents both in economic and political organizations create structures intended to overcome information and transaction problems and make credible commitments possible. In both instances, institutional rigidity and path dependence may give rise to decisions and outcomes that appear irrational for the collectivity. In the political sphere, it is common in many countries that the shape of electoral districts adjusts slowly to population changes, and that procedures in legislatures, such as the rules of the committee system, outlive their general usefulness. Slow adjustments in the institutional structure can give much power to small groups and produce results that do not reflect the will of
the majority, as Alston and Ferrie (1993) have shown in a study of the former control by Southern legislators of the committee system in the U.S. Congress.\footnote{59}

**Informal Institutions**

The widely observed phenomenon that the transfer of the legal system of one country to another may bring different results in the new country is attributed to differences in acceptance and enforcement. The acceptance and enforcement of formal rules is closely related to informal institutions, such as norms, customs, and conventions.

The existence of cooperation that is not reinforced by coercion has puzzled rational choice theorists, somewhat like the existence of political equilibrium in spite of the impossibility theorem.\footnote{60} For instance, various studies of stateless societies reveal that these communities are able to rely entirely on informal rules, such as norms and customs, and private enforcement to prevent anarchy, achieve cooperation, and make small-scale investments.

In theories employing rational choice, and assuming that the players are non-altruistic, cooperation emerges only if the individuals in question decide it is in their private interest to cooperate. However, when the problem of cooperation is formulated, for instance as a prisoners' dilemma, it appears that non-cooperation is the best alternative (dominant strategy) for the rational individual.

The dilemma of how rational selfish individuals manage to overcome inefficient social situations has been intensely studied recently, but no general and recognized solution has emerged. One approach is simply to bypass the problem and assume that (some groups of) individuals are endowed with altruistic norms. The existence of altruistic norms is then explained in terms of evolutionary theory: group competition selects groups with altruistic individuals.\footnote{61} Other solutions have involved: (i) modeling exchange not as a single-shot but as a repeated game or as games that produce cooperation more easily than the prisoners' dilemma; (ii) assuming that individuals switch between an opportunistic and non-opportunistic mode; and (iii) having groups that are formed around the joint production of private goods and which enforce the provision of public goods.\footnote{62}

In this line of investigation each study introduces some device for overcoming the fundamental dilemma, but we have no obvious criteria for ranking alternative solutions. So far the work has yielded few testable hypotheses, and many of the models are based on restrictive assumptions that make the findings relevant only to a narrow range of social situations.

**Mental Models**

The introduction of information problems to economic theory is not complete. We still do not understand how individuals, who lack both information and have limited capacity to retain and process data, model their environment and create various social conventions (institutions) that economize on the information cost of making sense of the world around them.\footnote{63} A positive theory of social value is one of the great unresolved tasks in the theory of institutions and is critical for a better understanding of institutional change, such as the transition to markets of the former socialist economies.

**Application to Policy**

In sections III and IV, wealth (or economic growth) and the structure of economic organizations were the dependent variables, and institutions and transaction costs the main explanatory variables. In the current section we examine theories that explain various aspects of institutions. The theory of institutions seeks not to explain simultaneously the entire framework of
institutions but consider isolated aspects of institutions and marginal institutional change. Below we discuss three topics that are of great importance for the transition to markets: commercial morality, the structure of political organizations, and the dynamics of economic policy.

**Commercial Morality**

There is no doubt that appropriate norms are of great importance for supporting exchange between unrelated individuals. According to Arrow (1990):

"there has to be some kind of commercial morality for the contracts to be executed. ...[A] theory that depends merely on reputation is not enough because there will always be circumstances where it pays to violate the rule. The workings of the whole system depend on the fact that contracts indeed will be executed."**

We have already emphasized the lack of a general theory of informal institutions. However, most scholars agree that informal rules are path dependent and evolve slowly over time, which suggests, in view of the urgency of transition in the former socialist economies, that changes in informal institutions cannot be an important intermediate policy goal for the reformers. However, as a long-run project it is reasonable for the state to promote "commercial values," although such values seem to emerge in part spontaneously rather than in response to government propaganda.

There is another side to the rigidity of informal institutions. The argument above suggests that informal institutions that existed prior to the establishment of the socialist regimes in Eastern Europe and Central Asia may be an important determinant of success in the transition. Such a hypothesis can be used to predict the relative success of the various countries in the attempted transition to markets.

A final note of warning concerns not overplaying the role of value systems. The possibility of substitution creates difficulties for the empirical detection of changes in social values. In short, it may be impossible to distinguish a shift in constraints (relative prices, police protection) from changes in individual value systems. The problem arises because people substitute one valued object for another when their constraints change, which may wrongly suggest that they have adopted new norms and a new system of values. For instance, as the relative price of time increases (with economic growth) there may be a decline in home cooking, and more eating out in restaurants. It is easy to conclude that tastes have changed: now people value home cooking less and have developed a taste for ethnic restaurants. However, nothing more profound may have happened than the substitution of one valued object for another because relative evaluation has changed within an unchanged value system.

Critics may argue that the way that the public rapidly turned against many of the former socialist regimes and deprived them of legitimacy suggests that social values do indeed change rapidly. However, Kuran (1991) has argued that the rapid withdrawal of support from the regimes and their ideologies did not reflect a change in values but the phenomenon of preference falsification. His argument is that people do not express their preferences when the expected cost of doing so is high enough relative to the expected benefits. When the cost of expression falls for some reason, individuals express their true preferences.**

**The Structure of Political Organizations**

To complete a successful transition to markets, the former socialist countries must restructure their government organizations at all levels. The task is monumental. The old organizations are dysfunctional because they were designed to cope with central management, as can been seen clearly by examining the vital systems
of public finance or money and banking, which were entirely system specific. As the capacity to successfully generate a simultaneous change in a whole range of political institutions and organizations is limited, it is vital to economize and find a feasible time-path for step-wise reforms that do not totally unhinge the macroeconomic balance in the region. The appropriate measures must be both country specific and based on a theory (which barely exists) of macroeconomic relationships in economic systems that are at various stages of evolution between central management and a fully-developed market system. Recommendations in this area are beyond the scope of the present paper.

Fortunately, the former socialist countries need not invent new government structures from scratch. They can learn from the experience of other countries and in some instances draw on their own experience prior to the Soviet system. Various international agencies are particularly well placed to provide assistance with the organization of public finance and other government activities.

However, institutional theory again warns against uncritical importation of forms of organization, whether they are economic or political organizations. In each country, new organizations must be adjusted both to the stock of productive resources and the stock of institutions. The danger is present that institutions appropriate for one level of economic development be applied indiscriminately at another level. Consider the adaption of a foreign system of taxation. The measurement of the tax base and the collection of taxes involves measurement, monitoring, and enforcement problems that may be more complex than any activity undertaken by a government. However, the measurement and enforcement problems vary from country to country, both with the general level of technical and economic development, and with the prevailing commercial morality. These factors must be considered in designing an effective system of public finance, but frequently they are forgotten.

The Dynamics of Economic Policy

Institutional change in the region will be brought about primarily by changes in formal institutions (laws and regulations) and their enforcement, which is the domain of players in political organizations. Recommendations for institutional change and the transition to markets involve two separate considerations. One is the normative or factual question concerning the formal institutions that are most likely to maximize the height of the transaction frontier (in Figure 1) — or, in plain language, maximize wealth (subject to reasonable constraints on distribution) — if political considerations are ignored. The other question relates to institutions and institutional change which are politically sustainable, or the search for a reform strategy that will maximize the height of the social frontier (in Figure 1).

The two questions are clearly related, but economics and the theory of institutions do not have ready answers. The answer depends on the influence of politics on economic policy, and on the economic and political response to policy. Krueger (1993) discusses how policy that distorts economic incentives in a vital sector, for instance in agriculture or the export sector, can create a series of economic and political disequilibria and give rise to a vicious circle of falling real consumption.

According to Krueger (1993), the political equilibrium depends both on the relative strength of various groups and on the system's overall economic performance, particularly the trend in real consumption per capita. A new political equilibrium often leads to changes in economic policy, and a new economic equilibrium. A change in economic policy always creates both
winners and losers, and once all changes and effects have exhausted themselves there is a new economic equilibrium, which feeds back to the political system and upsets the political equilibrium which again gives rise to economic policy measures that upset the economic equilibrium. Krueger (1993) considers, in terms of the wealth criterion, under what circumstances the circle of political-economic-political interaction is vicious and when it is virtuous. She concludes informally that government interference seemingly irrational outcomes are consistent with an efficient structure of incentives in a vital industry (of a developing country), such as the export industry or agriculture, may create a vicious circle. The initial restrictions create continuously new groups that have strong economic interest in more restrictions. The downward spiral is likely to be stopped and turned around, when real consumption has fallen to a point where the general population rebels. It is at that point that the advice of (sound) economists is most likely to be heeded. Krueger (1993) also argues that the elimination of restrictions on efficient incentives in vital industries is likely to create a cumulative political support by interest groups for more such measures and the rising levels of consumption will reinforce the tendency.

Recently, a number of analysts have tried to capture various aspects of policy dynamics in formal models. Many of these scholars have been motivated by the ups and downs of economic policy in various Latin American countries. The behavior of policy makers (and their constituency) often appears as collectively irrational: countries wait for years to introduce policies that seem to benefit the vast majority of the public; populist, restrictive policies alternate with liberalization; and the delayed liberalization of macroeconomic policies is often accompanied, when it finally comes, with full-scale liberalization of microeconomic policies.

No one solution to these dilemmas has emerged from formal theory, but a number of seemingly irrational outcomes are consistent with various information constraints, such as a general uncertainty about who are the prospective winners and prospective losers of an economic policy that increases wealth in the aggregate but hurts some segment of society. Relatively rich explanations emerge from models that specifically introduce groups which, in the short run, gain or lose from economic reforms, but these early efforts suggest that the diversity of political behavior will not be captured by a single model.

Finally, a dilemma emerges when we endogenize the behavior of policy makers. If the players of the political game merely react to the political and economic forces in their environment, what role is left for economists and other advisers? The answer is that such theories are never complete; they always leave out certain variables that still can be manipulated, such as the exact nature of particular measures or the sequence in which they are introduced. However, the question is legitimate and of great intellectual interest: how many degrees of freedom do we have?

**VI. CONCLUDING THOUGHTS**

In this paper we have reviewed a new theoretical perspective for the study of economic systems, a perspective that combines the basic economic approach and an explicit concern with institutions, information, and transaction costs. The approach is of a relatively recent origin and has hardly been applied to Soviet-type economies and their transition to a market system. We conclude by laying out five important lessons suggested by the theory and relating the lessons to various problems of the transition. Rather than
suggest answers, we ask questions for reformers to ponder and scholars to research.

**Specifying the Relevant Institutional and Informational Constraints**

The economics of institutions creates an awareness of constraints that often are ignored. The theory emphasizes the vital importance of specifying major information and institutional constraints that individual decision makers confront, particularly when they operate in a changing environment.

Consider the case of the Soviet enterprise. Prior to the current reforms, Soviet enterprises were constrained to pass their 'surplus' to the state budget. In the transition these constraints were in effect removed and replaced with new institutions without properly exploring how the managers and the employees would behave under the new constraints. Their response, it has been suggested, was to appropriate the surplus and use it to raise wages and hoard intermediate goods, thus depriving the state of a major source of revenue and, in the former Soviet Union and elsewhere, initiate serious inflation.\(^7\)

In general there is an urgent need to model the behavior of micro units (and micro-micro units) under a new and changing institutional framework. There are many important questions that require answers. Can state enterprises be made efficient, or must they all be liquidated? Is it possible to break the old links between government officials and managers of state enterprises, to find new ways to control their performance and harden their budget constraints?\(^7\)

There are other critical questions. Is it possible to create a culture of ownership by giving state-owned assets to private individuals? Are such heirs to state property likely to behave in the same way, or differently, than individuals who buy capital assets — perhaps on credit and offering their personal property as collateral?

Finally, the information perspective suggests to reformers that they should seek institutional arrangements that economize on the limited administrative and political capacity of the former socialist countries (and indeed all countries). Vaclav Klaus goes so far as to suggest that the most crucial reforms must be taken in proper sequence, even without knowing the proper sequence a priori and the outcome in detail: "When we play chess we have to know the opening strategies. But it is impossible to foresee the situation on the chessboard after the 25th move."\(^7\)

**Competition Among Organizational Forms and Evolutionary Selection**

The economics of institutions, with its emphasis on costly information, suggests that the knowledge of how to design efficient organizations cannot be pooled or centralized and used in a massive way to restructure the economic and political organization of a whole country. The most realistic alternative for the reformer is to create a favorable setting for experiments with alternative forms at the grass roots. As we discussed in section IV, it is also essential to establish an efficient selection process where the winners in the race between organizations are selected on an economic criterion: those who minimize costs win.

In addition, the success in promoting the evolution of a decentralized, capital-intensive organizations depends on the state's ability to make a credible commitment to potential investors that it will not prey on their assets once they are in place.

**The Weight of the Past**

The collapse of the socialist regimes did not create an institutional vacuum in Eastern Europe
and Central Asia, as we discussed in section III. The stock of institutions changes only at the margin. Path dependence in the region involves not only the stock of institutions but also the stocks of physical and human capital. It is not clear how rapidly these three stocks can be changed.

A successful transition to markets requires the establishment of a legal framework for market activities. The former socialist economies must modify or recreate their laws in virtually all fields, including constitutional, real property, intellectual property, contract, company, foreign investment, bankruptcy, and competition laws. In most cases, the task is simplified because the country has a pre-socialist legal tradition. Poland, for instance, can draw on its pre-World War II legal system, but as Gray (1991) reports, the laws are general and it will take considerable time to build up cases and refine and adjust the law to current needs. Further, the courts have little experience with economic cases. In section V, we discussed the critical role of commercial morality in the self-enforcement of contracts.

The weight of the past also affects the stock of physical capital. Some estimates for the countries of Eastern Europe suggest that in one-third of the industrial sector the value added at world market prices is negative, and another one-third of the industrial sector is so backward that it is uneconomical to try to make it competitive. The estimates may be pessimistic, but the problem is large and the vast labor force employed by inefficient enterprises limits the options open to the reformer.

The human capital stock of some of the former socialist countries is not well suited for a modern market economy. For instance, entrepreneurial skills are said not to exist outside small-scale services and the craft sector, as it is common to discount the skills and motivation of managers of the state enterprises.

The reformers must seek all conceivable ways to reduce the weight of the past, and constantly reevaluate their strategies. For instance, how adaptable is the human capital stock to a new market environment — will hidden entrepreneurial talent spring forward? Can informal arrangements and private enforcement in an important way substitute for the formal legal system during the transition? How malleable is the physical capital stock in the hands of skillful entrepreneurs?

The System as a Whole and Tragic Choices

The economics of institutions is concerned with practicable social arrangements and considers the system as a whole rather than single margins. Coase (1960) illustrates this point with the example of an individual who decides to drive through a red traffic light at a deserted intersection late at night and gets fined for doing so. As the driver does not harm anyone, fining him may appear as an inefficient punishment, but does that imply that we should leave it to the judgment of each individual whether to stop on a red light? Coase’s answer is that “the problem is to devise practical arrangements which will correct defects in one part of the system without causing more serious harm in other parts.”

The transition in the former socialist countries demands that the system be viewed as a whole rather than individual margins be examined in isolation, but the trade-off between various margins will continuously force tragic choices on the reformer. The liberalization of trade, that is an invigorating tonic for the fledgling private sector, spells disaster for the massive state sector and its work force. On the other hand, attempts to isolate the state sector and temporarily keep at least select enterprises going until new jobs are available for their work force, may contaminate the selection process in the private sector. With subsidies and protection provided in the state sector, the private sector may demand similar
treatment. In view of the discussion in section V, the reformer must show particular caution not to initiate a vicious circle of subsidies and restrictions on efficient incentives.

The Political Constraint

The economics of institutions reminds us not to consider institutional change or reforms in isolation from political factors. All institutional change creates winners and losers, and the losers, operating through economic and political organizations, will work to prevent changes that harm them.

In the former socialist countries there are two categories of persons who lose from the reforms, at least in the short run. First, the poor and needy and the newly unemployed will be hurt by inflation and the upheaval associated with major structural changes. Special emergency measures can improve their situations and limit their opposition, but a viable sequence of institutional change must consider its impact on these individuals. The second category of losers from the transition to markets are agents of the old state system, individuals with human capital specific to the socialist system, who in many instances are still in strategic locations to undermine the reforms, as we discussed in section II.

The final consideration we mention is the vast potential for gains open to select individuals when the restrictions of the old system are lifted. In some instances these gains are perceived as legitimate and their pursuance contributes to the national wealth. Other cases are instances of rent-seeking or windfall gains that the public perceives as being unfair or illegitimate. Strong general perception of unfairness and illegitimacy can undermine the transition.

NOTES

1. The founding fathers of the new economics of institutions are Ronald H. Coase, the winner of the 1991 Nobel Prize for Economics, and Armen A. Alchian. Many of Coase’s most important essays are found in Coase, Ronald H. (1989), The Firm, the Market and the Law (Chicago: Chicago University Press). Several of Alchian’s best papers are found in Alchian, Armen A. (1977), Economic Forces at Work (Indianapolis: Liberty Press).


3. For applications to economic development see Nabli, M.K. and Nugent, J.B. (eds.), The New Institutional Economics and Development: Theory and Application to Tunisia (Amsterdam: North-Holland). In various studies, that initially were controversial, Eirik Furubotn used the theory of property rights to analyze the nature of socialist firms with remarkable accuracy. The early work on the theory of property rights is

4. Ronald I. McKinnon has made pioneering contributions to the study of macroeconomic relationships in diverse institutional settings, ranging from developing economies to the former socialist economies. For instance, see *The Order of Economic Liberalization: Financial Control in the Transition to a Market Economy* (Baltimore: Johns Hopkins University Press). Although the first generation of so-called rational expectations models swept information problems under the rug, macro theorists routinely include transaction costs in their theories, for instance to explain the existence of unemployment. However, their theories usually refer to advanced market economies and the macroeconomics of institutions is not an active field. It is to be hoped that the vast unfolding experience of the former socialist economies will lay the foundation of such a research program.


6. The discussion is based in part on my 1990 survey of the economics of institutions, but the framework presented there has been extended and clarified. Eggertsson, Thráinn (1990), *Economic Behavior and Institutions* (Cambridge: Cambridge University Press).


8. Wealth can be defined to include ideological values.

9. Our definition of property rights is more comprehensive than both the usual legal definition and definitions used by some writers on the economics of institutions. For a comparable definition see Barzel, Yoram (1989), *Economic Analysis of Property Rights* (Cambridge: Cambridge University Press).

10. From the viewpoint of an economy as a whole, the distinction between internal and external property rights disappears, except in the case of international property rights.

11. Note that for our purposes a contract is essentially a theoretical fiction. We assume that exchange is ordered by a contract, even in situations where no written contract exists. The literature on contracts is extensive and often highly technical, but an excellent and accessible survey is found in Migrom, Paul, and Roberts, John (1992), *Economics, Organization and Management* (Englewood Cliffs; Prentice Hall). Pioneering contributions to the theory of contracts were made by Cheung. See Cheung, Steven N.S. (1979), "Transaction Costs, Risk Aversion, and the Choice of Contractual Arrangements," *Journal of Law and Economics* 12, 23-42. Also see Winiecki, Jan (1991), *Resistance to Change in the Soviet Economic System -- A Property Rights Approach* (London: Routledge Press).

12. This example is due to Barzel (1989).

13. When the state constrains competition among contractual forms, change in economic organization may be brought about by competition between economic systems.


16. This insight is due to Coase's famous 1960 article on social cost. The conclusion is valid if there are no costs to bargaining. Also note that, when we say that joint value is maximized, the initial distribution of exogenous rights (or wealth) is held constant. A new initial distribution of rights would change both the distribution of wealth and the structure of demand, and give rise to aggregate output that also represents maximum value but has a different composition than before. See Coase, Ronald H. (1960), "The Problem of Social Cost," *Journal of Law and Economics* 3 (October), 1-44.

18. Note that exclusive rights include individual property, state property, and communal property.


21. Again we simplify by ignoring the distribution of wealth, which affects the valuation of property rights.

22. For an accessible introduction to the literature on the economics of law, see Cooter, Robert, and Ulen, Thomas (1988), Law and Economics (Harper Collins).


24. The relatively slow adaption of formal rules to fundamental changes in relative prices is due to information problems and to the nature of the decision-making process in political organizations. The information for an efficient reallocation of rights is usually available more cheaply to the relevant economic organizations than to political organizations, and in the market decisions tend to be taken more swiftly than in political organizations. In legislatures, for instance, committees can delay the voting on an issue for years or even decades. Finally, we still assume here that political organizations attempt to maximize aggregate value, but in real life political organizations may be preoccupied with the redistribution of wealth.


27. In other words, the low quality and limited variety of commodities was not only due to shirking by managers and workers in state enterprises, it was also designed by the center.


30. Other factors helped make the system function relatively well in the early phases, such as the opportunity to borrow new technology from the advanced industrial countries. The central command system was not well suited for technological innovations because of moral hazard and coordination problems. A temporary slowdown in the rate of production because of the introduction of innovations could not easily be distinguished from shirking. Also, a temporary dislocation in one sector or even in one large firm, for whatever reason, could cause serious disequilibria and problems for the central management system. Initially, the Soviet Union was technologically backward in all industries, and could import technology in big waves at long intervals. Later, when the country attempted to compete with other industrial countries using the latest technology, the system's anti-innovation bias became a serious handicap.

31. The concept of moral hazard is discussed in some detail in the following section.

32. See note 28.


34. The limited attention that economists have paid to the structure of contracts and informal exchange in the Soviet economies is comparable to the failure until recently, of students of market economies to explore contractual arrangements both within firms and across markets.


36. In many instances, the theory of organization implicitly takes the institutional structure of the U.S. economy as given. There is much need for comparative studies of organizations in diverse institutional settings. For an outstanding survey of the modern economies of organization, see Milgrom,
Eggertsson


38. The approach has also been used to explain how members of political organizations, such as the U.S. Congress, design organization structures that lower their costs of transacting. An excellent selection of such studies is found in McCubbins, Matthew D., and Sullivan, Terry (eds.) (1987), *Congress: Structure and Policy* (Cambridge: Cambridge University Press). See our discussion of these issues in Section V.

39. The results are inefficient in the sense that no one would be worse off and at least one person better off with an alternative outcome which could be reached if the information constraint were not there. The analysis is often stated in terms of the theory of agency, where a principal hires an agent to advance his or her interests, but problems with disparate interests can also arise in various types of exchanges where the two sides are on equal footing in the sense that one side is not obviously an agent of the other side.

40. Both concepts are taken from the insurance literature, but they have been given a more general interpretation in the theory of contracts.


42. Screening is another solution to the problem of adverse selection. With screening the buyer designs a selection process where sellers have an opportunity to indirectly demonstrate their level of quality, again using proxies.

43. For references and further elaboration, see Eggertsson (1990), Chapters 5 and 6.


45. See footnote 43.


47. Some economists object to this approach, as no theory exists for explaining who is risk averse and who is not. They prefer to explain the structure of contracts on the assumption that all individuals and organizations are risk neutral. See Barzel (1989), 30-31.


51. Our statement oversimplifies, as the techniques of production and organization are related. Modern methods of organization depend on recent advances in measurement and communication technologies, and advanced methods of production often require new forms of organization before they become economically viable.

52. Although cultural values and other informal institutions also affect what we call the social frontier, scholars should be careful when they appeal to cultural factors. For instance, the Japanese have strict limits on imported rice, although the price of domestic rice is several times the world market price. If it were true, as some scholars argue, that the Japanese limit foreign rice because domestic rice has an enormous religious and national value, then the reliance on domestic rice is consistent with the maximization of value. However, it also follows that the costly enforcement of trade obstacles against foreign rice is irrational as presumably the Japanese would not buy foreign rice, even though it is inexpensive, because they have little value for it. Still there is no doubt that cultural values affect the output of all economic systems -- even in the most successful industrial countries, an appropriate shift in cultural values could raise the rate of economic growth.

The Economics of Institutions in Transition Economies


56. Mancur Olson has theorized that, with the passage of time in a stable political environment, various groups gradually overcome the problem of free-riding and organize to change the institutional structure of the economy to transfer wealth to themselves. In the language of game theory, the practice is a negative-sum game as rent-seeking uses up resources and reduces the communities' aggregate wealth, and also the winners usually gain less than the losers loose. Olson, Mancur (1982), The Rise and Decline of Nations (New Haven: Yale University Press).

The rent-seeking model of regulation has been criticized justly for claiming too much. Critics have pointed out that in most countries the "rent-seeking industry" is smaller than the theory suggests. In defense of the theory of regulation it must be admitted that only the simplest versions of the theory imply a "corner solution" with almost no free trade. In more sophisticated versions, equilibrium outcomes balance the forces of competing special interest groups and the interests of the general public, which generally leads to some form of compromise. Peltzman, S. (1976), "Towards a More General Theory of Regulation," Journal of Law and Economics 19, 211-240.


We use the term political organization to refer to all organizations that are involved in designing and enforcing the rules that form the institutional framework for households and economic organizations.

59. In an unpublished study, Alston and Ferrie (1992) argue that Southern legislators in the U.S. Congress, through their control of the relevant committees of the legislature, blocked for decades the passage of welfare legislation in order to protect the social order in Southern agriculture. The authors maintain that concern about an adequate supply of labor following the Civil War and demand for protection by black workers with their uncertain rights, gave rise to a system of paternalism where owners of plantations provided a certain amount of social services in return for reliable labor services. Competition from social services provided by the state would have undermined Southern paternalism. The mechanization of Southern agriculture displaced millions of agricultural workers who migrated out of the South, especially to the cities of the North. Only then did Southern legislators, who were still in control of the relevant committees, yield and allow Lyndon Johnson's Great Society legislation, which was aimed at the urban poor and stimulated migration of unemployed black workers out of the South. The example illustrates the persistence of structures in political organizations that may outlive the fundamental power relationships which originally gave rise to the structures. (The committee system of the U.S. Congress was "reformed" in the early 1970s.) Alston, Lee J., and Ferrie, Joseph P. (1992), "Paternalism in Agricultural Labor Contracts in the U.S. South: Implications for the Growth of the Welfare State," American Economic Review, forthcoming.

60. See Eggertsson (1990), Chapter 9, "Property Rights in Stateless Societies."


62. For instance, see Hechter, Michael; Opp, Karl-Dieter; and Wippler, Reinhard (eds.) (1990), Social Institutions: Their Emergence, Maintenance, and Effects (New York: Walter de Gruyter).

63. The point has been recognized, for instance, in the work of Douglass North, but progress so far has been limited. North, Douglass C. (1993), "Institutions and
Eggertsson


69. The following account is based on Rodrik, Dan, "The Positive Economics of Policy Reforms." A paper prepared for the annual meeting of the American Economic Association, January 5-7, 1993.


II

TRANSFORMING THE STATE:
THE KEY INSTITUTIONAL CHALLENGES
ORGANIZATIONAL DIMENSIONS OF PUBLIC FINANCE IN TRANSITION ECONOMIES: An Assessment of the Recent Literature

Suphan Andic

I. INTRODUCTION

The social and economic conditions in Eastern Europe and in the former Soviet Republics are in a state of flux. Property rights are being drawn; private sector organizations are being created, gradually replacing many of the traditionally state-owned production units. Efficiency and effectiveness are increasingly becoming the key pillars of decision-making with ensuing emphasis on costs, prices, and profits. Domestic and international trade relationships are being overhauled. Monetary and fiscal policy are being revamped. Laws are being scrapped and new legislation is being drafted to correspond to the new economic, social, and political environment that is unfolding.

Foremost among such changes is the legislation of new types of taxes and tax collection and assessment methods formerly unknown in these economies, and which gives prominence to fiscal policy as an instrument of their management. Obviously, their successful implementation requires the establishment of mechanisms that are suited to the effective execution of the new policies. Accordingly, the government apparatus is being reorganized: numerous ministries previously established along sectoral lines are now being consolidated; efforts are being made to set up the new machinery to collect taxes, to transform the budget into a document which relates scarce resources to the competing ends they are expected to meet, and to link efficiency and effectiveness to the attainment of publicly mandated goals. Ministries of finance, which were traditionally weak, are acquiring due significance.

The present paper examines the recent writings on precisely these organizational dimensions of public finance management in Eastern Europe and the former Soviet Republics. The explicit reference is to organizations within the central government. The survey is selective. Its scope is specifically limited to the central government’s management of: (a) tax administration; (b) budget formulation and monitoring, including social safety net expenditures; (c) public investment evaluation, programming, and execution; (d) budget financing and public debt management. It does not cover the literature on tax or expenditure policy issues (which is extensive). Rather, it concentrates on finding out what has been written and publicized with respect to the organizations in charge of carrying out the prescribed policies.
The paper synthesizes the views and recommendations on the subject that have appeared since 1989. The ultimate aim is to pinpoint the key questions relevant to the development of organizations in light of the region's transition towards a market-oriented economic system, and draw implications for technical assistance for organizational development. The Annex contains a partially annotated bibliography which consists both of consulted references and works only tangentially related to the subject matter.

A clear understanding of the meaning of the terms "institution" and "organization" is called for before one begins to examine the selected literature. The use of these two terms is not without confusion. In many instances "institutions" are stated to be the rules and conventions that define the choice sets that constrain and shape human interaction, while "organizations" are primarily agents that are created with the purpose of promoting the objectives for which they were set up (North, Bromley). In others the terms are used interchangeably (Ruttan & Hayami; Murrell). In yet others "agency" replaces "organization" when reference is made to public sector organizations that collect taxes and deliver goods and services; nevertheless the term "institutional" is used when reference is made to the framework within which they are to be managed efficiently (WB 1992a). Finally, the all-comprehensive definition of institutions is also used outright when the concept is generalized to encompass both the rules of the game as well as organizations (WB 1991c).

To prevent any misunderstanding, the paper defines organization as the agent that carries out the designated mandates within the institutional arrangements that describe the property rights and constrain its actions. It is thus a formal structure of authority through which work subdivisions are arranged, defined, and coordinated along functional lines for the efficient attainment of the defined objectives (Gulick; North). The scope of the paper is limited to the survey of the literature on central government organizations in public finance as instruments to assist and improve the management of the public sector in formerly planned economies currently in transition towards a market-oriented system.

Sections II to VI survey the literature on central government organizations in each of the specified areas. Section VII summarizes the key points that emerge from the critical review. It also draws implications for relevant technical assistance and identifies the areas where applied research would be needed.

II. TAX ADMINISTRATION

The Previous System

Like all governments, those of centrally planned economies have collected tax revenues to finance the provision of public services. The revenues were designed and collected in a way that minimized the transaction costs within the context of the organizational structure of the command economies which eliminated the need for a tax administration in the western sense. The bulk of the revenues came from turnover taxes, state enterprise profits, and the payroll tax. The specifics of their application may have differed among countries, but they were levied with the same basic principles. The turnover taxes consisted of the difference between administered wholesale and retail prices less notional margins and were deposited into state banks. Taxes on profits were merely negotiated transfers from state enterprises and were collected directly from them by the banks. Payroll taxes also were collected directly from the enterprises by the banks. All were mere transfers debited to enterprises'
CHART 1: Armenia - Organization Chart of the Tax Inspectorate

TAX INSPECTORATE
Tax Design and Administration

PRICE INSPECTION

TAX INSPECTION
State Enterprises
Non-state Enterprises
Citizens
Other Incomes
Coordination

INVESTIGATION

ANALYSIS AND METHODOLOGICAL ISSUES
Tax returns; taxpayer information; international comparisons
Identification of non-payers; auditing; legal advice
Tax law proposals; regulation

accounts at the banks and credited to the budget (Casanegra, Silvani & Vehorn; Campbell; Chand & Lorie; Gray; IMF/WB/OECD/EBRD; Tanzi 1991b). There was no tax administration to speak of, except for the administration of a few local taxes on the few private activities. Nor was there a need, since the task consisted of verifying the validity of the amount of the funds to be transferred from one account to another and their actual transferral. This was performed by the finance departments of the ministries at various levels of government. The absence of tax administration proper, however, did not imply the total absence of transaction costs in collecting revenue, since the asymmetries of information between the government and the enterprises could not allow the government to know its revenue correctly.

The Current Situation

In the movement towards a market-oriented economy the first step has been to establish tax inspectorates, frequently independent from, and sometimes a semi-autonomous organization within the ministry of finance. This has been the practice in almost all countries in the region. In so doing the customs administration has in some cases been made a separate organization. In Estonia, for example, customs duties are organized in a separate directorate. In Latvia the Customs Department is in charge of collecting foreign trade taxes and is responsible to the Ministry of Finance, while the State Finance Inspection Board, which collects domestic taxes, is independent of the Ministry of Finance and is accountable formally to the Parliament.

The inspectorates have not been organized along functional lines (technical, collection, information, processing, auditing etc.), but according to: (i) type of taxpayer, or (ii) type of tax, or (iii) economic sector. Nor do they always encompass the customs administration. Armenia is an example of the first system (see Chart 1). Its Tax Inspectorate is a separate ministry, with four vice-ministers one of whom is in charge of Tax Inspection and another is in charge of Analysis and Methodological Issues. The Vice-Ministry of Tax Inspection contains five departments: one for state enterprises, another for non-state enterprises, the third for citizens, the fourth for other taxpayers (joint ventures), and the fifth for coordinating them all (IMF 1992). The identification of non-payers and auditing is the responsibility of the separate Vice-Ministry of Analysis and Methodological Issues.

Russia is an example of the second system. Its Main State Inspectorate is part of the Ministry of Finance and is organized according to tax types (see Chart 2) (IMF/WB/OECD/ EBRD).

Bulgaria is an example of the third system. Its tax inspectorate, the State Financial and Tax Control Department, forms part of the Ministry of Finance and is organized along economic sectors (agriculture, industry, etc.). The taxpayers are distributed across these sectors. Bulgaria is planning to move towards a hybrid structure with some units organized along tax types, others along taxpayers, and yet others along functional lines.

The tax administration in Ukraine has a hybrid structure. The State Tax Inspectorate is under the Ministry of Finance and is organized partially by type of tax, partially by type of taxpayer, and partially by function. It contains divisions for VAT and the turnover tax, personal income tax, enterprise income tax, as well as for state enterprises, joint ventures, and cooperatives, and for internal audit and organization.

The inspectorates usually embody units at different geographical levels (headquarters, regional, local) with loosely structured supervision, lack of coordination, absence of clear delineation of the tax base of each and of mechanisms to apportion the revenues among jurisdictions. They are also entrusted with activities that remain outside the sphere of tax administration, such as allocation of tax revenue to budgets of other levels of government (provincial, local). In Poland, for example,
CHART 2: USSR - Structure of the State Tax Inspectorate
of the USSR Ministry of Finance
complicated agreements between levels of government permit the allocation of a portion of a tax on a given enterprise to a specified local government for a specified purpose. This increases the attraction of setting up enterprises to increase local government revenue and lowers the economic profit incentive. And, if the enterprise is not profitable, the soft budget constraint allows it to survive from state-provided subsidies. (Casanegra, Silvani & Vehorn; Tanzi 1992b). The end result is a penalty for profitable firms to the benefit of unprofitable ones.

The administrative procedures are outdated and manually executed; tax offices are ill-equipped; tax returns are not processed to capture essential data; the filing of returns and the collection of taxes are cumbersome; taxpayers are not identified by a unique taxpayer identification number. Nor are they properly informed of their obligations under the tax laws or provided the necessary assistance for filing.

The Objectives of Organizational Reform

The current situation is incompatible with the requirements of market economies. There is a critical need for change in tax administration, and for its adaptation to modern accounting, auditing, assessment, collection and enforcement techniques, appeals procedures, and the rapidly growing number of individual taxpayers and private profit-motivated firms (Casanegra, Silvani & Vehorn; Chand & Lorie; Gelb; Gray 1990; Tanzi 1991a, 1991c, 1992b). The new administrative structure will have to represent a fundamental departure from the old one and be a completely new organization designed and set in motion along modern blueprints and plans.

The technical advice given by the IMF with respect to transforming the tax administrations has been quite detailed in spelling out the procedural requirements of the new structures, beginning with critical taxpayer services, staff training requirements, establishment of new procedures of collection, enforcing, monitoring, auditing, data processing etc. It is given in general terms, as well as with respect to the administration of particular taxes, often down to the minutest details of the shape and contents of the tax forms and the individual steps to follow. Three distinct points are emphasized in restructuring the organization: (a) the location of the tax administration unit vis-a-vis the ministry of finance; (b) its internal organization; and (c) its phasing in during the transition.

With respect to the location of the tax administration unit, support is given in some cases to making the tax departments part of the ministries of finance rather than independent agencies in charge of tax administration or a separate ministry (Casanegra, Silvani & Vehorn), while in others an autonomous revenue service, elevated to the status of a ministry, or a board independent from the ministry of finance is also accepted. Obviously, the significant issue is not so much where the agency is located, but to have it function effectively and efficiently. This depends upon the extent to which practical adjustments have already been made to deal with evolving responsibilities and the requirements to further strengthen the organizations.

There is agreement that the internal reorganization of the tax departments should be along functional lines to cut across all taxes. (A sample organization chart is given in Chart 3.) This restructuring has at least three advantages (Casanegra, Silvani, & Vehorn). First, it increases productivity, since it permits specialization in given technical tasks. Tax officials will not need to spread their knowledge to most of the tax laws, nor will they need to be responsible for assessing an entire array of taxes applicable to the group of taxpayers assigned to them. Unless the department's functions are reorganized to meet the new tax assessment, collection, auditing, and enforcement demands, the new taxes and the increasing number of taxpayers the officials will have to deal with will not allow professional standards of performance. Specialized divisions staffed with appropriately
CHART 3: Sample Organization Chart for a Tax Department
trained personnel are called for to cope with the new requirements. More productive use will be made thereby of specialized skills; routine duties can then be performed by clerical staff, for example, and inspectors can concentrate on audit activity.

Second, organization along functional lines provides a system of checks and balances. When one tax official does not handle all the functions related to one taxpayer, an error committed in one function (e.g. assessment) is likely to be caught in another (e.g. audit). Third, the tax department will be able to operate more effectively. If a taxpayer fails, for example, to comply with his obligations in more than one tax, the collection will be handled by one official in the collection section, and not by more than one individual in more than one section. The setting up of a taxpayer services division, for example, would obviate the need for a "personal" tax inspector who will be able to continue with his work without interruption while the taxpayer's need was being attended to.

Practical considerations weigh heavily in the phasing in of the new organizational structure. Some give top priority to the reform of an existing tax, which constitutes a significant share of total tax revenue, over the introduction of a new tax which may have onerous administrative requirements. Accordingly, the recommendation is made to first create a strong department for the existing tax which would eventually be able to administer the subsequent taxes to be introduced. Others prefer the introduction of a significant new tax, such as the VAT. In this case the strategy proposed is to use the forthcoming tax as a pilot project and to introduce it with modern methods of taxpayer identification, filing, payment, and control, untouched by the outdated systems used in other taxes. It is then recommended to extend the new structure to other taxes, including social security contributions, once it is properly in place. Both strategies presuppose the assignment of top priority to procedures, i.e. the design of taxpayer registration, collection, and accounting systems, the development of tax return forms, detection of delinquency, and audit selection methods. Consequently, recruiting, allocation, accommodation, and training of the new officials also acquire top priority. It is implicitly assumed that the transaction costs of the reorganization will be minimized.

Often, the recommendation is to develop the procedures within the short run (six months), emphasizing especially taxpayer services. Most modern tax administrations incorporate a special division to assist, inform, and educate the taxpayers. This increases confidence in the tax system, reduces the compliance costs, makes it easier for taxpayers to fulfill their obligation under the law, and improves the level of compliance. This requires information to be available through publications, the media, telephone contact, correspondence, and personal contact. Which method is the most suitable depends upon the technical infrastructure of the country in question. Whatever the method, general literature needs to be provided on how the tax system works, what the tax privileges are, accompanied by clear instructions on how to complete and file tax returns, in addition to providing assistance in the actual filing process.

Effective results are expected almost immediately from giving the existing tax administration the ability to handle what amounts to an entirely new procedure, hence the emphasis on developing the procedures immediately and putting them in place as fast as possible. As indicated earlier, this calls for massive training of the existing staff, and of those that are newly to be recruited, in all the aspects of the wide spectrum of procedures. Restructuring the organization is deferred to the medium term (up to two years), to be carried out step by step, as this would be easier and less costly to do once the procedures are in place. Once one organization is in, setting up the others would follow with greater ease. In the interim the objective is to strengthen the management capacity of the inspectorates, departments, or divisions.
The Needs

The steps to strengthen the tax administrations may not yield substantial revenue gains in the short run; yet action needs to be taken as soon as possible to address their weaknesses, as discussed above. The top priority task appears to be the development of procedures to register taxpayers, file returns, process payments, monitor taxpayer compliance, and arrange for appropriate staff training. A concomitant top priority is to improve taxpayer information and education; hence the need to create a taxpayer services division within the tax departments.

The reorganization of the existing tax administrations along functional lines is a longer-term process which entails the reallocation of the staff to the new divisions, identification of the requirements of the new jobs, beginning of appropriate training programs, developing management information and internal audit systems, and planning for computerization systems. No doubt the organization that will be installed will require reviewing and revising over the long run as to its continued appropriateness.

The change from the old structure to the new is a formidable task. So also is the training of the staff, who will need to learn and understand the new methods and procedures and apply them impartially and equitably; the education of the taxpayer who will have to cope with totally different sets of rules; and the change in attitudes to do away with preferences and discriminations. But, if the new structure is not put in place as fast as possible and the accompanying tasks are not accomplished, the modern taxes the codes will come to incorporate will fail to generate the revenue to finance the operations of the government, thus aggravating the existing fiscal imbalances and management problems in other areas of the public sector.

III. BUDGET FORMULATION AND MONITORING

The Previous System

In centrally-planned economies the budgetary process and its implementation procedure derived logically from the economic structure built on the particular ideological foundation and the associated property rights. The state and the public enterprises were one and the same entity. The state established the enterprises, provided needed inputs, and purchased and sold outputs. This system led to a budgetary structure which embodied a large number of separate funds, each intended for a specific activity. It also gave an immense role to the central bank which met the day-to-day needs of the state, furnished the initial accounts for the state's financial report, and controlled budgetary compliance.

Resources were allocated in the annual physical plan where prices played only an accounting role. The budgetary process was part of the preparation of this plan by the central planning agency. The plan was communicated to the ministry of finance (for preparation of preliminary revenue-expenditure balance), branch ministries (for relevant instructions to the enterprises with respect to projects), and to the national bank (for budget estimates and their subsequent revision). All agencies and ministries contributed to the contents of the plan and the budget in a process of negotiation and bargaining, but the central planning agency gave it its last review and approval. The ultimate approval of the budget, however, rested with the party congress; its implementation was monitored by
the central planning agency. As decisions were overwhelmingly state enterprise sector. The economic restructuring, of which the budget is but one reflection, is progressing at a rather slow pace. Hence, the existing budget systems continue to show the characteristics of those designed for centrally planned economies. In Latvia, for example, which is said to have abandoned the old system in 1990 (IMF, 1992), of the three deputy ministers of finance, one is in charge of the industry department which incorporates industrial development, investments, industry and infrastructure, and agriculture. These are all divisions in charge of budget preparation in addition to the budget department, which is the responsibility of another deputy minister. In Belarus, the departments of industry, agro-based complexes, and Chernobyl are organized within a deputy ministry.

Common weaknesses in the budgetary process of the transition economies are not difficult to spot. The first is the inadequacy of expenditure classification for efficient resource management as corresponds to the structure and requirements of a market-oriented economy. Budgetary expenditures are classified in categories that are not clearly demarcated. Functionally classified categories are combined with those classified along economic sectors as well as recurrent and capital items (Premchand & Garamfalvi). In Armenia, the expenditure classification separates between the "national economy" and "other". The "national economy" part of the budget includes items classified along functional lines, combined with items classified along both economic and functional lines, and with capital and recurrent items. Some subsidies are included while others are not. In Belarus, the expenditure classification is rather complex. It has four levels: section, chapter, paragraph, article. Section expenditures are divided into "national economy" and "others". In the "national" component of the budget the emphasis is on the administrative units undertaking the expenditures rather than the economic sectors. The "other" part incorporates several social services, administration, law and order, special
expenditures, and various transfers. The classification by article attempts to identify expenditures by economic type, but a large portion of the expenditures are entered without classification whatsoever as "expenditure not separated by item." The classification by functional categories, as is utilized in the western world, and by economic categories (current, capital, lending minus repayments) is yet to be established. The confusion is extreme.

The lack of clarity and inappropriate disaggregation as practiced in these economies lead to difficulties in the formulation and implementation of fiscal policy within the framework of a market economy. The lack of functional and economic classification of expenditures obstructs the accountability of management in using allocated resources for efficient delivery of services and prevents the cross classification analysis of outlays to enable budgetary control, improve economic analysis, and provide a better framework for decision making.

A second deficiency is the inadequacy in monitoring. Even though organizationally the expenditure control function may be entrusted to the budget department of the ministry of finance, the latter does not possess the power to manage the accounts centrally. The dependence on national banks for cash management is very high. Information on budget allocations to the spending ministries is communicated to the banks, which credit the ministries' accounts. Similarly, payment requests are transmitted to the banks, which then debit the appropriate accounts. The banks report the financial data to the ministries of finance. Moreover, the reports are usually very late, in extremely aggregated form, do not provide detailed accounting of expenditures by spending units, and refer almost entirely to functional categories.

Moreover, the monitoring needs to be extended to encompass the transactions of the extrabudgetary accounts. Otherwise the full impact of government activity cannot be gauged, especially since such accounts shoulder an important portion of public expenditures, such as social insurance and unemployment benefits, and any imbalance they may develop will require budgetary support.

A third deficiency is that the budgets have a short time horizon, at least at the present (Gomulka; IMF 1992). This is a constraint forced upon budget preparation and formulation by current economic developments. Supply shortages and price liberalization and the ensuing inflation, exchange rate movements, and so on, accompanied by the absence of a comprehensive legal and administrative framework, have forced upon the governments the use of short period budgets, in many cases even monthly. The unpredictable environment is not conducive to making correct expenditure decisions and leaves little time for realistic changes in the estimates to adjust expenditure plans in line with available resources. It also makes the tasks of expenditure reviews and priority setting impossible.

A fourth deficiency is the failure to use cost analyses. Ministries of finance do not usually conduct analyses of the programs, or use macroeconomic analyses during budget preparation, or necessarily solicit such analyses from the spending ministries. This is because they do not have the apparatus and the staff and the skills with which to carry out such analyses. There are no well established systems of critical evaluation of the economic benefits and costs of government programs. Ad hoc controls, rather than systematic methods, are utilized in negotiating with the ministries.

Finally, one can mention the absence of consideration of resource allocation efficiency. As indicated above, this absence is thrust upon the ministries not only as a legacy of central planning, but by the quickly changing present economic environment which forces them to draw
up short-term budget plans. As a result, budgets are not based on an internally consistent macroeconomic framework, and it becomes impossible to undertake expenditure reviews. Yet such reviews would form an integral component of the overall adjustment process; force economic analysis upon budget decisions; and help develop the multi-year expenditure framework which is crucial for evaluating and implementing investment projects and reducing waste.

**The Objectives of Organizational Reform**

The move from a centrally planned to a market-oriented economy requires that a number of key transactions that were internal to the old system must now be externalized. This requires a brand new mode of budget organization. The old budgeting structure, just like the one for tax administration, has to be dismantled and replaced with one that should reflect three major characteristics.

*First,* the budget will have to acquire a major role in macroeconomic management, i.e. in the entire process of allocating resources towards competing ends. It has to carry out functions which it has not been accustomed nor equipped to do, such as forecasting and program formulating in an environment of freely changing and interdependent economic variables.

*Second,* the change of the political system to one approaching democracy entails the representative legislature as the organization where public outlays and revenues and their likely impacts are to be made clear and where finally the budget is approved. Poland already has legislation that expresses clearly the legislature’s role in budget matters (Premchand & Garamfalvi; WB 1992d).

*Third,* under the new system the legislature acquires the prerogative to monitor the executive branch of the government and make it accountable for the efficient and effective delivery of public goods and services.

The advice in the field of budget preparation and formulation centers around the need to change the procedures, on the one hand, and the organizational structure, on the other, so that the ministries of finance will be liberated from their subservience to central planning. No doubt, the two changes go hand in hand, since procedural changes will, by necessity, lead to the reorganization of the agency. In the process, new departments will be created while other functions which are unrelated to fiscal management (e.g. foreign exchange) should be transferred to other agencies. Thus, the procedural recommendation to improve cash management requires a separate treasury department within the ministry of finance, which would also be in charge of financing the budget deficit, registering the assets and liabilities of the government, and debt management. The analysis of macroeconomic policies and developments, forecasting of revenue and expenditures, review and analysis of revenue and expenditure policy and of budget developments needs a department for macro analysis (although not necessarily in the ministry of finance). The preparation and appraisal of budget estimates, budget legislation, public expenditure coordination should be the responsibility of a department for public expenditure management. Central accounting operations, control of government accounting, internal audit and control, financial management information should fall under the department of accounting and information systems.

**The Needs**

**Immediate Measures**

The introduction of a totally new budget system, within which public expenditures are planned consistent with macroeconomic policies and executed in a way that accounts for the use of public resources is difficult, time-consuming and could be distortive (WB 1991c). Given the prevailing uncertainties in economic conditions within which the budgets operate and the difficulties that make it difficult to keep the
budget deficit within the targeted limits, immediate measures should aim at supporting the efforts for economic stabilization. Four areas acquire top priority in this context:

- **Improving procedures in monitoring.** The information flow from spending ministries to the ministries of finance should be speeded up and contain analysis by main economic aggregates (wages and salaries, interest, etc.) if not by detailed breakdown of expenditures. The same reporting requirement should be extended to extrabudgetary accounts. A move to full budget classification meeting international standards is not an immediate necessity; it will progress gradually with the reorganization of other features of public expenditure management. However, broad groups of economic transactions need to be identified in the short run to allow the appropriate analysis.

- **Developing macroeconomic analysis.** The capacity must exist to forecast major expenditure commitments and revenue developments and coordinate them closely with budget management so that the budget’s impact on the economy can be analyzed. Such techniques must be introduced and the personnel trained in their use. This capacity may or may not be located in the ministry of finance.

- **Establishing cash management on a firmer basis** involves a series of ancillary policy measures, such as setting suitable interest rates for government deposits. From an organizational standpoint, the need is for a treasury department within the ministry of finance with the appropriate cash management functions assigned to it. Such a department can evolve only over the medium term. In the immediate term consideration should be given to a unified treasury account at the national bank.

- **Developing the accounting system.** The capability of the ministries of finance to undertake the complex accounting that corresponds to the requirements of a market economy can only be built up over time. Strengthening the existing divisions, however, will have to begin in the short run to enable the development of the required information and control mechanisms.

**Medium-term Measures**

At the same time that short-term measures are being taken to address stabilization urgencies, the foundation must be laid for reorganizing budget management in correspondence with the needs of the market economy. In the medium term the requirements will be:

- **Improving the budget control and adjustment mechanisms.** This entails not only installing the actual mechanisms with which to carry out the tasks, but a mechanism of setting priorities and determining the core activities that would be assured funding. Procedures will have to be introduced and/or strengthened to analyze the economic costs and benefits of government spending.

- **Improving fiscal reporting and analysis.** The budget classification system must be amenable to economic analysis. This requires a consistent classification of expenditures by functions, rather than agencies, and distinguishing clearly between current and capital expenditures. This permits cross classification analysis of outlays and reveals important insights into the shares of expenditures devoted to each function.

- **Improving/developing the accounting system.** Aggregate budget control and resource allocation cannot be exercised without appropriate information. The ministries of finance will have to assume the central role in accounting, especially since economic
restructuring will divest the banks from such a function once they become fully commercial. The accounting systems will have to be redesigned, and new systems of record keeping and reporting will have to be introduced in keeping with the expected increase in complexity in governments' dealings with a growing number of private sector entities.

- **Reorganization of the ministries of finance.** It is easy to design the reorganization of the operational structure of a ministry of finance. However, to put it in a functioning form and have the working procedures fully implemented is a lengthy process. The speed of accomplishment will depend upon the particular circumstances of each country with respect to, among others, the availability of skilled staff and its deployment, recruiting and effective training of new staff, the interactions with other institutional and organizational developments, and of course the speed of the move towards a market economy. In the process of reorganization the ministries of finance must divest themselves of functions that are not properly within their sphere of action (e.g. foreign exchange operations), and the new structure must be designed around core functions which are essential to the public management of resources. These are especially the treasury, accounting, public expenditure management, macro-economic analysis, and taxation.

A good start has been made in the area of taxation; whatever the shortcomings of the departments of taxation or of tax inspectorates, incremental improvements give them a good chance of success. Similar steps need to be taken on the expenditure front. Granted, the budget systems are fragile; but the procedural improvements, if installed carefully and wisely, will of necessity lead to the required reorganization. (See Section VI and Chart 4 for an overall discussion of the restructuring of ministries of finance.)

**IV. SOCIAL SAFETY NETS**

The literature on transition economies emphasizes that the prevailing budgetary situation requires reducing government expenditures. The absorption of subsidies formerly associated with state enterprises into the central government budget is an added pressure on public spending. Price liberalization leads to price increases, which call for a well-designed approach to adjusting wages and social benefits to prevent inflation without an undue erosion of incentives. Improving the efficiency of the industrial sector requires retrenchment of workers. Scaling down the size of the public sector likewise requires the reduction of excess employment.

The resulting unemployment and loss of income can be of short or long duration, depending upon the speed with which policies reduce the contraction in labor demand and induce the resumption of growth. The challenge is, therefore, to design social protection policies for the transition period and structure their administrative organization to prevent groups of population finding themselves in situations of unacceptable living standards caused by the elimination of implicit and explicit support through traditional price controls, subsidies, and guaranteed employment. In these circumstances there is an urgent need to establish both
emergency safety nets for the most vulnerable, as well as permanent programs for the long term.

**The Current Situation**

All countries have been re-orienting their existing social assistance programs and setting up new institutions from scratch to provide for unemployment compensation and social assistance (which had no place under central planning as unemployment was inconceivable). There is variation among them in terms of the extent and coverage of different schemes and their budgeting and financing. The schemes are funded partly out of general revenue and partly out of relatively high payroll-based social security contributions, almost exclusively paid by the employer with minimal contributions by the employees. The contributions, though generally earmarked, flow into the central government budget and are lumped together with the rest of general revenue.

In the process of structural transformation towards a market economy three fundamental changes have taken place in budgeting for social safety nets. The first is the separation of the social insurance budget from that of the central government in Eastern European countries. The second is the establishment almost from scratch of such funds and budgets in countries that were part of the former Soviet Union. And the third is the establishment of unemployment compensation schemes, which previously did not exist. Such schemes had to be introduced formally, as the resources of the existing social security programs were limited to cope with the social implications of the economic transformation.

The structure of the new social security and insurance organizations, their operations and control, the extent of their coverage, the eligibility requirements, and the method of financing vary from country to country. Hungary, has shifted social security operations to the State Insurance Fund under the authority of the national Social Insurance Directorate. The budget of the Fund is subject to legislative debate and approval, separate from that of the state budget (Kopits 1992). In a similar move, the former Soviet Union has separated the Pension Fund from the Social Security Fund and moved them off budget. Romania has introduced two separate Social Security Funds (Kopits 1992; WB 1992c). Bulgaria separated social welfare from social insurance and placed the former under the responsibility of the local governments (WB 1991a). The newly independent former Soviet republics have set up their own insurance funds. For example, Uzbekistan now has a pension fund partly financed out of central government transfers where benefits are not linked to contributions, and a State Insurance Fund where benefits are provided and controlled by the trade unions at the enterprise level (IMF 1992). Tajikistan has separate Pension and Social Insurance Funds financed by contributions from employers (IMF 1992). Latvia has established an independent social security system covering all individuals whether they have worked or not. It has a separate budget funded through contributions of employers with minimal contributions by employees (IMF 1992).7

As mentioned earlier on, financing is largely through very high employer contributions (37 percent of the payroll in almost all cases) and very minimal employee contributions (about 1 percent of wages). Deficits are met out of central government transfers. Benefits in most cases are tied to the contributions, but there are exceptions, such as in Uzbekistan, where they are specified without such connections.

The first broadly applicable formal unemployment compensation scheme is that of Hungary which was introduced in 1989 (Kopits 1992). Since then all economies in transition, including those who have newly become independent, have enacted similar schemes (IMF 1992). Again, the application varies from country to country. In Hungary the benefits are paid over a limited period with a high replacement rate;
social welfare takes over after its expiration (Holzmann). Poland and Hungary have longer payment periods (Holzmann). All have adopted earnings-based benefit schemes.

The minimum and maximum level of pensions and unemployment compensation benefits are linked to the minimum and the average wage. In most cases the minimum benefit is equivalent to the minimum wage; in others it is a portion of the minimum wage. The cap is set at either a multiple of the minimum wage or as a proportion of the average industrial wage. In general the benefits are inflation-indexed. In Russia the indexation is full. In Kyrgyz Republic the adjustment is by the cost of minimal consumption basket (Kyrgyz Republic). In Latvia the increases are discretionary. However, since wages are also adjusted to price changes, the link of the benefits to the minimum or average wage preserves their real and relative (to current wages) levels.

The Objectives of Organizational Reform

Much more has been written on social safety nets in economies in transition than on all the other topics under consideration in this paper. The primary focus of analysis is the design of a comprehensive safety-net policy framework which is efficient and cost-effective, matches benefits with resources, and does not create supply and/or demand disincentives. The World Bank has been involved in analyzing, evaluating, and making recommendations for the design of such comprehensive policy framework (WB 1991a, 1992b, 1992c). Social assistance is given priority to meet the immediate needs over the structure of particular programs. For incentive reasons flat-rate social assistance and unemployment benefit payments are favored for the short term while earnings-related benefits are recommended over the long term when production will have recovered and inflation subsided to what can be considered normal levels (WB 1991a, 1992b, 1992c; Holzmann). Means testing for social assistance is not recommended for the initial stage but postponed until the capacity to implement it is installed. Raising the retirement age is supported. The importance of containing the costs of social protection is stressed to control financial instability. Full indexation of benefits is usually not favored.

The Needs

The reorganization needs to concentrate on the appropriate framework for administration. There seems to be a consensus among experts on the structure of typical social assistance programs. A national framework is recommended for all cash benefits (unemployment compensation, pensions, family allowances, social assistance) with specifically indicated benefit regimes, eligibility criteria, and financing arrangements. Within this national framework social assistance and insurance units need to be separated. Subsequently their administration should be strengthened and their expenditures controlled to prevent adverse budgetary implications. This should not be taken as advocating a single formula for a social safety net to be applicable for all the countries in question. Recommendations are made taking into account the particular circumstances of individual countries, though this does not preempt drawing up the general characteristics of such schemes.

As family allowances and social welfare payments of various types are conceptually different from pensions and unemployment compensation benefits, their exclusion from the system of pension funds is recommended as quickly as possible. They should be located within the state budget, if their costs are to be distributed among all economic agents, be transparent, and accordingly more easily monitored. The scope of the pension system needs to be redefined to convert it into a veritable social insurance system through which individuals save over their working life and receive their accumulated funds in retirement. The pension fund should be responsible for the administration and payments of pensions only. Moreover, separate pension funds should not be set up for
special groups; rather all should be integrated into a standard system with a unified benefit structure. The fund should be on a pay-as-you-go system and separate from the budget. Earmarking earnings-based contributions to an extrabudgetary account to pay for insurance type benefits would enhance the rationale of the contributions on the basis of the benefit principle of taxation (Kopits 1992), while financing social assistance, health care services to non-contributing low income households out of general revenue. Such separation should not lead to a lessening of the control of the social security budget.

A cost-efficient safety net also requires transparent administrative management and control mechanisms. The authorities have limited capacity and are ill equipped to administer the schemes, hence the administration needs to be made as simple as possible, with proper innovations introduced into their operations; e.g. a gradual move to automated administration accompanied with the assignment of unique identification numbers to each insured employee or self-employed (preferably the same as the taxpayer identification number), maintenance of records of lifetime contributions, and joint administration of income taxes and social security contributions (Kopits 1992).

The option should be explored for establishing private pension systems as a complement to the pay-as-you-go social security system (Jenkins; Kopits 1991a; WB 1992b, 1992c). These, however, will have to be coordinated with the plans for the reform of the financial system.

There is also the problem of the sustainability of the benefits of the various off-budget insurance/welfare schemes over a foreseeable future, for it is likely that they will experience financial stress in the short term with employer contributions falling as a result of growing unemployment. The impact of such expenditures on the state budget requires close scrutiny in the wake of large projected deficits, freely adjusted prices, and wage-price inflation. The state budget could easily be put in jeopardy, since the deficits of the off-budget trust funds are met out of transfers from the budget.

This raises an issue of fundamental significance: the identification of the deserving sections of the population and targeting the benefits to them. Efficient targeting techniques need to be developed and rules need to be instated to lower the high administrative costs of full targeting and to assure that while the most vulnerable are protected, resources do not leak to those who should not qualify.

Administratively satisfactory criteria for targeting are very difficult to formulate. The recommendations in this respect focus, in general, on setting up income standards; determine the cost of a minimum consumption basket and accept it as the poverty level. Population sections whose incomes exceed this level should be left out. This seems to be the direction adopted in many of the countries, though the efficiency in delivering the benefits may leave a lot to be desired. Setting up income standards require abundant information on household income and expenditure patterns by levels of income and on prices of the commodities that make up the consumption basket. Official data are deficient. All incomes are not reported; the data may exclude incomes that are earned in the newly emerging private sector, in black market activities, and in secondary employments. Concomitantly, food coupons are also suggested to supplement the deficiency in assistance payments. It should be recognized, however, that the administrative requirements and costs of a coupon system can be excessive, since like in any income standard scheme lists of eligibles will have to be maintained and altered according to the changing circumstances of the individuals, if properly reported.

With respect to unemployment benefits the general view is to exclude first-time job seekers, new entrants or re-entrants into the labor market,
or those who have worked only for a short period and assist them through training, i.e. replace unemployment benefits by training benefits. Tightening the net is also suggested by reducing the number of times jobs offered may be refused. In the case of family allowances costs might be reduced by making those earning above a multiple of the minimum wage ineligible.

Tightening the eligibility of unemployment benefits can be achieved over the short run. The immediacy of social protection also justifies why many countries have presently opted for flat rate payments in many instances. This system is acceptable under transitional circumstances, but will need to be replaced by a more efficient targeting technique. The appropriate techniques for income standards and means testing, and the administrative mechanism to implement them can only evolve over a longer period of time. The length of the period will depend upon the particular circumstances of each country. Estonia, for example, has a small population with predominantly urban concentration; it may, therefore, be possible to establish the criteria within a relatively short period while conducting carefully drawn up household income and expenditure surveys.

As a final point, it should be emphatically repeated that a cost-efficient social safety net requires not merely appropriate policy design, but also transparent administrative management and control mechanisms.

V. PUBLIC INVESTMENT PROGRAMMING AND EXECUTION

Investment management still carries the burden of the legacy of central planning which had no well-established system of critical evaluation of the economic benefits and costs of government expenditure programs and where project preparation was dominated by engineering inputs. This state of affairs continues to characterize the present situation, and none of the countries in question has as yet initiated a systematic and comprehensive review of public investment using standard rate-of-return criteria (Campbell; Chand & Lorie; Kopits 1991a; Rice; Tanzi 1992b). This is much too harsh a judgment, since no country anywhere has initiated such reviews. Good judgment and reasonable priorities could go a long way to terminate non-viable old projects and/or initiate new viable ones. Nevertheless, an expenditure planning and management system in line with the requirements of a market economy and the organizations to implement it have not as yet replaced the procedures of central planning. In Poland, for example, components of the state investment budget are scattered through the administration and do not form a coherent program (WB, 1992d). Investment plans consist of a wish list of projects presented by each ministry. The lists are then trimmed to meet the dictates of resource availability without adequate assessment of intersectoral resource allocations and the overall financial needs of the economy, because techniques with which to do so and the required budgetary process is not in place to undertake these functions. Thus the budget becomes incidental (Kharas). In fact, in the present budgetary situation where expenditure cuts are imperative, the system has made it expedient to make substantial reductions in investment rather than in current expenditures.¹⁰

The uncertainties of the economic environment restrict the time horizon for financial planning to at most a year. This is exacerbated by the difficulties of establishing realistic estimates. Such an environment makes planning of public investments nearly impossible and restricts them to ongoing projects. Efficient investment planning and execution over a longer period require rigorous economic analysis to minimize arbitrary reductions, to determine the
priorities especially with respect to targeting the identifiable needs of the private sector and rehabilitate existing underutilized assets (Rice), as well as to make realistic multi-year budgets that take their recurrent cost implications into account (WB, 1992d).

The World Bank has been focusing its attention on precisely this sort of analysis in the case of the developing countries. It has advocated the reduction of non-viable projects and has supported the setting up of medium-term rolling public investment programs consisting of projects analyzed according to their economic financial and social viability and making them an integral part of the government budget preparation system. It has also supported adequate operations and maintenance expenditure, and use of better screening criteria. It has endeavored to enhance the capability to carry out sectoral economic studies and prepare sector strategies, strengthen policy analysis and budget preparation and execution, from finance ministries down through line ministries to operating departments (WB, 1991c).

The public sector must be in a position to identify, analyze, and implement capital projects and to budget for them on the basis of a multi-year (the usually recommended period is three years) investment program with sources of finance duly indicated. This should allow a smooth stream of projects and their review over time. However, without the appropriate organization this is impossible to embark upon. As analyzed in the previous section the task awaits the installation, especially within the ministries of finance but also in other spending ministries, of the departments with the appropriate analysis and execution capacity, including public procurement practices and project monitoring and management capabilities. There is a need to strengthen public investment preparation and execution from finance ministries down through line ministries to operating departments and local public entities.

VI. BUDGET FINANCING AND DEBT MANAGEMENT

This section draws in large part from two published sources (Allen; Cheasty) which deal with the experiences of Czechoslovakia, Hungary, Poland, Romania, and the former USSR. The management of foreign debt and issues related to financial organizations and instruments are not addressed in this paper.

The Previous System

The objectives of the governments of the formerly socialist countries to expedite the industrialization process, provide virtually free education, health care, culture, and transportation services, and implement a comprehensive system of social security and welfare and a uniform system of income and consumption, were generally financed without recourse to inflationary financing. Expenditures were matched by revenue collections (Ericson) through a system which minimized the transaction costs of collection given the organizational structure of the economies. Deficits tended to be small. Whenever warranted, either prices were altered to increase the credit of the needy enterprises, transfers from state enterprises were renegotiated, or local governments were required to make greater contributions out of their reserve funds. The accounting system of public finances facilitated the immediate and automatic access to financing. The usual method of financing the deficit was bank finance based on the high savings rate of the individuals, since commodities on which to spend incomes were in short supply. The governments issued securities destined to the households only on rare occasions and in small
amounts and at low interest rates. This did not mean that the government incurred no debt and liabilities. These took the form of currency issues and deposits backed by the assets of the banking system.

The Current Situation

The transformation brought drastic changes both to the tax and the expenditure side of the budget. The liberalization of market prices, the privatization of state enterprises, and the establishment of new private sector activities made the old tax system obsolete. It had to be dismantled and replaced by a new system based on new economic parameters. All countries have made such changes or are in the process of doing so. The changes, however, were accompanied by a drop in revenues, the result of the economic crisis associated largely with the collapse of inter-republican trade. Moreover, it was not easy to make the change from a tax collection system which required virtually no administration to one which required a variety of skills in a variety of fields for its effective implementation.11

On the spending side pressures mounted for new types of expenditures, which made their scaling down very difficult. Though price liberalization reduced the cost of subsidies, the emergence of unemployment added the cost of social safety nets to entitlement. The absorption by the governments of the social security function of state enterprises introduced another expenditure item into the central government budget. Inflationary developments led to upward adjustments in pensions and public wages. The financial system needed capital injections to make it viable. Health and education spending had to be increased. There is also pressure on the budget from the need to increase infrastructural and other investments to revitalize the economy and renew growth. Last but not least, there are strong expectations on the part of the population that the new governments will respond better to their various demands than the former ones (Batt).

Thus, revenues fell at a critical time when stabilization programs were being put in place and public spending could not be cut to accommodate this fall. Budget deficits appeared in all countries at a time when a balanced budget was to be the central pillar of price stabilization. Some countries, like Hungary, were able to contain the deficits within a narrow percentage of GDP, while in others deficits exceeded 10 percent. Deficit financing and the issue of debt and its management surfaced into the open.

Two aspects need to be taken into account when analyzing debt management in the transition to a market-oriented economy. The first relates to existing domestic debt which was assumed by the newly formed governments of the region.12 This inherited debt consisted of bad loans of the state enterprises and specific debts to the banking system arising from past operations, such as housing, foreign exchange liabilities to residents, foreign debt servicing, export credits, and that part of the Soviet Union bonds which became the responsibility of the newly independent republics.

To ensure their competitive viability in the new economic environment, commercial banks were recapitalized with government debt to allow them to meet their liabilities. This injection of capital merely swapped the banks’ claims on the enterprises with those on the government. Debt was reduced by earmarking privatization proceeds (Czechoslovakia, Hungary, former German Democratic Republic) or by writing off part of the debt with government deposits and financing the remainder with non-negotiable instruments which subsequently were to be retired with the proceeds from the sale of state assets (Czechoslovakia, Romania).

The procedure has been essentially the same with respect to mortgages held by the National Savings Bank (Hungary) and the foreign exchange losses resulting from the devaluation of the currencies. The governments have simply assumed the losses. In Poland the arrears in reimbursing the banks for the debt service were
converted into two-year non-interest bearing government bonds. Assets of dubious value held by financial institutions were either taken over by the governments or were exchanged for government paper. The negative balance of insurance companies was also auctioned in this way.

The second aspect is the management of new debt which results from fiscal deficits and from the acquisition of new responsibilities in the transition period, such as improved cash management. These are being financed to a large extent by attempts to cut expenditures and enhance tax revenues. Most countries have largely abandoned the policy of meeting the deficits by money creation. However, Bulgaria is continuing to do so (WB 1991a). Many (Poland, Hungary, Romania, Czechoslovakia) have attempted to close the gap between revenues and expenditures by trying to scale down subsidies, as recommended by international organizations (e.g. WB 1991a) and other advisors, and enhance revenues by eliminating tax reliefs or taking other tax measures.

Governments are also gradually moving towards substituting the reliance on bank borrowing and transfers from Russia, wherever applicable, by new debt instruments. The extent of the practice varies among the countries. Kazakhstan has implemented a broad-ranging tax reform, attempted to reduce expenditures, and continues to borrow from the National Bank of Kazakhstan, albeit at very low interest rates (IMF, 1992). Azerbaijan has floated government bonds in exchange for Union bonds and for the finance of the budget deficit (IMF, 1992). Poland has financed its 1989 budget deficit largely by printing money, but subsequently (October 1989) resorted to issuing bonds (Kolodko & Gotz-Kozierkiewicz). One type of bond the Polish government issued was convertible into cash six months after the date of its issue. A second type was price-indexed and convertible into shares of companies to be privatized (Gomulka). Short-term paper — 30, 60 or 90 day treasury bills — is also auctioned or privately placed to permit the central bank to perform open-market operations, rather than using the current administrative limits. Hungary has been experimenting with limited periodic auctions of government obligations to the non-bank public at market interest rates.

The Objectives of Organizational Reform

Understandably, the issue of government paper is only beginning to develop, and is bound to remain limited in the near future. So far the major holders have been the banks (Allen); the general public and private sector bodies can be expected to invest in government bonds over the longer term as the economies develop and interest rate policy becomes increasingly more active. Hence, the use of government paper to finance deficits needs to be given serious thought and should take into account the potential implications on the budget.

The argument concerning the adverse budgetary implications of bond-financing runs as follows. Debt servicing costs are reflected in central government budgets. A growing debt will require greater mobilization of additional resources. The tax systems are in their infancy; the inefficiencies of the tax administrations prevent the realization of expected yields; the fall in output leads to tax revenue shortfalls; the necessity to maintain and even raise certain social expenditures raises the demand on resources. One should, therefore, be cautious in issuing debt and should not allow the debt service to rise excessively to levels that are not easily sustainable in relation to GDP levels (Cheasty). Issue of government paper to finance the fiscal deficit is revenue for today’s budget, and hence may appear very attractive politically, but it is an expenditure item in the subsequent year’s budget whose servicing will have to compete with other essential services for available resources. In this respect, government bonds convertible into shares of companies to be privatized should be preferred at
this stage (Dornbusch; Allen; Kopits 1991a). Moreover, if new debt instruments are issued, the interest rate needs to correspond to the market rate if they are to be credible and acceptable by the public and other private sector bodies. The experience has been to price-index them or to use floating rates. But an interest rate at the market level will affect not only the servicing of the new debt, but also the servicing of the old debt converted into bank deposits held by the government.

These arguments are valid from the point of view of the interest burden on the central government budget. However, the implications for the economy of alternative methods of financing the deficit may be much worse. There is no doubt that non-bank financing of the deficit, if voluntary, is preferable to bank financing, since the ensuing increase in liquidity is far smaller. Certainly, either method is preferable to accumulating arrears, which very quickly destroys public confidence and threatens the success of the transition. At the present time, the major obstacle to non-bank financing of the deficits (aside from confidence in economic policies and stability of the political system), is the absence of the markets, organizations, and the capacity to manage public debt, which limits the introduction of government securities with a range of maturities and yields.

The view that the purchase of government securities should be made more attractive is appealing; but the role of debt finance can only grow to the extent that the appropriate debt management capacity is put in place. This is a longer-term question, while the financing of the deficits is a pressing issue. The onus then of redressing the fiscal imbalance appears to be more on measures that will reduce the decline in the level of output, if not orient it towards growth, and putting into place a tax system that responds to output growth and a tax administration that will enforce the tax statutes effectively.

The Needs

Issues related to tax administration have been taken up in Section II. From the expenditure side, institutionally, the difficulty of scaling down the size of spending arises from the fact that such decisions are made by parliaments under populist measures, and that the ministries of finance are very new establishments without as yet full mandate over all aspects of fiscal management. The banks continue to play a significant role in generating information on expenditures and revenues in imperfect and aggregative form, and the ministries of finance rely on this imperfect information for control and payments. With a weak system of budget accounting and monitoring they are unable to give clear directions to the other ministries to make adjustments in expenditures.

As noted earlier, the ministries of finance need to be restructured to enable them to undertake all the fiscal management functions that correspond to the demands of a market economy, including tax policy, fiscal forecasting and reporting, all budget operations (extrabudgetary funds included), and treasury and debt management. Chart 4 depicts such a reorganization, in summary form, as recommended in the case of one country. Accordingly, the present arrangements with the banks will have to be modified; and the accounting system will have to be redesigned so that systematic information can be provided on commitments, payables, receivables, and cash by the economic nature of the transactions rather than the sector to which they apply. A new set of accounting regulations will have to be drawn up. A network of computerized information systems will have to be installed which would enable cash flow forecasts, monthly revenue and expenditure reports from the individual ministries, and short-term revenue forecasts for several months to permit adjustments in expenditures. Obviously, good information systems need to be established
CHART 4: Sample Organization of the Ministry of Finance

MINISTRY OF FINANCE

MACROECONOMIC POLICY ANALYSIS
- Policy Analysis
- Revenue and Expenditure Analysis
- Revenue and Expenditure Forecasts
- Analysis of Budget Developments

PUBLIC EXPENDITURE MANAGEMENT
- Budget Estimate Preparation
- Budget Legislation
- Coordination of Public Investment
- Budget Execution
- Budget Systems Development

ACCOUNTING AND INFORMATION SYSTEMS
- Systems Development
  - Accounts Regulation
  - Computerization
  - Training and Staff Development
- Accounting Operations
  - Accounts Processing
  - Fiscal Reporting
  - Financial Reporting
  - Government Finance Statistics
- Internal Audit
  - Internal Audit
  - Compliance Reporting

TREASURY
- Domestic Debt Register
- External Debt Register
- Debt Servicing
- Assets Register
- Cash Management

TAX DEPARTMENT
in all ministries if the estimates are to be reliable. Also a training program will have to be initiated to train the staff to form the central government accounting cadre as well as the staff of the individual ministries.

In general, the treasury’s functions cover the cash execution of the budget, financing the deficit, and management of the government’s assets and liabilities. It maintains registers of domestic and foreign debt, forecasts the debt service, issues government securities to finance the deficit, and forecasts and monitors the government’s cash position and short-term cash requirements. The setting up of a treasury, consolidating the primary responsibilities for budget control, government accounting (including the extrabudgetary funds), and cash and debt management, entails eliminating the current responsibility of the central banks in this area. The individual spending agencies would then have their accounts with the treasury and the treasury would have an account with the central bank, which would act as the agent of the treasury.

The new treasury department can be designed and put in place quickly, but full development of its functions will take several years. Hence, in the interim, a two-part recommendation is made: The first is to locate in suitable departments of the ministries of finance (such as the department of foreign economic relations or the accounting department) a cash management unit in charge of monitoring deposits and overdrafts. The second is to consolidate the government accounts in a unified treasury account at the central bank with sub-accounts for each spending entity.

To conclude, the restructuring of ministries of finance will have limited usefulness in the absence of the required review of government expenditure programs, based on clear sectoral priorities within the redefinition of the role of the state in the new market-oriented systems.

**VII. TECHNICAL ASSISTANCE NEEDS**

The review of the literature highlights the need for the reform of the administrative and organizational set up if the public sector is to have a constructive role in managing the economy. In turn, private sector development would be badly hampered in the absence of a more efficient public sector and better economic management. The efforts that have been devoted over the years to the design of economic policies in the transition to the market economy now need to be devoted to the organizational machinery without which policies will have no meaning and the transition will fail.

Technical assistance is needed in large quantities in all the areas that have been covered in this paper. Subject to judicious recognition of the limits of expatriate technical assistance and of its real risks of long-term dependence, technical assistance should help the countries in question minimize the cost of the transition and accelerate it. The World Bank, the International Monetary Fund, the European Communities, the European Bank for Reconstruction and Development, the U.N. Development Programme and other international agencies have already initiated a substantial flow of expertise. The Fiscal Affairs Department of the Fund has been advising Eastern Europe and the former Soviet Republics on tax policy design and reform, tax administration, expenditure reviews, policies for an efficient and effective social safety net, reorganization of the ministries of finance, and development of the statistics appropriate for the conduct of the proposed policies. The World Bank has been active in the areas of external aid management, design of social safety nets, and investment programming. But the agencies and organizations related to all fields are advancing only negligibly. For expediency purposes the consensus appears to
be to give immediate priority to putting in place first the procedures for the implementation of proposed policies in all the areas of central government domain covered in this paper, utilize some of the existing structures, and achieve an organizational restructuring gradually over the medium term. The claim is made that a large change in the organizational structure (as required by the economics in question) is a lengthy process and will induce much poorer economic performance during the process of changing the organizational routines and reallocating personnel who are attuned to the existing set of organizations and may not be of great use if the organizational structure is destroyed.\textsuperscript{13}

Within this context one can view the creation of organizations in two separate but related categories. One category is where the tasks can be accomplished relatively quickly and easily, because it would be possible to transfer external experience with minor modifications. The other category, setting up the organizations on a sustainable basis, is more complex, has a longer time horizon, and cannot be easily handled through external technical assistance. Technical assistance will have to concentrate both on short-term result-specific aid as well as capacity building for the longer term. In the latter respect, civil service reform and adequate incentives are absolutely essential, although outside the scope of this paper.

This section lists the technical assistance needs for the organizational development of the central governments, as revealed by the survey of the literature. The list is understandably long, since in many of the countries in question the organizations and the procedures that accompany them will have to be installed from scratch. No doubt, the parameters of such technical assistance will have to be determined and designed in country-specific form taking into consideration the social, economic, and political dimensions of each case. There can be no single generic recipe applicable to all countries. The type of technical assistance for the reorganization of the central government apparatus, its sequence, and timing will have to be tailor made taking into account the many-faceted specifications of each country. Of course, not all countries will be in need of all technical assistance identified below.

**Tax Administration**

- There will be at least two \textit{immediate} technical assistance areas in tax administration. The immediacy stems from the need to raise the efficiency of collections to meet the expenditure demands.
  - Improving the procedures for the assessment, collection, auditing, accounting, and enforcement of taxes. These need to be established in general and also geared to the requirements of particular taxes.
  - Educating the staff in the exigencies of the modern tax accounting, auditing, and enforcing capabilities. There must, therefore, be immediate, as well as ongoing training.

- The reorganization of tax administration calls for two types of \textit{medium-term} technical assistance:
  - The proper location of the tax department within the ministry of finance. This calls for assistance in the design of the ministerial structure and the coordination of the interdepartmental functions.
  - The proper reorganization of the tax department along functional lines (technical, collection, information, processing, auditing etc.). This will of necessity lead to the shuffling of personnel to new offices, with new tasks and new responsibilities in which the staff will have to become proficient.
Within the international community the International Monetary Fund has the overall lead in technical assistance in tax policy and tax administration. It is to be stressed, however, that performance of the tax system is one element in the structural adjustment of these countries in which all external agencies have a profound interest.

**Budget Formulation and Monitoring**

- The *immediate* technical assistance need lies in improving the procedures for:
  - Budget adjustment.
  - Supervision of extrabudgetary accounts.
  - Promoting efficiency in the government.
  - Developing accounting systems that enable the information and control mechanisms corresponding to the management role of the public sector.
  - Starting to introduce the functional and economic classification of expenditures in a simple aggregate form.

- The following technical assistance can be undertaken over the *medium term*:
  - Full restructuring of budget classification by economic and functional expenditure categories in correspondence with the requirements of a market-oriented economy.
  - Shifting government accounting from the banking system to the ministry of finance.
  - Designing a new statistical system and collecting new statistical data.
  - Installation of techniques and management procedures for the preparation of annual budgets as well as investment budgets that go beyond one year.

- Training in techniques for expenditure reviews.
- Training in techniques for determining priorities for short or medium-term expenditure review.
- Training to improve the analytical capacity of the staff of the ministries of finance and of spending ministries to assure the full operation of the budget mechanism.
- Training in rolling expenditure planning.

- Improvement of procedures requires a total reorganization of the ministry of finance with respect to budgeting. Hence, technical assistance is needed to set up the particular departments, equip staff with the capabilities and equipment that correspond to their tasks, and give them the proper orientation to carry them out. These include:
  - Setting up a separate treasury department.
  - Setting up a department for macro analysis.
  - Setting up a department for public expenditure management.
  - Setting up a department of accounting and information systems.
  - Training to support these functions.

**Social Safety Net**

- The *immediate* need for technical assistance lies in:
  - Separating the true insurance funds from social assistance programs and locating the latter in the general budget.
Establishing links with the general budget, and especially with the ministries that handle social welfare, employment, health, social security, and employment.

- Strengthening and simplifying the administration of the extrabudgetary units to improve their management and control mechanisms.

• Over the medium term technical assistance is needed in:

  - Unification of separate pension schemes.

  - Establishing computerized record-keeping with employee identification numbers and cross-referencing with related taxes, especially the income tax.

  - Designing and developing efficient targeting criteria and techniques to screen potential recipients and identify the deserving sections of the population.

  - Developing and maintaining statistical data that enable the design of efficient targeting techniques.

  - Establishing the administrative mechanism to implement the targeting techniques.

Public Investment

The World Bank has performed a vast amount of technical assistance work in this general category over the years and provided eminent expertise in public investment programming and evaluation. This is a tailor made field for this international agency.

• The immediate need for technical assistance would be in:

  - Adoption of competitive procurement.

- Adoption of project evaluation guidelines.

- Establishing, improving, and strengthening the capabilities of ministries and departments to prepare sound projects.

- Strengthening the capabilities to review ongoing projects in order to be able to discard those that do not stand rigorous economic scrutiny.

- Improve the accounting practices for a proper execution and monitoring of budgeted projects.

• Over the medium term technical assistance is needed in:

  - Setting up the relevant units in the ministries and undertaking major training efforts to introduce new investment evaluation, programming, and management techniques.

  - Strengthening the forecasting capacity of the ministries of finance and the budget departments.

  - Introduction of investment/expenditure planning and multi-year programming.

Budget Financing and Debt Management

Many of the technical assistance recommendations, when implemented, would go a long way in rationalizing expenditures and raising the capacity to equitably and efficiently collect taxes, and help reduce the gap between outlays and revenues. The improvement in debt management capacity is a longer-term proposition and is closely linked to the developments in the financial institutions that remain outside the public sector. The ministries of finance will need technical assistance in:
• the use of domestic debt instruments which should be specified in a fully developed organic budget law;

• the installation of a network of computerized information systems which would enable cash flow forecasts, monthly revenue and expenditure reports from the individual ministries, and short-term revenue forecasts;

• setting up a treasury department within the ministry of finance (as indicated above) consolidating the primary responsibilities of budget control, government accounting, including extrabudgetary funds, and cash and debt management (thus removing the central banks from this area of responsibility); and

• Setting up a government securities market.

VIII. SUMMARY AND CONCLUSIONS

The present study reviews and assesses the recent writings on the organizational dimensions of central government finance in Eastern Europe and the former Soviet republics. Specifically, it surveys the current literature on tax administration; budget formulation and monitoring; social safety net schemes; public investment evaluation, programming, and execution; and budget financing and debt management. The emphasis throughout the paper is on organization, which is defined as the agent that carries out the designated mandates within the institutional arrangements that define and constrain its actions.

The review reveals two important and interrelated findings. First, apart from theoretical writings on institution building, property rights and transaction costs, there is hardly any practical analysis of public finance organization of operational use. The bulk of the literature is on policy rather than organizational issues. Second, there is a need for technical assistance to establish organizations in line with the requirements of market economies.

The centrally-planned economies did not need a tax administration system as it exists in western economies: the bulk of the tax revenue consisted merely of transfers debited to the accounts of state enterprises at the banks and credited to the budget. This type of system is incompatible with the requirements of market economies. A new edifice has to be constructed with emphasis on modern accounting, auditing, assessment, collection, and enforcement techniques, appeals procedures, and a rapidly growing number of individual taxpayers and private profit-motivated firms.

In centrally planned economies the budgetary process and its implementation derived logically from the economic structure built on a particular ideological foundation and the associated property rights. In that system the budgetary process was part of the preparation of the annual physical plan by the central planning agency. The ministry of finance contributed to the process only by preparing preliminary revenue and expenditure balances. Control and monitoring rested with the central planning agency. Budgeting was subsidiary to the plan and meant merely fine tuning the spending programs.

The transition to a market economy reorients the role of government and gives to the ministry of finance a prominence it never had under central planning. It now has to give up its passive position and start actively managing the economy by allocating resources among competing ends. In the process, it will have to be totally reorganized in line with the functions that correspond to those of a market economy. New procedures need to be adopted and new departments have to be set up. The two are intricately related, as procedural changes by
necessity lead to the reorganization of the institution. The capacity of the ministry of finance will have to be built up to make it an organization with accountable management.

In its new role as active resource manager the ministry of finance will have to deal with short-term needs as well as long-term requirements for growth. The prevailing fiscal deficits, exceeding 10 percent of the GDP in some cases, underscore the significant and trying role of the public sector in economic stabilization, in a period when expenditures do not reflect market orientation, but revenues do. It is difficult to cut back expenditures and increase tax revenues during the transition period. The decline in output has prevented the reformed tax systems from yielding the expected revenue at a time when pressures are mounting for new types of expenditures which made their scaling down very hard. Although the governments are gradually moving towards replacing past reliance on bank borrowing by new debt instruments at market interest rates, the issue of government paper is understandably only beginning to develop, as conventional financial instruments are absent and capital markets are underdeveloped.

Countries of Eastern Europe and the former USSR provided virtually free education, health care, culture, and transportation services, and implemented a comprehensive system of social security and welfare and a uniform system of income and consumption. Open unemployment was inconceivable under central planning. In the transition, most implicit and explicit support through traditional price controls has been eliminated and there is no guaranteed employment. New social protection schemes need to be designed and structured to prevent groups of population from finding themselves in situations of socially unacceptable living standards. There is an urgent need to establish targeted and administratively efficient safety net schemes for short-term transitional emergencies, as well as permanent programs for the long-term.

Investment management still carries the legacy of central planning which had no well-established system of benefits cost-analysis of government expenditure programs. Project preparation was dominated by engineering inputs. This state of affairs continues, and is a hindrance to sound management of economic resources.

The task of reorganization and reconstruction is enormous. A vast range of technical assistance is required for the immediate term and for the longer run in correspondence with the radical turnaround in the role of the public sector as manager of economic resources. The tasks range from complete overhaul of the tax administrations, set up during the transition, to restructuring the ministries of finance to give them the full mandate of fiscal management a market economy requires. New procedures will have to be introduced and concomitantly new departments will have to be created in correspondence with the new functions the ministries will assume. Other functions will have to be relegated to other agencies. The long list of technical assistance needs attest to the severity and extent of the challenge at hand. Although civil service issues are outside the scope of this paper, few if any of the improvements suggested can be sustainable without civil service reform and adequate incentives.

The success and speed of the transformation depend upon the extent to which transaction costs can be minimized within the process of reorganization of the central government agencies, as well as upon its consequences for the economy as a whole. How long should it take to restructure the tax administrations and ministries of finance in line with requirements of a market economy? How should one proceed in this reorganization? What type of taxes should be introduced? What type of social assistance programs should be implemented and how? Can the budgeting process incorporate long-term considerations, especially under the prevailing turbulent circumstances? These are but few of the
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myriad questions that need to be answered, in terms of the social costs they involve. This is not easy. We do sense that some organizational forms must evolve from within the countries themselves, and others will have to be imported. We are not, however, clear on which forms of organization belong to which category, nor do we have a conceptual framework or body of empirical evidence to enable us to identify them. The international community is groping its way in designing the technical assistance that will help reduce the transaction costs and accelerate the transition.

NOTES

1. Among such laws perhaps the most important are those that relate to property rights and contracts. This paper will not enter into details; the literature is vast. Suffice it to note that the ownership rights to an asset — to use an asset, to appropriate its returns, and change its form and substance — will have to be reformed in a way which will put the effective control in the hands of those who can use these rights most productively (Williamson; Gelb & Gray; Blommesteen & Mares). This change is a pre-condition for all other reforms. Since property rights promote economic efficiency by internalizing net benefits of resource use and minimizing the transaction costs of exchange, all other reforms will lack a strong underpinning, unless the issue of property rights is solved and the appropriate legal framework is set up within which deals can be contracted. (Brenner; Dornbusch; Rausser; United Nations). This is a key issue which also governs the relations between government and citizens in that both will have to be equally subject to contractual obligations and to law, rather than law being an instrument of government as was the case in the former Soviet Union.

2. Local government finances and the implications of decentralization for public sector management remain beyond the scope of this paper, and are treated elsewhere in this volume.

3. This is obtained by scanning the extensive multi-language (English, French, German, Spanish) bibliographical references contained in the Journal of Economic Literature; the contents of the catalogue files of the Joint Bank-Fund Library; and the country reports of the World Bank (WB) which has marshalled expertise in the areas of stabilization and adjustment, privatization, trade and price liberalization, financial and physical infrastructure, agriculture, and social security and human resource development.

4. One could view this as a case of joint production: the control of taxation was a by-product of the strict control by the state of the process of production. I am grateful to Thrainn Eggertsson for pointing this out to me.

5. In Russia the system of profit transfers was replaced by an enterprise income tax in 1991 (IMF/WB/OECD/EBRD).

6. Central and Eastern European countries had relatively well developed social security systems prior to the establishment of socialist regimes. The central planning that the socialist regimes espoused widened the extent and transformed the institutional and financing structure by, among others, price controls; access to consumer goods; guaranteed employment; free health care and education; old-age, disability, and survivors', sickness, maternity, and family benefits provided through the places of employment (Kopits 1991a, 1992).

7. For some brief information on the other independent Russian republics' safety net systems see IMF 1992.


10. In Poland investments have been cut by 73 percent in real terms over the past four years, while current expenditures have been trimmed by 26 percent (WB, 1992d).

11. For example, in Poland, when the automatic tax collection procedure from the enterprises' bank accounts was suspended, the enterprises successfully delayed...
their tax payments. Also, the reduction in the corporate tax rate and the introduction of an assets related tax turned out to be a revenue loser (Gomulka).

12. Although the scope of the paper is confined to the operations of the organizations of the central government, in the pre-transition period it is impossible to draw a clear line between the debt of government proper and that of the state enterprises and the banking system. Hence, the domestic debt inherited by the new governments refers to its overall amount defined as net claims of the private sector on the government, government organizations, and the state-owned banking system.

13. One could counterargue that reform is tantamount to change, maintaining the old organizations would impede the change, would run counter to the objectives of the reform, would perpetuate the continuation of the old interests and assure that reform would progress at a speed that suits the managing groups and may even deter it (Popov). This would be especially true if the old organization was highly dependent on the structure of the old political system.
ANNEX
A PARTIALLY ANNOTATED BIBLIOGRAPHY


On economic policy: price liberalization; exchange and trade liberalization; exchange rate policy and reserve management; monetary policy; interest rate policy, incomes policy; privatization. Half a page on fiscal policy in extremely general terms.


The Bank also finances public sector projects in infrastructure, telecommunications, transport, and energy systems.


Assesses inequality and poverty in transition economies and the constraints for policy making. Discusses policy options for formal social security systems and temporary protective measures.


Deals with the management of the existing and growing domestic debt and stresses the need to develop financial markets to encourage financial saving.


Refers very briefly to the changes in the tax system in Bulgaria since 1988.


Refers very briefly to the changes in the tax system in Poland since 1988.


Official aid transfers would be more likely to hurt rather than help. Instead, reformers need to recognize that the only way to create the conditions necessary for self-sustaining economic growth is to move toward a market economy as fast as possible.


There may be a general acceptance of the need for structural adjustment, but there is also the expectation that such transformation should not be allowed to encroach on the interests of any major social group. Political support must be mobilized from new economic groups with an interest in change who expect to benefit from the transition to a market economy. Also, there are strong popular expectations that the new "democratic" governments will be even more responsive to all their various demands than the former communist regimes. Thus the demand on the government as "employer" remains far stronger than the active search by individuals and enterprises to seize new opportunities offered by new economic conditions. Where governments give in to demands in order to avert social revolt they merely delay the necessary changes, confirm popular expectation, and provoke further demands from other aggrieved groups.


Is against the current methods of assistance. Prefers technical assistance rather than financial support, especially for the development of the human and financial substructure. These can be purchased by the reformists themselves. The current methods of assistance to the Eastern governments do not reflect the merits of the case.
but rather the climate of opinion, the play of political forces, and above all the influence of the aid lobbies, especially the international organizations, in politics, the media, and the academies.


Brenner, R. 1991. From Envy and Distrust to Trust and Ambition. Eastern Europe’s Problem: How to Solve It and Why It May Take Long. Univ. de Montréal: Centre de Recherche et Développement Economique. Cahier 0391. Credible legal reforms enabling the emergence of private property rights must be enforced first, without which other reforms cannot be implemented. Legal reforms should take place by letting the "customary laws" of informal markets become the core of laws concerning private property and contracts. It would be a mistake to either impose such laws from above or transfer Western laws to countries in which there is no legal tradition.


Carter, Neil. 1991. "Learning to Measure Performance: The Use of Indicators in Organizations." in Rhodes, R.A.W., ed., The New Public Management. Oxford, England: Basil Blackwell for the Royal Institute of Public Administration. Demonstrates the conceptual and technical complexity in measuring effectiveness, discusses the feasibility of developing consumer oriented indicators. Although the form a performance indicator system takes will be contingent on the needs of different organizations, the findings suggest that there tends to be an evolutionary pattern of convergence between the indicator systems. Contains a lengthy discussion on what constitutes a good performance indicator.


Centre for Cooperation with European Economies in Transition. 1991. The Role of Tax Reform in Central and Eastern European Economies. Paris: OECD. An attempt to examine current or proposed tax reforms in Central and Eastern Europe and compare them with trends on OECD countries without doing so.

Chand, Sheetal K. and Henri R. Lorie. 1992. "Fiscal Policy," in Tanzi, Vito, ed., Fiscal Policies in Economies in Transition. Washington, D.C.: IMF. The inherited fiscal systems are not geared to the requirement of a market economy. Expenditures need to be contained and directed to new goals. The tax administration will have to be capacitated to tax a rapidly growing number of private and profit-motivated firms. Several limitations will have to be overcome on the expenditure side. New approaches to the determination of goals and means are needed, including reducing the size of the government. Budgeting and expenditure management systems will have to encourage spending agencies to avoid waste. Government administration, and the tax administration in particular, will have to be reorganized, retrained, and recruit new staff to install an effective monitoring system. Capability will have to be built for undertaking cost-benefit evaluations of expenditure programs. Expenditure control and accountability will have to be stressed. Institutional practices for financing a budget deficit and managing cash will also need to be reformed to accommodate a market economy. The budget can no longer be financed through monetary accommodation. Spending agencies will have to change their operating procedures to cope with this hard budget constraint.


Clague, Christopher. 1991. "The Journey to a Market Economy," in Clague, Christopher C. and Gordon Rausser, eds., The Emergence of Market Economies in Eastern Europe. Oxford: Blackwell. Among the tasks of the transition the design is mentioned of a system of taxation of the new private sector, i.e. defining accounting rules for taxation purposes, organizing an Internal Revenue Service to collect taxes from the private sector.


Organizational Dimensions of Public Finance in Transition Economies


A discussion of suitable taxes.

On economic reform with no reference to public sector. The familiarity with the institutions and functions of market economies could lower the costs of transition. Ingrained habits, in contrast, may raise them, because of resistance to change.

On IMF stand-by arrangement negotiations.

In a brief section on the public finances the paper refers to the passive and subordinate role of fiscal policy and to the difficulty of initiating large scale tax reforms in face of expenditures on the social safety net.


Report submitted to the Slovak Ministry of Finance. The report examines the existing taxes, analyzes the tax reform and the administration of all the taxes. It finds the main danger of the tax reform and the transition to the market economy in the insufficient capacity to implement the new taxes for the rapidly growing number of private business enterprises. It recommends that the administration of the income tax, VAT and excise duties be combined; that the local tax offices and the Ministry of Finance be reorganized along functional lines, and that legislation and tax administration be separated.

Refers to fiscal reform as part of the transformation program, but merely mentions that Hungary has already instituted a VAT as well as a corporation and personal income tax, and that Poland plans to institute a VAT.

The paper is on the new trend of budgeting which aims to forge a more direct link between the allocation of resources through the budget and performance in reaching objectives. The focus is on developing measures of output and assessing productivity in government. The paper examines the meanings of efficiency and performance. It reviews the quantitative techniques used for this purpose and discusses their limitations.

As necessary institutional reforms the paper recommends first the paring of central budget expenditures, while maintaining a social safety net. Military expenditures, foreign aid, investment projects with long payoffs, and subsidies to non-essential consumer goods are among the obvious targets.

Argues for 4 principles: (a) the administrative and political capacity to design and implement policies must be devoted to achieving what is essential; (b) reforms should not lead to more encompassing government action; (c) government should retreat immediately from producing and distributing goods and (d) the government should protect a small targeted group only. The two most important items
on the agenda should be first the establishment of
the rules of the game, and second, the creation of
institutions (the fiscal and legal system, pensions,
and social safety net). Argues against gradualism
and for a rapid radical reform. Favors importing
and adopting wholesale and without question the
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well functioning.

Dyba, Karel and Jan Svejnar. 1991. "Czechoslovakia:
Recent Economic Developments and Prospects,"
On the scenario of economic reform submitted by
the Government on Sept. 1, 1990. Among its
components are, among others, a major tax
reform, a budgetary reform stressing transparency
of budgetary allocations, and a restructuring of
social security and health care systems.

Eggertsson, Thráinn. 1990. Economic Behavior and
Institutions. Cambridge: Cambridge University Press,
385 pp.
Surveys institutional research under way in various
branches of economics and brings together such
topics as the economics of property rights, the
theory of the firm, industrial organization, and law
and economics.

Economy: Nature of the System and Implications for
pp. 11-27.
The paper outlines the traditional Soviet economic
system, develops its logic of institutions and
interactions, points out their natural economic
consequences, lists the characteristics that define
the system, and discusses its strengths and its
weaknesses. There is no reference to the Ministry
of Finance or to any fiscal institution when
discussing the requirements of reform.

Challenge, 34:4. pp. 4-10.
Neo-classical economists tend to assume that
human adjustments to new situations and signals
will be essentially swift and basically
unproblematic. Hence they advocate shock therapy
when in fact frictionless transition is an illusion.

Socialist Economic Transformation," Journal of
Economic Perspectives, pp. 91-105.
Discusses the elements of reform (macroeconomic
stabilization, price and market, enterprise, role of
the state) and sequencing of reforms among which
he includes tax administration, budgeting, legal and
regulatory institutions, but says absolutely nothing
on them.

Reform of Socialist Tax Systems," in Tanzi, Vito, ed.,
Fiscal Policies in Economies in Transition. Washington,
D.C.: IMF.
Argues the need for immediate tax reform to
establish compatibility with the market-oriented
economy, to facilitate and support the other
economic reforms, and achieve macroeconomic
stability. Identifies the major objectives and
constraints in the short and the long run, and
outlines appropriate alternatives for tax reform.

Gelb, Alan H. and Cheryl W. Gray. 1991. The
Transformation of Economies in Central and Eastern
and Research Series, 17. 74 pp.
Among the elements of transformation is also
reorienting the role of the state in the economy
toward a regulatory role. Concurrent reforms are
needed in the central institutions of government,
including the central bank, tax administration, the
expenditure budget and control system, and policy
making bodies. Although substantial progress has
been made in many areas of legislation and
economic regulation and in reshaping public
institutions, institutional capacity to implement the
new legislation is severely constrained by the
shortage of experience and relevant skills.
Moreover, in many cases they need to reduce its
overall size, retrain many remaining civil servants,
and maintain and if possible augment the small
cadre of well-qualified policy analysts and
decision-makers. Both spending priorities and
means of financing government need major
overhaul as reforms proceed. Indeed, the public
sector has a very important role to play in
improving the network of roads, ports, water and
sewer systems, telecommunications, and other
infrastructure needed for private firms to function.
The tax administration must be reoriented to deal
with hundreds of thousands of private firms and
individuals. This requires techniques of selective
auditing and tax enforcement, standard accounting
practices, and a reliable and objective legal
framework for dispute resolution. Central
institutions of government - including those in
charge of budgeting and tax collection - need to be
strengthened. It is clear that none of the reforming
countries has adequate administrative capacity.
Because techniques are standard across countries,
technical assistance from industrial countries in tax administration is especially valuable.


Examines the features of several budgets from 1983 to 1990.


Drawing upon the experience in Great Britain, the article investigates the relationship between the Financial Management Initiative (FMI) and the characteristics of central government to which it was applied.


Basically on tax systems, except for a short reference to the fact that stabilization programs require tight fiscal policies to control budget deficits, that a tight fiscal stance generally leaves little room for revenues to fall, and that hence it is difficult to eliminate old and reliable sources of revenue even if they do not support the goals of a market economy. Maintaining revenues to meet balanced budget targets during the transition is even more difficult given the unemployment and the slowdown in growth that tend to accompany the process.


Deals with the private sector, intellectual property, and foreign investments.


Explains the laws related to rights to real property, rights to intellectual property, companies, foreign investment, contracts, bankruptcy, competition, and judicial institutions. The administrative and judicial machinery to implement them is developing slowly.


In the technical assistance area the Fund has reached unprecedented levels and has marshalled expertise available, within and outside the institution, in fields like exchange systems, central banking, fiscal administration, economic legislation, and statistics.


Deals solely with economic policy.


Examines federalism and decentralization issues; identifies possible problems that might arise if currently discussed reform proposals are adopted; discusses the trade-offs that policymakers face in designing the intergovernmental fiscal system; and analyzes alternate systems in developed market economies with a view to deriving relevant lessons from their experience.


A discussion on professional management in the public sector.

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Examines the implications of economic reforms for tax policy and stresses the constraints on the administrative capacity of the bureaucracy and the compliance capacity of taxpaying population.


This is purely on economic policy; contains nothing on the public sector.


Discusses the challenges and constraints of fiscal adjustment and refers to the specific case of Poland.


Discusses the old system of taxation, subsidies, social security etc. Recommends a restructuring of government finances to approximate a tax system close to that of EC countries. Warns against widening fiscal imbalances resulting from the upward pressure on government expenditures despite the reduction in some of spending items, since this is likely to occur at a time when revenues will fall. Useful to note is his reference to the ill-equipped authorities to create a cost effective social safety net and the difficulty of initiating a systemic and comprehensive review of public investment at various levels of government and to apply standard social rate of return criteria to account explicitly for external economies and diseconomies.


Outlines options for a fundamental and urgent reform effort to encompass the restructuring of pension schemes and payroll-based contribution rates.


Discusses the main tasks of public finance in the process the country's economic transformation.


Recommends funded private pension schemes as a supplement to public pension plans. Also suggests that assets obtained through privatization of state-owned enterprises be used to offset public pension liabilities.


Discusses the main tasks of public finance in the process the country's economic transformation.

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Murrell, Peter. 1991. "Evolution in Economics and in the Economic reform of the Centrally Planned Economies," in Clague, Christopher C. and Gordon Rausser, eds., *The Emergence of Market Economies in Eastern Europe*. Oxford: Blackwell. Makes an argument against large changes in organizational structure via radical reform; advocates the useful role the organizations of the pre-reform economy can have since organizational efficiency is intimately tied to the exercise of a particular routine or narrow range of routines, while large changes in organizational structure induce much poorer economic performance during the lengthy and difficult process of change. However, by tying the efficacy of the old institutions to the structures of the old political system, the paper appears to defeat its own argument, since organizations lose their efficacy by high dependence on the political system.


On economic reforms.

Defines institutions as the rules of the game in a society, or, more formally, as the humanly devised constraints that shape human interaction. In other words, institutions define and limit the set of choices of individuals. Institutions affect the performance of the economy by their effect on the costs of exchange and production. Together with the technology employed, they determine the transactions costs that make up total costs. Transaction costs in political and economic markets make for inefficient property rights. Organizations include political, economic, and educational bodies and are primarily agents of institutional change. Organizations are created with the purposive intent in consequence of the opportunity set resulting from the existing set of constraints. They are designed to further the objectives of their creators: to maximize wealth, income, or other objectives defined by the opportunities afforded by the institutional structure of the society.


The paper is on the tax system and the characteristics it should have to ease the move to a market economy. The constraint imposed by the tax administration on implementing the tax reform is noted.

Oxley, Howard, et al. 1990. The Public Sector: Issues for the 1990s. Paris: OECD, Dept. of Economics and Statistics. 86 pp. Although the publication relates to DCs important lessons may be drawn for CIS. The relevant sections are those dealing with reforms in public sector management, introducing market disciplines into the public sector, improved procurement practices, and franchising and private financing of public infrastructure. The intention is to restrain public spending.

Paull, Gillian K. 1991. Poverty Alleviation and Social Safety Net Schemes for Economies in Transition. Washington, D.C.: IMF. Working Paper WP/91/14. The paper attempts to develop a general income support scheme that could serve as a model to alleviate poverty in the transitional phase. The underlying concept is income maintenance that is conditional upon fulfillment of forward-looking requirements such as workfare, training or job search.

Popov, Gavril K. 1992. "Moscow's Testing Ground for New Forms of Economic and Political Life," The Cato Journal, 2:3. pp. 337-342. In most regions of the country the apparat was the dominant force. As a result, the idea of restructuring the apparat turned into a project that suited the apparat forces. Hence the country can change only at the speed that suits the apparat.


The orthodox prescription for the public sector focuses on the policy space: macroeconomic instruments to control inflation, the removal of price controls, trade liberalization, currency convertibility, financial discipline, privatization, and de-monopolization. These, however, cannot be effectively implemented without an underlying constitution and a legal and regulatory infrastructure (LRI). Only if a constitution is designed that defines basic rights and an associated LRI secures those rights can economic policy reform be sustained on a number of fronts.

Discusses the difficulties and problems involved in instituting and implementing a VAT when the legal bases will have to change, and underscores the powerful role the ministry of finance will have to acquire with the change to a market economy.

The paper aims to (a) determine what is known about capacity constraints in key public institutions involved in the transition, (b) identify current and proposed actions by the World Bank and other donors, and (c) indicate critical institutional issues that might be the focus of future operational work and research by the World Bank. In this context the targeting of investment priorities, civil service reform around organizational structure, mechanisms to assure accountability, training, and overhauling of tax administration and budgeting weigh heavily.


All the countries of Eastern Europe have aimed at streamlining public administration while establishing new public institutions such as the tax, privatization, and antitrust agencies. But the process is hampered by numerous bureaucrats, state enterprise managers and others who perceive themselves as the likely losers if the process continues. There is also growing discontent with the emergence of the visibly rich individuals, often from the ranks of the former communist nomenklatura. All these factors hold back the process of transformation. The Tax Office is still one of the least developed and hence ineffectual government agencies.

Comments that expenditures for operation and maintenance should be given first priority, even if this means reducing the level of investment.

The centrally planned economies have been very effective in developing revenue systems that have raised high revenues at low administrative cost. The new systems that will replace them will almost surely yield less revenue, hence public spending must be reduced. Moreover, the tax administrations must be given greater powers and substantially expanded and strengthened.

The countries are characterized by underdeveloped fiscal and monetary institutions whose creation will require important legal and accounting reforms which will take time to implement. The creation of a tax system requires much more than the writing up of tax laws. It requires the creation of the relevant administrative set-up, the education of the taxpayers etc.

Surveys some of the major tax issues that will arise or have arisen in reforming the economies in transition; provides a broad description of the main characteristics of these countries' tax system under central planning; describes the major changes that
have occurred and discusses the remaining agenda for tax reform. The fundamental reforms will be in attitudes, in the statutory characteristics of the tax systems, and in their administrative set-ups. Policymakers should refrain from choosing "essential" and "non-essential" investments through tax rate differentials or incentives to enterprises in given activates. The tax administrations that exist in these countries have served them well in connection with their traditional tax systems. They would be inadequate to cope with the new developments. New administrations should be created. This is not easy since tax administrations do not lend themselves to reproduction through cloning. In this area progress has been very slow. The design of adequate administrative mechanisms must be developed.


On economic policy. Refers very briefly to the changes in the tax system in Hungary since 1988. The codification of taxation represents a decisive element in the change of the state's economic role. Social security will be separated from state finances and will exist independently relying on its own sources of income. Another institutional change worth considering is the establishment of an audit office for the control of state finances.


The Bank has been active in macroeconomic policies towards stabilization and adjustment, enterprise reform and privatization, financial and physical infrastructure, social safety net and human resource development, agricultural development, public sector management through EDI, and financial sector and capital market development through IFC.


The paper looks at the changes needed in fiscal institutions and discusses the establishment of Western style tax administrations, the main elements of the reform of the tax system, social security reform, the implementation of a modern budgetary system, and the reform of public expenditure. It cautions that simply transplanting Western institutions is likely to lead to disappointing results.


A review of the transition economies -- Eastern Europe and the former Soviet Union -- and a discussion of the international support for transformation. Chapter 6 is particularly important, since it deals with property rights and the privatization process. It argues that establishing clear property rights is the necessary prelude to move to the market economy and to the privatization process. It also makes a case for external assistance for institution building in the transition economies.


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The three papers discuss the current status of social safety nets in these countries, and elite and public opinion on these issues.


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Organizational Dimensions of Public Finance in Transition Economies

Extends the use of transaction cost economics to the study of economic organizations and explores its implications for public policy.


Has a short section on Macroeconomic Management and Financial Sector Reform.


Volume I deals briefly with fiscal policy without reference to institutions. Volume II is sectoral analyses, excluding the public sector, but including the social security system and proposals for reform. Accordingly, holding the line on current entitlements is recommended for the short run reforms are being designed.

Sees the role of the state as provider of equity and security without seriously undercutting the objectives of economic efficiency; as promoter of competition and avoider of monopolies; as regulator of monopolies; as provider of economic and social infrastructure; as handler of pollution externalities. The state must play a positive role in building the institutions and implementing the policies that accompany using the market as a basic tool of management. The institutional reforms it considers refer to the social safety net; the economic safety net (ability to mobilize external resources); commercialization of SOEs; and encouragement of foreign investment.

Although this is not specifically on ex-socialist economies, lessons may be derived. It calls for a different, probably smaller, but nonetheless strategic role for the public sector. Three themes are treated in detail: the management of public spending, cost containment and improved institutional effectiveness in the civil service, and improved performance of public enterprises. The conceptual thread unifying the three themes is that their reform requires both the downsizing of public sector efforts and the strengthening of core central governmental organizations. The main lesson is that reform takes root and flourishes only over relatively long periods of time.

Identifies four areas of governance: public sector management, accountability, the legal framework for development, and information and transparency, but discusses on the last three. It reveals that the World Bank has been focusing for some time on improvement in overall public sector management emphasizing public expenditure management, and civil service reform (cost containment measures, strengthening personnel management and the effectiveness and efficiency of public agents). It has historically focused on financial accountability in the context of investment projects, on the efficiency of resource use in public investment programs, on procurement practices, on contracting out of services to private providers, and on public-private and public-public competition. It has been developing service level indicators, especially in relation to environmental projects. The Bank has also been active in assisting governments in decision-making for public expenditures, improving public procurement undertaking country procurement assessment reviews. It has actively assisted governments in improving the transparency of the budgets. It has a long record of helping countries build the institutions and discover the practices which are essential for an efficient economy.

The study evaluates the overall social policy system. It proposes reforms to strengthen the defense against poverty, to raise the quality and
equity of social programs, to ensure financial sustainability, and restore incentives suitable to a market economy. It summarizes the economic context of social policy, postulates how expenditures may develop in the future, makes recommendations for needs for reform, and discusses the major implementation issues, in particular: (a) the new relationship between local and central government in the administration and financing of social policy; (b) the tasks of administering a new "selective" social policy, including problems of means-testing, information exchange, and monitoring of system performance; and the linkages between tax policy and social benefit policy.


LOCAL GOVERNMENT FINANCE IN TRANSITION ECONOMIES: Policy and Institutional Issues

Richard M. Bird
Christine I. Wallich

I. INTRODUCTION

An important and unduly neglected aspect of the changes taking place in transition economies is the extensive decentralization, both political and fiscal, that is taking place in many of the countries newly emerging from behind the socialist veil. Decentralization represents both a reaction from below, to the previously tight political control from the center, and an attempt from above, to further the privatization of the economy and to relieve the strained fiscal situation of the central government.

Despite much talk about "autonomy" and "fiscal independence", few of the countries surveyed here offer their subnational governments much in the way of fiscal discretion. Indeed, most recent legislation has focussed on codifying the revenue side of the equation, before deciding what the expenditure responsibilities of local governments should be, in effect, putting the cart before the horse. Expenditure "autonomy" is codified in legislation, but not really effective: an inadequate revenue base on the one hand, and spending mandates and norms on the other together limit the effective budgetary autonomy at the local level.

This paper argues that the ongoing reforms of subnational finance in the transitional socialist economies are much more important than seems generally to be recognized. Intergovernmental finance is not a "local matter". How services and goods are provided by various levels of government and who pays for them have consequences that extend throughout the economy. In transition economies, the design of fiscal federalism is crucial — we argue — because it affects almost all of the key goals of reform, including macroeconomic stabilization, the effectiveness of the social safety net, private sector development, and, in the case of Russia, even nation building. How a better designed fiscal system can contribute to these goals is the subject of this paper. A broader framework than is customary is needed to analyze intergovernmental fiscal issues in the transitional economies. This framework must incorporate such elements as the likelihood of ongoing structural changes in the economy and continuing political shifts, the need to undertake intergovernmental reforms while coping simultaneously with stabilization pressures, and the likelihood of continued local public ownership of enterprises on a significant scale.
II. THE CHALLENGE OF DECENTRALIZATION

One of the most important characteristics of the process of political and fiscal decentralization now taking place in the transitional countries of eastern and central Europe is how very recent it is. In Poland and Hungary, for instance, the local governments were established in their present form in 1990, in Romania, Bulgaria and Russia in 1991, and in Albania in 1992. In most cases, additional important legislation came even later — e.g. legislation to set out local revenue sources (such as Poland’s 1991 Act on Taxes and Local Fees) — and in many countries it is still to come (e.g. laws outlining the precise ownership and control of some important local assets).

Key elements of the legal framework needed for efficient local government are still missing in most countries, and further structural changes (such as the introduction of intermediate-level regional governments (Section VI) are still under consideration in countries such as Poland and Bulgaria. Although the evolution of local government has clearly begun in all the transitional countries, it has by no means ended. Indeed, to paraphrase Winston Churchill, far from being near the "beginning of the end" of this process, at best some countries may be near the "end of the beginning."

Problems of Design and Implementation

What remains to do? A great deal. Even after the basic structure of local government is established, local elections still have to be held, new local governments established, and a myriad of important administrative details determined. In Romania, for instance, the first local elections were not held until February 1992, and the new mayors did not take office until April 1992. In the Russian Federation, the first local elections were held in November 1990, in Hungary in April 1991, and in Albania in 1992. Even after a year or two of experience, mayors and local officials in some countries, particularly in the smaller communities, often appear to have little idea of their real powers, responsibilities, and limitations.

Moreover, matters are not much better at the central government level in some countries, where all too often no one really seems to be in charge of decentralization. Although the extent to which there is real decentralization differs from country to country, all too often, key decisions seem to have been made rather hastily and without empirical basis. One result is that some key issues appear to have been decided (or left undecided) more by accident than design. This is particularly true of issues concerning the interaction of the new local government fiscal structures with such critical elements of the transition process as privatization, stabilization and tax reform, financial sector reform and infrastructure finance, price and subsidy reform and income distribution policies. Such neglect bodes ill not just for the local government sector but also, to varying degrees, for the ambitious reform plans in all these areas of policy.

The Political Dimension

Decentralization is both politically and economically driven. Central governments in most countries seem to want "each tub to sit on its own bottom", that is, to assign taxes, reduce transfer dependence and be done with local government concerns. This is the economic dimension, as seen from the center. Local governments, especially the richer ones, also want to shake off the shackles of past central control and be "masters in their own house" — the political dimension from the local level. However, local governments, while seeking full revenue autonomy still expect expenditure subsidies, given that the fiscal bases bestowed upon them are inadequate. This mismatch between local governments' political aspirations and their economic powers is problematic,
inefficient, and probably untenable in the long-run.

**Lurking Dangers**

Unless more systematic attention is paid to such questions in the near future, matters seem likely to deteriorate. Up to now, many potential difficulties have been kept in check largely by the continuance (de facto if not de jure) of the pre-reform system. Under this system, local governments receive most of their funds from central government budgetary transfers which are basically allocated on the basis of negotiation and bargaining. The central government always has the upper hand in this process since it controls not only the total amount of such transfers, but also who gets them, and when. When combined with the continued central control in most countries of such critical determinants of local budgets as wage structures, enterprise prices, and so on, and the habit of local dependence on central guidance, the de facto persistence of the ancien régime in most countries has played an important role in preventing local budgets from exacerbating the generally tenuous fiscal situation of the central government. However, the fiscal squeeze at the local level, and the emerging difficulties with the "transitional systems" make the need for a more systematic approach to policy development clear. The phenomenon of decentralizing expenditures without decentralizing resources has of course, been attempted in many countries long before the Eastern European transition. The objective has been similar — carried out as a way to meet stabilization targets and achieve "hidden" expenditure cuts. However, the peculiar nature of the soft budget constraint in transition economies mean that the outcomes may be very different.

In the absence of strong central political control, this situation of unbalanced spending mandates and revenue authorities seems unlikely to continue in the long run. Already, some countries are finding that the combination of strong political forces urging more local control and the unbalanced mandate — virtually unfettered "local autonomy," but a totally inadequate fiscal base — that has been legally bestowed on the new local governments is causing trouble. In Hungary and the Czech Republic, for example, central authorities have been concerned about the implications of local government's new business activities and local government borrowing — although in practice the results do not yet appear to be very serious. In Russia, the only formally "federal" transition economy, separatist tendencies fueled in part by fiscal pressures and imbalances are exacerbating more fundamental political problems.

At present in most of the transition economies, those local officials who are not simply waiting, more or less passively, for orders to come down from above — as they have for decades — have understandably been using their energies primarily to attempt to wheedle more money out of the central government. In Romania, for example, where the entire 1992 transfer budget to the subnational level was spent by the middle of the year — largely on centrally-mandated subsidies to enterprises — Bucharest city officials were to be found two or three times a week at the Ministry of Finance trying to secure more funds. The need for a more transparent — and equitable — transfer design is clear (see section V). Those local officials fortunate enough to possess clear title to significant assets have been selling them off and using the proceeds for current expenditures (as in towns in the Czech Republic) or trying to use their assets as equity in joint ventures with foreign investors (as in towns in both Hungary and Romania).

On the whole, there is, as yet, little evidence at the local level of widespread inter-regional differentials in the provision of essential services, other than those resulting from the general fiscal penury afflicting all countries in the region, although in some, regional differences seem primed to emerge (Section IV). Similarly, and in
part reflecting the relatively undeveloped financial sector, there is as yet little evidence of either significant local budgetary deficits or excessive local borrowing. As it becomes increasingly difficult to squeeze money out of the center, however, as well as more difficult to secure easy revenues by selling off assets (certainly not a good option for financing re-current spending), more and more local governments in all countries are likely to find moves in such undesirable directions more tempting. It is thus critical to use this time of transformation and reform — the "middle game", as it were — to develop a more satisfactory local government fiscal and financing framework.

III. FISCAL DECENTRALIZATION - ITS RATIONALE IN TRANSITION ECONOMIES

Political decentralization has been paralleled by decentralization of fiscal responsibilities. In most countries, autonomy and control over (often ill-defined) "local matters" is increasingly being devolved to local governments. Most of the new local government legislation thus affirms decentralization, local financial autonomy, and the administrative independence of local governments from central control. The language differs, but the general intent is clearly to free local governments from the dead hand of central control with the implicit assumption that this would let local democracy flourish, and make for a more efficient local government. Presumably, this would occur without compromising the attainment of the broader reforms under way in the transitional economies, such as stabilization and privatization. It is far from clear, however, that the costs and benefits of the local and intergovernmental fiscal structures that are being set up have been adequately studied, or that they will support all these goals.

The End of Central Planning

Some form of local government structure had of course existed in most of the transition economies under the socialist regime. However, the fiscal system of this regime was essentially unitary (all taxes were centrally set and collected) and local governments were little more than administrative units or "departments" of the center, with no independent fiscal or legislative responsibility. Policy-making was controlled and centralized, and local governments had virtually no independent tax or expenditure powers — part of a larger picture in which the budget, and the Ministry of Finance itself was seen only as the handmaiden of the central plan.

Now, however, virtually every transition economy is in varying degrees decentralizing, deconcentrating, and delegating functions and responsibilities. ("Deconcentration" refers to dispersion of responsibilities within the central government structure from the center to regional "branch offices." It differs from "delegation" in which local government may execute certain functions on behalf of the central government — and be accountable to it for their performance — and "decentralization," in which full decision-making and implementation authority is transferred to local government, which is accountable only to its own constituents).

Why Decentralize?

Decentralization has many merits, both in political and economic terms. It has, for example, the potential to improve the efficiency of local government by subjecting its actions to the scrutiny of the local electorate, by sharpening both the articulation of, and response to, demand for public services. In a well-designed
intergovernmental system, local governments, fully accountable to local constituents, are in a better position to identify and respond to their needs. Residents obtain what they want (and are willing to pay for), rather than what the center provides. This is the standard "efficiency case" for decentralized local government in the academic literature. (The efficiency case for decentralization assumes there is a mechanism for taxpayers to convey their preferences to local authorities, and a mechanism to make local authorities accountable to taxpayers. Voters' ability to appoint and remove elected officials is the key to this model. In transition economies, these characteristics are beginning, now, to apply. However, decentralization may also complicate considerably the design and implementation of other important policy changes taking place in the transitional economies. The interaction of fiscal decentralization with some of these changes needs particularly close attention at this critical time.

**Traditional vs. Systemic Frameworks for Analyzing Decentralization**

The traditional analysis of intergovernmental finance examines the fiscal functions of local and central governments in terms of their respective roles and responsibilities for stabilization, income distribution, and expenditure provision, focussing on the appropriate assignment of tax functions, and the design of a transfer system that provides appropriate incentives. The benefit model of service provision, for example, suggests that local governments — whose role in this analysis is essentially that of service provider — should be financed to the extent possible by charging for the services they provide, with local taxes making up the remaining gap, supplemented as appropriate by transfers and, perhaps, some limited borrowing.

This focus on revenue and expenditure assignment, and on transfer design is of course important in the transitional economies also. For example, the obvious need for flexibility in today's rapidly changing environment has led many central governments to attempt to preserve degrees of freedom by continuing with the "negotiated" tax sharing systems of the past. But this approach is less and less acceptable now in transition countries where demands for "fair" treatment and equalization are strong and where local governments are seeking greater autonomy. It is also incompatible with the efficient provision of local public services. Therefore it is especially important to replace the present "bargained" intergovernmental outcomes with a well-designed, integrated fiscal framework consisting of transfers, own local revenues, and clearly defined local expenditure responsibilities. Ideally, this would be a framework that is both firm enough to serve as a basis for action, and flexible enough to be compatible with the on-going structural changes and reforms that will continue to take place.

**Privatization**

The traditional focus on intergovernmental finance, however, misses several key features of local government roles, responsibilities and economic functions in the transitional economies. First, the emphasis in traditional analysis on the local government as a service provider ignores local government's important roles as producer and as enterprise owner, as well as the still-complicated and critical relationships between enterprises and local government in most transitional economies. The important role of local governments as owners means that they have a major role to play, either as potential impediments to, or supporters of, privatization. Moreover, the asset stock and enterprises which the center has transferred to them in the decentralization process represents a potential source of revenue (or, in some instances, loss). The interaction of local government finance and privatization thus merits careful attention in the transition economies (see Section IV).
Stabilization

Second, the traditional approach focusses insufficiently on the links between stabilization and local government. In most transitional economies, government, both local and central, played a major role in the so-called “productive sectors” and was the major investor and financier in the economy. In transition economies (the picture across countries varies), the expenditure side of the budget remains burdened with many outlays such as subsidies, investment and inventory finance and wages of workers in the productive sectors — which in a market economy are not the responsibility of government. Unfortunately, in all these countries central government revenue is declining more rapidly than the government is able to divest these expenditure responsibilities, thus contributing to stabilization problems. A response in many countries has been for the central government to try to shift the deficit down by making local governments responsible for more expenditures, while simultaneously reducing central transfers to the subnational level. This approach, however, is unlikely to be sustainable (see section IV).

Distribution

Third, the present strategy of devolving expenditure responsibilities downward while holding back on transfers is unlikely to prove successful for more than a year or two at best. Indeed, net expenditure reductions at the subnational level may prove very difficult to achieve. The subnational sector is significant in expenditure terms in many transition economies — in Russia and the Czech Republic local outlays account for over 40% of total outlays. Elsewhere, they account for 10-30% of total outlays. Moreover, in most countries, the local government sector plays a critical role in terms of providing a "social safety net" which makes the pain of the wrenching economic transition more politically tolerable. (State enterprises also provide a wide range of social sector outlays which, with privatization, may have to be taken over by local governments). Since the revenue sources assigned to local governments simply cannot finance the level of expected local activity in the immediate future, the result of shifting expenditures downward is likely to be strong demands for increased, rather than reduced, transfers. Distributional problems and the divergence of service provision levels across localities could emerge. Further, the general rule that local governments should charge for services and "get the prices right", may be oversimplified, given the "social contract" under the previous regime and the important distributional role these prices (rents, transport, utilities, etc.) played. At the very least, some phasing and coordination with other national-level (wage) reforms and the social safety net is in order (see Section V).

Organizational and Institutional Issues

Virtually every transitional country is to varying degrees decentralizing, deconcentrating, and delegating functions and responsibilities. However, a striking feature across all transition economies is the lack of an appropriate — or sometimes any — central government structure to monitor and support the new local governments. In most, the Ministry of Finance, (whose major responsibility is stabilization) remains in the lead role in local matters, but naturally, does not count local government matters amongst its lead responsibilities. Thus, much that needs to be done, or undone, has no formal coordinator.

Establishing responsibility for the design of the local financing system for some agency (or institutional coordinating body) is crucial. Among the tasks of this body would be the development of legislation, and the monitoring of local needs and emerging concerns. It could also be charged with design of the ongoing modification of the system. Notable across the transition economies is the fact that there has been a general absence of concrete empirical estimates or simulations of "correspondence" between taxing authorities and expenditure assignments and the implied need for transfers. Legislation on
Local Government Finance in Transition Economies

Intergovernmental finance relations in Eastern Europe has typically been developed with no quantitative assessment of its implications for the local government sector. Designing a new system of intergovernmental relations is a concrete, technical exercise, and requires an explicit and detailed accounting of the costs to be borne by subnational governments for both newly transferred and traditional spending responsibilities. This would not be a simple task given that information on the costs and prices of service provision might not be fully available nor stable. However, without a rigorous effort on this front, the adequacy of subnational revenue assignments will remain at a conjectural level. Similarly, designing a system of intergovernmental transfers whose objective is to equalize opportunities across localities will require accurate information on expenditure needs, tax bases, and subnational government tax efforts. Most industrial countries have standardized data sets that are used regularly for policy research purposes (see Section VII).

The interaction of fiscal decentralization with each of these five key areas of reform — privatization, stabilization, distribution, expenditure and revenue assignment, and the organizational and institutional setting needs careful attention in designing the new systems of local and intergovernmental finance being set up in all the transitional economies.

IV. FISCAL DECENTRALIZATION AND PRIVATIZATION

Decentralization and intergovernmental fiscal reforms are taking place in the context of a major change in the role of government in the transitional economies. In the past, governments at both the central and local levels were involved in almost every aspect of economic activity in the socialist economies. The state, broadly defined, owned all enterprises, from the steel plant on the "commanding heights" of the economy to the local laundry. The state organized production, allocated labor, planned exports, and so on. Recent reforms aim to decentralize ownership to the private sector. The transition is still far from complete.

The Changing Ownership Roles

Although all the transitional countries are committed to privatizing state assets, liberalizing prices, and withdrawing from the role of the state as direct producer and provider of economic goods, many productive assets — industrial assets, agricultural and urban land, the housing stock, commercial property — still remain in government hands, sometimes local, and less frequently now, in national hands.

As a rule, the status quo at the local level in transition economies thus contrasts starkly with the role local governments generally play in market economies. In the latter, local governments provide basic urban infrastructure and local public services (sometimes through local public enterprises) as well as often acting as local administrators of national policies in such areas as education, health, and social services.

In the former socialist pattern, on the other hand, enterprises owned by local governments had their investments financed from local budgets, and local budgets in turn derived revenues from the enterprises they owned (via profit remittances). Government-enterprise relationships were close, and the distinction between enterprise functions and government functions was murky. Localities often asked enterprises to construct and finance local facilities such as roads and schools, clinics, and even sports stadia and clubs. "Donations" to the budget for "one-time" outlays were also
Table 1: Ownership and Asset Transfers in Transition Economies

<table>
<thead>
<tr>
<th>Country</th>
<th>Recent Transfers of Ownership</th>
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<tbody>
<tr>
<td></td>
<td>Housing¹</td>
</tr>
<tr>
<td>Hungary</td>
<td>Local Government</td>
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<tr>
<td>Poland</td>
<td>Local Government</td>
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<tr>
<td>Romania</td>
<td>Local Government</td>
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<tr>
<td>Bulgaria</td>
<td>Local Government²</td>
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<tr>
<td>CSFR</td>
<td>Local Government</td>
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<tr>
<td>Russia</td>
<td>Local Government</td>
</tr>
</tbody>
</table>

Notes:
1 Housing is also owned by enterprises in many countries.
2 Almost exclusively local, but exact proportions unknown.
3 In Bulgaria only 10-15% of the total housing stock is in the hands of local authorities; the remaining 85-90% is now privately owned.

common. It made little difference whether such outlays were undertaken directly by the enterprise, or via the more circuitous route of profit remittance (from which most local government revenue originated until recently) and funding via the government budget: the burden on the enterprise and the net budgetary position was the same.

All this is now changing. As a result of reforms to the national tax system, and especially of the enterprise tax system, in most countries the system of profit remittance has largely been replaced by corporate taxes on enterprises. Tradition however, dies hard. Some countries such as Romania still provide for such "ownership" rights in the new tax system by giving local governments the right to both profit and dividends taxes (levied by the central government) on local public enterprises.

Indeed, in most transition economies, local ownership of enterprises is becoming an increasingly important issue as assets are transferred from the center in the course of decentralization (see Table 1). Via this process, local governments are becoming owners of enterprises, housing, vacant urban land and retail establishments. In Hungary, for example, the "Act on Property Transfer" (1991) gave local governments ownership of the housing stock previously owned by the central government as well as many commercial units. In Romania, local governments have been given all formerly "state" (centrally-owned) owned properties within their territories, ranging from public domain property (parks) to private domain property such as enterprises. In Russia, enterprises have long been owned by different levels of government, and housing and land was transferred to subnational governments beginning in 1991. In Albania, housing and all small and medium scale enterprises were transferred (in 1992) to the districts, which have been given the responsibility for privatizing them.

Such asset transfers may be a mixed blessing. While consistent with decentralization and the prevailing rhetoric about local autonomy, such transfers also constitute burdens that the center is
all too anxious to transfer to localities. Indeed, one motivation for asset transfers in some instances may well have been to avoid the fiscal burden (such as subsidies, maintenance and repair) that ownership responsibilities carry. Local governments will thus be faced with major maintenance and subsidy burdens, especially for housing, unless privatization proceeds apace.

**Privatization vs Entrepreneurialism**

Quite apart from the potential financial burden that this new transfer of assets implies, there is another emerging concern. A worrisome pattern in virtually all transition economies has been the involvement of governments at different levels in joint economic ventures with respect to purely private market-oriented activities. Romania’s law puts it best, but is not exceptional: "Local governments are authorized to create, contribute equity and/or take shares in commercial enterprises formed with their assets belonging to or transferred to their ownership, including the possibility of forming joint ventures with foreign or domestic partners." Similar language can be found in laws in Russia and Hungary. If the privatization process is to be completed, getting local governments out of the business of business — and into the "business of government" — is crucial. Unfortunately, in at least some countries the process of property transfer appears to have given undesirably broader scope to the entrepreneurial ambitions of local governments — underscoring both the advantages and risks of decentralization.

In almost every country some misuse of local assets is already visible. This misuse is in no small part due to the fiscal squeeze at the local level: enterprise revenues are a "tried and true" source of funding. The new taxes given to local governments in most countries are both unfamiliar and untested, and by market economy standards, they mostly fall into the "nuisance tax" category (see section V). Thus, local assets may represent a windfall unless saddled by central policy restrictions, such as rent or price controls. But they may also be misused, whether they are privatized or not:

- A local heating plant that is privatized, for example, but remains a (local) "natural monopoly" may obviously raise regulatory problems: who deals with these problems, and how?
- What should be done with the proceeds of asset sales? Under what (very limited) circumstances should the very transitory proceeds be used to finance recurrent local expenditures?
- If an asset is not privatized, but is used to generate ongoing revenues for the local government (and perhaps some foreign partner, with the municipality using its ownership of land or assets as its contribution to equity), the temptation to sustain and strengthen any monopoly position is obviously again a problem, as is that of regulation.
- Even more damaging is the high probability that more speculative ventures — examples include tourist lodges and bakeries — are likely to fail.
- Also of concern is the dissipation of scarce local managerial skills on trying to squeeze money out of such entrepreneurial gambits rather than focusing on the more essential task of trying to provide local public services efficiently.

**Revenues from Privatization**

Too many local authorities in transitional countries appear to be excessively optimistic about their abilities to derive increased revenue from their assets. Some hope to establish joint ventures with a domestic or foreign partner, or another state enterprise, using local assets as the locality’s equity share. In those localities well endowed
with land, this appears to be the preferred equity contribution (McDonald's in Moscow, is a joint venture with the Moscow city government which derives a share of the profits — and foreign exchange — earned by this venture). Other localities appear to see potential in developing and servicing empty land so as to enhance its value as equity.

In Hungary, tourist lodges, recreational facilities and golf courses are examples of joint ventures-in-process. In localities which inherited important real properties, similar potential was seen in developing these as contributions to industrial joint ventures such as construction firms, and food processing. In Russia, virtually all subnational governments appear to feel the need to develop and exploit their asset base through domestic joint ventures, and appear to anticipate a positive revenue flow from the projects, once completed. Similarly, in Poland, the provision of private services as a means of earning local revenues appears to have strong support: housing and real estate development, food and furniture manufacture have been cited as examples.

From the perspective of local government, there may seem to be good reasons for government involvement in such market ventures. With available land that can be privatized only with difficulty, the cost to the government of contributing this resource to a joint venture may be perceived as very low. Many local public officials understandably wish to create business employment opportunities in their jurisdictions, which are often economically depressed and lacking private entrepreneurship. All too often, however, the hope for profits from such ventures may quickly turn into demands on government budgets to cover losses.

Experience everywhere shows that the perspectives and goals of public officials tend to make them poor business managers. In particular, it is very hard for a government to close a failing business, especially when the local employment situation is far from healthy. There is also the risk that local governments and their businesses will undercut private competitors, possibly by playing regulatory games to protect local monopolies, with the result that the role of government in the economy will not diminish. Of course, if local governments own businesses, they may fall prey to the risks of ownership. In the industrial market economies, the rate of small business failure is high: only one in five of such businesses survive their first three years. In particular, real estate development and financing is one of the riskiest business areas in market economies. There is no reason to expect that the transitional economies can beat these odds.

In addition to being risky, entrepreneurial activity by local governments is fundamentally inconsistent with the privatization drive, and represents a bottleneck to true decentralization — that is, decentralization, not from the central state to local governments, but from government to the private sector. Local entrepreneurial activity is neither privatization nor true decentralization. Local "entrepreneurialism" may slow down, even reverse, the process of privatization — the long-term goal of getting government out of those activities that can be handled by the private sector.

Entrepreneurialism and Adequacy of the Local Revenue Base

One implication of this argument is simply that it is critical in the transitional economies to provide adequate and appropriate revenue instruments and flexibility at the local level. If the only flexibility available to local governments in their struggle to cope with budgetary pressure is using such economically undesirable sources of revenue as profits derived from direct public ownership of local businesses, they are likely to do so. Municipalities should not be encouraged (or effectively be required) to develop local monopoly enterprises in order to secure the revenue they need to function, just as they should not be forced to establish small taxes on a wide
range of products and activities which are especially the establishment of at least some expensive to administer, generate widespread significant revenue sources under local control public resistance, and typically yield little. Some local access to the national tax base (through transfers), the ability to levy local surcharges on certain national taxes where appropriate, and especially the establishment of at least some significant revenue sources under local control thus seem essential, if the struggle for local revenue is not to delay or impede privatization reforms.

V. FISCAL DECENTRALIZATION AND STABILIZATION

The Macroeconomic Context for Local Finance

The wrenching reforms most transition socialist economies are currently undertaking in order to achieve macroeconomic stabilization and to compress the state budget may also produce perverse effects at the local level. As noted earlier, some central governments have shifted expenditure responsibility downwards in the hopes of improving their budgetary position. Revenue assignments and/or transfers to local governments are generally tightly restricted for the same reasons. One unintended result of such policies may be to tempt local governments to rely on enterprises for continued budgetary outlays and consequently to protect locally-owned enterprises to ensure their profitability. Unless a workable framework for intergovernmental finance is put in place, the current budgetary stringency thus seems likely to create additional hurdles to disassociating local governments from their enterprises.

Shifting Expenditure Responsibilities "Downstairs"

Central governments in most transitional countries appear to view fiscal decentralization as an opportunity to reduce central expenditures in two ways: first, by spinning off expenditure responsibilities to the subnational level, and second, by reducing fiscal transfers. Both are purportedly to make local governments more "independent," but with the welcome side effect of reducing central outlays. This has happened in LDCs, as well, in the name of efficiency.

A striking example of this shift, as noted, is the transfer in a number of countries of increased responsibility for social expenditures and the social safety net to local government. In Hungary, for example, the responsibility for "welfare" expenditures was transferred to the localities in 1991. In Russia, the central government transferred social expenditures equivalent to an estimated 6% of GDP (1992) to the local level, with the objective of "pushing the deficit down", presumably in the hope that the subnational governments would perform the politically painful cost cutting required. Ironically, the demand for these services is likely to grow with the worsening of Russia's economic situation, and the shift in the safety net could prejudice reforms and hence the country's economic future. The safety net is, arguably, a national concern. More recently, responsibility for key national, inter-jurisdictional investments (e.g. in transport) has also been transferred to the subnational sector in Russia. (See Table 2 below for expenditure assignments in selected transition economies).

Even some of the extensive asset and enterprise ownership transfers to local governments that have taken place in most countries appear to have been partly motivated by budgetary concerns. Some of the "assets" transferred — notably housing and some enterprises — are really liabilities, given the
heavy burden of maintenance and operation costs of these units and the fact that rental income (last
adjusted in the Russian Federation in 1928) covers only an insignificant small part of these costs.

Table 2: Expenditure Assignment to Subnational Authorities

<table>
<thead>
<tr>
<th></th>
<th>HUNGARY</th>
<th>POLAND</th>
<th>ROMANIA</th>
<th>CSFR</th>
<th>BULGARIA</th>
<th>RUSSIA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defence</td>
<td>No local responsibility</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Military housing</td>
</tr>
<tr>
<td>Justice/interior security</td>
<td>Enforcement of rights of national and ethnic minorities</td>
<td>No</td>
<td>Public security is provided by local branches of the Ministry of Interior</td>
<td>-</td>
<td>Security of farming estates</td>
<td>-</td>
</tr>
<tr>
<td>Foreign Economic Relations</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>No</td>
<td>-</td>
</tr>
<tr>
<td>Education</td>
<td>Primary and secondary only including day care and high schools</td>
<td>Kindergarten and pre-elementary schools only</td>
<td>None</td>
<td>Partial responsibility in the Czech Republic</td>
<td>All expenditures (capital and current) of primary and secondary schools. Some kindergartens. Some technical and vocational schools</td>
<td>Several special vocational schools. Wages, operation construction and maintenance of all primary and secondary schools. Local enterprises build some facilities</td>
</tr>
<tr>
<td>Culture and parks</td>
<td>Supporting cultural activities</td>
<td>-</td>
<td>Over-lapping responsibility for cultural activities</td>
<td>-</td>
<td>No</td>
<td>Some museums with oblast significance. All recurrent expenditures of all sport and park facilities and all other cultural facilities.</td>
</tr>
<tr>
<td>Health</td>
<td>Basic health and social service</td>
<td>No</td>
<td>None</td>
<td>No</td>
<td>Tertiary care and psychiatric hospitals. Polyclinics. Some primary care and drugs.</td>
<td>Paramedics, Medicines, Primary health clinics, Secondary hospitals. Also tertiary hospitals, psychiatric hospitals, veteran hospitals, diagnostic centers, and special service hospitals (cardiology, etc.)</td>
</tr>
<tr>
<td>Service</td>
<td>Hungary</td>
<td>Poland</td>
<td>Romania</td>
<td>CSFR</td>
<td>Bulgaria</td>
<td>Russia</td>
</tr>
<tr>
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</tr>
<tr>
<td>Roads</td>
<td>Maintenance of local public roads</td>
<td>Only local or urban roads/street</td>
<td>Maintenance</td>
<td>No</td>
<td>Improve traffic safety.</td>
<td>Maintenance of oblast, rayon and city and commercial roads</td>
</tr>
<tr>
<td>Public transportation</td>
<td>Local mass transport</td>
<td>Construction and maintenance of bridges</td>
<td>Public transport investment</td>
<td>Urban transport only</td>
<td>All modes of city transport.</td>
<td>Most public transportation facilities (earlier assigned to federal government). Also subway systems.</td>
</tr>
<tr>
<td>Fire protection</td>
<td>Local fire protection</td>
<td>-</td>
<td>None</td>
<td>No</td>
<td>Most fire protection services.</td>
<td>Most fire protection services. Voluntary, military and enterprise services are also possible at the rayon level.</td>
</tr>
<tr>
<td>Libraries</td>
<td>-</td>
<td>Partial responsibility</td>
<td>No (books purchased through the budget of the Ministry of Culture)</td>
<td>No</td>
<td>Local libraries</td>
<td>Special library services at the oblast level and most local library services at the rayon level.</td>
</tr>
<tr>
<td>Police services</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>No</td>
<td>Sofia has a signed contract with the National Militia; other municipalities get the service free.</td>
<td>Road (traffic) police</td>
</tr>
<tr>
<td>Sanitation (garbage collection)</td>
<td>Garbage collection</td>
<td>Ownership and provision of cold water at all levels</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>Part of garbage collection at both oblast and rayon levels.</td>
</tr>
<tr>
<td>Sewage</td>
<td>Garbage collection and settlement cleaning</td>
<td>Ownership and provision of sewage service</td>
<td>Sewage collection</td>
<td>-</td>
<td>Garbage collection and sanitation in the settlement</td>
<td>Most of the operational expenditures at the rayon level and some operational expenditures at the village level.</td>
</tr>
<tr>
<td>Service</td>
<td>Hungary</td>
<td>Poland</td>
<td>Romania</td>
<td>CSFR</td>
<td>Bulgaria</td>
<td>Russia</td>
</tr>
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<td>----------------------------------------</td>
<td>----------------------------------------</td>
</tr>
<tr>
<td>Public utilities</td>
<td>Water management and maintenance of public cemeteries</td>
<td>Supply street lighting</td>
<td>District heating and water</td>
<td>-</td>
<td>Water supply infrastructure.</td>
<td>Subsidies to households (not enterprises) at the rayon level</td>
</tr>
<tr>
<td>Housing</td>
<td>Housing management</td>
<td>Shared responsibility</td>
<td>Housing services</td>
<td>No</td>
<td>Management of common pastures and other municipal property. Financing, building and subsidizing for residential housing.</td>
<td>Maintenance is the responsibility of the level of government or enterprises owning the housing. Capital expenditures are included unless otherwise noted.</td>
</tr>
<tr>
<td>Price and other subsidies</td>
<td>Rent subsidies</td>
<td>Rents</td>
<td>Energy subsidies to households and public transport subsidies</td>
<td>Direct subsidies to agricultural cooperatives, and subsidies to enterprises that are not involved in the production of local public goods</td>
<td>Mass transport and drugs. Subsidy to inter-village bus service within municipalities. Heating subsidy since 1992.</td>
<td>For fuels, mass transport, and food such as bread, milk and medicines at the rayon level. Also rent subsidies.</td>
</tr>
<tr>
<td>Social Welfare</td>
<td>Social care facilities such as old age and handicapped homes</td>
<td>Voivodship responsibilities</td>
<td>-</td>
<td>-</td>
<td>Homeless, disabled and orphans.</td>
<td>Part oblast government responsibility, and the rayon level management of programs funded by upper level governments</td>
</tr>
<tr>
<td>New Public enterprises (productive sectors)</td>
<td>Can establish new domestic joint ventures</td>
<td>Can establish new domestic joint ventures</td>
<td>Can establish new domestic joint ventures</td>
<td>Can establish new domestic joint ventures</td>
<td>Capacity to invest in joint ventures (keeps 50 percent of privatization proceeds if rayon subordination). At the rayon level this also includes 10 percent of any other subordination.</td>
<td></td>
</tr>
<tr>
<td>Environment</td>
<td>Protection of the environment</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>Measures to improve and rehabilitate the environment</td>
<td>Responsible for local environmental problems, e.g. preservation of forests</td>
</tr>
</tbody>
</table>

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Local Government Finance in Transition Economies

<table>
<thead>
<tr>
<th></th>
<th>HUNGARY</th>
<th>POLAND</th>
<th>ROMANIA</th>
<th>CSFR</th>
<th>BULGARIA</th>
<th>RUSSIA</th>
</tr>
</thead>
<tbody>
<tr>
<td>State-owned Enterprises</td>
<td>Major local ownership responsibilities</td>
<td>Local ownership responsibilities</td>
<td>Local ownership responsibilities</td>
<td>Major local ownership responsibilities</td>
<td>-</td>
<td>&quot;Group C&quot; enterprises, e.g. local light industry, housing construction and food industry. Rayon responsibility exists only if the enterprise is transferred to the local level</td>
</tr>
</tbody>
</table>

Notes:
1. In Vietnam, local governments are responsible for all of the above activities if they fall under their jurisdiction. That is, each level of government is responsible for those activities which fall under their jurisdiction.
2. '-' implies no information.
3. 'No' implies not applicable to subnational governments.

Reducing the Budgetary Cost of Intergovernmental Transfers

The stabilization difficulties at the national level have also led some Finance Ministries to focus on reducing intergovernmental transfers as one way out of their fiscal straits. Transfers have been seen as the "compressible dimension" of the federal budget. The principle of "local budgetary independence" mentioned above has (conveniently) been interpreted to mean that subnational governments should be self-sufficient, which in turn implies that direct transfers should be reduced, or even eliminated. In reality, however, in most of the transition economies, central transfers to local government are very large (far larger than in most market economies), reflecting both the rudimentary tax base available to local government and the center's reluctance — largely to avoid fiscal vulnerability — to part with any of the major tax bases and to assign them to the subnational level. As a rule, however, the amount and distribution of these transfers is determined each year on a discretionary basis, in accordance with fiscal exigencies.

While such budgetary flexibility is clearly desirable from the central government's short run macroeconomic view, it is a mistake to view transfers as a completely "compressible" portion of the national budget, as appears to be the case in countries such as Russia, Hungary and Romania. Many of the services provided by subnational governments, particularly in view of the "pass-down" phenomenon already discussed, constitute essential expenditures for continued political stability and support for reform or for future economic development. There is no way that the many small local governments that have been created in most countries can finance the provision of these services at an adequate level out of only their own meager resources.

Even from a short-run stabilization perspective, an underfunded subnational sector in the current environment is all too likely to result in a situation in which the only way local governments can cope with budgetary pressure is by using economically undesirable sources of revenue such as profits derived from the exploitation of income-earning assets transferred
to them and from direct public ownership of local businesses.

At the same time, local governments' open-ended expenditure responsibility for "social assistance" is likely to result in emergency recurrence to the central government for additional funds, or simply the unsustainable accrual of arrears — already a common phenomenon amongst local governments in many countries — or through short-term borrowing (see below). Local government arrears have been a problem in Russia, where "budget balance" at the subnational level was achieved by paying only partial pensions and other transfer payments. One way or another, intergovernmental transfers are thus likely to be an important component of the central budget for years to come in most transition economies.

Some Cautionary Notes

A strategy of continually devolving expenditures downward, while assigning limited taxes and cutting back on transfers is unlikely to prove successful for more than a year or two at best. Indeed, net expenditure reductions at the subnational level may prove very difficult to achieve. At present, for example, state enterprises provide a wide range of social sector outlays: with privatization, many of these outlays will have to be taken over by local governments. Since the meager revenue sources assigned to local governments in most countries simply cannot finance the level of local activity that seems likely to be required in the immediate future, the result of shifting expenditures downward is likely to be strong demands from politically stronger local governments for increased, rather than reduced, transfers.

An additional caution concerns the risk of excessive recourse to borrowing by hard-pressed local governments. Virtually all countries (Hungary, Russia, Albania and Romania) have granted almost unlimited borrowing powers to local governments without adequately taking into account the macroeconomic necessity of monitoring and controlling such borrowing. As yet, the relatively undeveloped state of financial institutions in most countries has limited the abuse of this borrowing power, but it remains a potential macroeconomic danger.

Given the expanded expenditure mandates, local expenditures cannot in many cases be postponed. Even if local expenditures had been rationally assigned and designed, the paucity of locally-controlled tax resources in most transitional countries, when combined with the universal reluctance of politicians to tax constituents too directly and openly, makes it almost inevitable that hard-pressed local governments will turn to other avenues for revenue. In the peculiar "soft budget" environment that still prevails in many transition economies they will demand increased transfers, they will try to borrow, and they will try to exploit to the full the new assets they have acquired as part of the decentralization and privatization process. Any of these paths carries with it dangers for the transition process as a whole. One way or another, intergovernmental transfers thus seem likely to be an important component of the central budget for years to come in most transitional countries: it is therefore critical that such transfers be well designed and implemented.

Implications for the Longer Term

Intergovernmental System

In sum, while intergovernmental fiscal reform is necessarily taking place in this strained macroeconomic context and hence inevitably reflects changing short-term fiscal needs and pressures, care must be taken to prevent the stabilization objective from fully dominating the redesign of the intergovernmental finances regime. In this context, it is crucial to ensure that stabilization targets are correctly specified, by properly defining the process as one involving the consolidated public sector and not only the central government. The adjustment experience in many
countries shows the costs of mis-specification. A major challenge facing the transitional economies is to develop an intergovernmental fiscal system which is an optimal combination of rules and discretion — one that will be both flexible enough to be compatible with macroeconomic stabilization and the major structural shifts which are taking place in the economy, — and at the same time provide a stable framework for the effective operation of both central and subnational governments in the longer term.

VI. FISCAL DECENTRALIZATION AND INCOME DISTRIBUTION

The evolving changes in expenditure assignments and the stabilization-driven concerns to reduce intergovernmental transfers and limit the revenue base are likely to imply a fiscal squeeze on local governments whose severity will depend on the evolution of each of these elements in the different countries. What does this mean from a distributional perspective for the transition economies? One picture is of a squeeze on subnational finance, in aggregate, and the emergence of increased differentials among local jurisdictions, in line with their different economic bases. Three areas are worth exploring in more detail.

"Expenditure Responsibilities" of Enterprises

The changing role of public enterprises has important potential consequences for the well-being of local populations and the regional pattern of equitable service provision. In many other former socialist economies, enterprises provide several services for their employees and their families which elsewhere are thought to fall under government jurisdiction. For example, they construct and support hospitals, construct and maintain housing, run kindergartens and preschools, make "voluntary donations" toward financing public transport systems, and to extrabudgetary funds of subnational governments. Public enterprises also play an important role in undertaking capital investments in the social sectors to benefit the local populations at large. This role typically consists of building schools and hospital facilities and then transferring their operation to local governments.

The capital expenditures of some larger public enterprises extend to roads, sewage, and water lines. Most enterprises provide housing for their employees, and, in principle, large enterprises are involved in environmental protection. Many public enterprises also build and operate child care facilities, such as summer camps. The operation of facilities is sometimes transferred to local governments, for example, if similar services are provided for the rest of the community. Some have put enterprises contributions to local budgets as high as 40%. And in some "one-company towns", where there is only one major employer (typical in Poland and Russia), the local budget may finance very few public services itself.

Who will take on these new responsibilities as these enterprises privatize? Whether such enterprise functions will accrue to national or local budgets is hard to predict. Many functions fall into areas of traditional "local responsibility". Many can also be privatized — the clubs, golf courses, housing, resorts. Thus it is difficult to predict the net change, in the short term, in the size of the local government sector. Nor is it easy to predict which local governments will be most affected. Most likely, and paradoxically, the regions that historically benefitted the most from a greater presence of enterprises (frequently highly subsidized industrial enterprises) are now at greatest risk from the discontinuation of the
enterprises' social responsibilities. These regional differences in "enterprise endowments" (and what they might mean for each locality's spending responsibilities will need to be incorporated into the design of the revenue cum transfer systems.

Unfortunately, no one has either quantified the dimensions of this problem or envisaged any workable solution for it. In principle, the shift in expenditure responsibilities from enterprises to local government should be matched, at least to some extent, by a corresponding change in the revenue base (taxes and transfers) of the local government. Concrete quantitative analysis of the budgetary implications on this divestiture must be undertaken to determine whether the reassignment of these expenditures corresponds with the local government's ability to finance them. In practice, however, that revenue base is already inadequate and is not being increased as needed.

Coordinating User Charges and Prices With Other Reforms

Another potential distributional problem arises with respect to the prices charged by those local public enterprises that may properly be retained in the public sector. In the past, governments in the socialist countries used low and fixed prices (including housing rents and other urban user fees) as well as wage controls, as part of their "distributional tool kit". The "social contract" in socialist economies called for the "basic necessities" to be provided free, or at low cost to all. In exchange, citizens accepted the low wages, the queuing and labor immobility that accompanied this system. Governments are now being asked, in the reform environment, to "get the prices right" and to use tax policies and targeted subsidies for distributional purposes instead. Changes in public sector prices (user charges) clearly need to be coordinated with wage reform on the one hand and with more general price reforms on the other, in order to avoid undue impact on incomes and major distributional shifts.

Public sector pricing, however, seems likely to be one of the last areas to be reformed in most countries. While national price reforms have liberalized most private sector prices, at the local level, governments are having a much harder time adjusting prices for public services, even for private goods provided by the public sector, such as housing rents and such ancillary services as water, heating and transport fares. Adjusting these prices is of course essential both for efficiency and to enhance local revenues.

Ironically, while responsibility for providing services has been transferred to local governments, in many countries, the central government sets these prices and at levels that are uniform throughout the country. Rents in Russia, for example, were fixed (at the 1928 levels) until 1993, and were identical for Moscow and Mumansk. Local governments, the new owners of the housing stock, were responsible for financing the subsidies implicit in these price controls. In Albania, water, gas, transport, and other charges are identical across all Albania's 37 districts, ignoring costs of provision, and are many multiples below cost recovery levels. In Budapest, the central government still sets the bus fares in 1992.

Introducing appropriate user fees, however, implies major changes in the cost of living and in welfare. Changing such public sector prices will entail major, and undoubtedly very unpopular, distributional shifts, if not properly coordinated with other reforms. Such shifts, if too wrenching, or too quick, could upset the fragile democracies that have only just emerged in most countries. In some transition economies, for example, it has been estimated that raising the prices of the main public utilities to cost recovery levels (transport, gas, power, water, etc) could cost households more than 50% of their average household income (these estimates typically do not factor in consumption shifts.) Partly for these reasons, local freedom to set local public sector prices remains heavily constrained in most countries.
One solution is to replace consumer price subsidies by targeted subsidies (with a smaller budgetary impact); but this requires the development of new information and tracking systems. One might think that such "targeting" could be relatively easy in the transition economies because of the pre-existence of a large "control" data base in such countries. This hope is probably naive, however. Surprising gaps in that data base, the dependence of official information on a local control system that is disintegrating rapidly (if it has not already disappeared), and the increasing growth of the euphemistically labelled "informal sector" make all statistical systems less than fully informative. And, it could require a large bureaucracy. Another approach would be to get the prices right — to achieve the allocational efficiency in consumption that is desired — and to offset the income impact by a system of rebates to consumers. However, this would reduce the revenue yield from the price change. Designing these systems will not be easy.

Decentralization and Differential Standards of Service Provision

The transfer of major expenditure responsibilities to local governments, the underfunded and generally counter-equalizing nature of the revenue systems and the absence, in general, of conditionality (or central standard definition) in transfers could lead to emerging differentials in levels of service provision across regions. In Russia, this is already happening, with the emergence of greater differentials across oblasts in per capita local expenditures (as measured by the coefficient of variation) and local social expenditures. For example, the coefficient of variation of per capita budgetary expenditures (the standard deviation divided by the mean) increased from 0.5 in 1991 to 0.8 in 1992.

Decentralization has led to many outlays with major externalities being shifted to local governments. With respect to education, for example in Hungary, primary and secondary schools have been shifted to the local governments, which, like many transition economies, are very small (the mean population is 2000). The normative grant provides a per pupil amount of funding (which does not fully cover costs); however the grant is not conditional. The financial incentives in the present Hungarian system may in the future, unless changes are made, lead to larger towns with secondary schools being unwilling to accept students from smaller towns without such schools since there is no mechanism to share unfunded costs. The completely unconditional nature of inter-governmental fiscal transfers in Hungary makes it very difficult to penalize such actions. Similarly, national education standards have vanished in the Czech Republic where education is now a "local responsibility". However, they have not yet been replaced by either guidelines or rules: totalitarian education was undoubtedly an evil, but it is not obvious that an absence of standards is better.

For the first time in decades, there is a clear possibility that wide variations in the quality of education will emerge depending on the fiscal resources available to the municipality in which a student lives. Similarly wide variations may equally arise in health, in social welfare expenditure, and in other areas of local government activity, as the power of the center to command vanishes. This outcome is unlikely to be considered desirable by most citizens. Albania's social welfare law is an interesting exception. Centrally funded and locally administered, the grants are distributed according to the center's "guestimates" of where the most hardship is likely to be, which in turn are based on unemployment data, family size, etc.

Divergent service provision standards across localities are not necessarily bad. However, it is one thing for local expenditure choices to reflect the wishes of local officials who have been democratically elected and who are spending funds secured from the citizens who elected them.
But it is quite another when services with substantial jurisdictional spillovers are underprovided in poor areas owing solely to lack of fiscal resources, or when transfer monies provided by taxpayers as a whole for specific national purposes are misspent by local officials responsive only to their own local electors. Yet both of these outcomes are all too probable over time, given the inadequate resource base and the virtually unrestricted "local autonomy" conferred by some of the new local government laws.

Transfer Design and the Intergovernmental System

What do the concerns expressed above imply for the design of local and intergovernmental fiscal systems in the transitional economies? In the first place, the level, design and effects of intergovernmental fiscal transfers obviously constitute key elements in the emerging intergovernmental and local finance systems of the transitional economies. This is all the more so since most transition economies are highly "transfer dependent" at present. Critical decisions must be made with respect to the overall size of such transfers (the "distributable pool of transfer resources") as well as with respect to the distribution formulas to be employed, taking into account both the severe fiscal pressures on the central government and the vital tasks to be performed by the local governments in the emerging new structure of the public sector.

Practical measures of "tax capacity", "expenditure need" and perhaps "fiscal effort" need to be developed for use in such formulas. Institutions must be developed at both the central and local levels to ensure that transfers are put to the best possible use. Critical decisions must also be made about equalization. Fiscally-pressed central governments may not have much revenue for such outlays. Better-off local governments may not have much patience for them. With negative growth in most countries, the "brotherly solidarity" of the past (if it ever existed) has been lost, and the feeling for "cross-subsidies" to poorer jurisdictions may be lacking. In many countries, subnational officials have expressed the view that their communities had been treated unfairly in the communist period, both in an absolute sense, and in a relative sense, vis a vis other communities. This perception may have been accurate, since in communist days, much government expenditure and a large share of GDP was dissipated in "prestige" projects. These considerations make the design of an equalizing transfer system even more difficult.

One solution along these lines that has been adopted in some market economies, for example, pivots around a system of intergovernmental transfers in which the total is flexible with changing macroeconomic circumstances — for example, some percentage of total central taxes — while the distribution of this total among different subnational governments is "formula-driven", with the amount received by different localities depending on such factors as potential "fiscal capacity" and assessed "need." This approach represents a compromise, in which the center gives up some degree of control over its revenue but also insulates itself from ad hoc and possibly escalating demands from localities, while localities avoid discretionary cutbacks in local transfers to meet stabilization objectives, with all the expenditure dislocations that this implies. In most of the transition countries, regularizing the overall size and distribution of the transfer, like strengthening local finances by broadening the local tax base to improve local tax yields, represent high-priority reforms.

Tax Assignment Choices and Distributional Outcomes

How the new subnational revenue systems are designed will also have important distributional outcomes. The "local autonomy" that has been enshrined in the recent decentralization legislation has often meant separating central and local spheres of fiscal responsibility to the greatest extent possible, so that each level of government reigns in its own sphere. On the revenue side,
Local Government Finance in Transition Economies

this translates into a pre-disposition towards "tax assignment" models, with certain taxes (usually the best ones) assigned to the center, and others (mostly a large number of low-yielding taxes) assigned to the local government. Where tax sharing is in place (Russia, Hungary and Poland) the experience is not much better, since taxes are typically shared on a derivation basis. This emanates from the pre-reform system, where most subnational governments received revenues from "their" enterprises, a historical legacy which has led to a strong bias in the new systems towards "derivation-based" sharing models in which revenues go to the jurisdiction in which they are collected.

Most tax assignment and derivation-based sharing systems are inherently counterequalizing. Those regions with the strongest economic bases will have the largest revenue collections. Those with a weak base will have less, although arguably, their expenditure needs may be the same or greater! This approach is destined to worsen fiscal disparities, unless transfers are adequately designed and factored in.

More generally, continuing to starve local governments fiscally by inadequate transfers and revenue bases will worsen distributional outcomes. In most of the countries analyzed, the principal "local" tax is some form of property tax. In addition, in many countries, a very large number of "nuisance taxes" have been given to subnational governments. These range from Russia's 21 local taxes (which include fees for car parks, fees for horse race winning, taxes on the resale of computers and cars, and a tax on dog owners, to name just a few), to Albania's 22 local taxes (that include essentially only "nuisance" taxes and fees, and are expected, in aggregate, to yield about 0.4 percent of GNP). Hungary has performed best, having chosen five minor taxes to assign to local governments. However, cumulatively these amount to far less than one percent of GDP in revenue yield. Finally, central governments typically limit local revenue discretion by putting ceilings on local tax rates and defining the tax bases for them.

Even where the local taxes have potential — such as with the property tax — in many cases, national governments have hamstrung the revenue potential of these taxes by granting long term exemptions to newly privatized land, housing, and enterprises. In sum, even when the local tax base is feasible and adequate in principle, in practice it will generally take some years before the system can be expected to produce sufficient revenues to meet perceived local needs.

More generally, it is critical that subnational revenue needs and possibilities be realistically factored into national plans for tax reform. Failure to look at intergovernmental dimensions of national tax policy changes can lead to problems. In Russia and Hungary, a share of major national taxes has been assigned to the subnational level and has given local governments (in aggregate) a claim on a fairly robust revenue pool. However, the local shares are determined by the center annually, and recent national tax policy changes in both countries have wrought havoc with the aggregate subnational revenue base, with very erratic effects across subnational jurisdictions. For example, in Russia, the VAT rate (about 25% of VAT revenues go to local governments in Russia) was reduced from 28 to 20 percent in 1993, effectively reducing local revenues by a third. Further changes to the VAT (to tax imports and exempt food) radically changed the revenue distribution across oblasts. This highlights the problems with tax "assignment" systems in transition economies, where the tax itself is undergoing continuous definition.

In many transition economies, however, local governments have nonetheless come out strongly in favor of revenue assignment under which they get "all" the revenues from "their" taxes (perhaps because they still expect expenditure subsidies). That this seeming revenue independence leaves
them with significant residual vulnerability to tax policy changes seems generally not to have been recognized. The level, design and effects of intergovernmental fiscal transfers thus constitute key elements in the emerging intergovernmental and local finance systems of the transitional economies.

VII. THE ORGANIZATIONAL AND INSTITUTIONAL FRAMEWORK FOR LOCAL FINANCES

How Many Levels of Government?

In the pre-reform period, virtually all the countries under review had a multi-tier organization, with the central level implementing its control over the local level through an intermediate tier of government. The central government was responsible for the overall plan and budget, and the intermediate level, variously called "Oblast" (in the Russian Federation); "Judet" (Romania); County Council (Hungary), and "Voivod" in (Poland), was the administrative, control and surveillance agency through which the center effected control and implemented policy. This middle tier oversaw the expenditures of local governments and was the channel for central fiscal flows to the localities. Substantively, however, none of the countries discussed here were organized, from a fiscal perspective, as a federation. Although the Russian Federation gave nominal autonomy to its 89 "autonomous" (or national) regions, oblasts, okrugs and republics, these sub-national governments too were neither fiscally independent nor able to determine their own expenditure and tax policies. At the other extreme in some respects is China, a unitary country with a very decentralized administration.

At present, only Russia (and until 1992 the Czech and Slovak Federal Republic) has a federal system of government, comprising the federal government, republics, and regions. All the other countries discussed here have a unitary system of government. A first look at the legal structure suggests that Poland, Hungary, and Romania have a two-tier level of government (central and local), and Russia and Bulgaria a three-tier structure (central, provinces/county/ regional and local) as shown in Table 3. However, matters are not so simple anywhere. Romania, for instance, has two tiers of local government (the old judets and municipalities): each judet is divided into municipalities, and in principle each type of local government is independent of the other. In Hungary, on the other hand, while the old counties still exist, they really have no functions, so that there are in effect only two levels of government, central and local. On the other hand, in Budapest and Moscow (as in the cities of the Czech Republic) there are "subcity" (district, or ward) councils and governments with elected councils and their own budgets and assets, so that the "local" level of government itself has two tiers. In Bulgaria, the municipalities are the basic unit of self-government, but they have contiguous borders and therefore contain both urban and rural areas. The municipality itself has an elected Council and Mayor, but urban settlements within the municipality also have an elected Mayor (no Council) with delegated executive powers from the municipality (i.e. county). This lower level is therefore a deconcentrated level of local government.

As a rule the "middle tier" of government continues to exist in vestigial form in most transitional countries, but it is struggling both for a role and for legitimacy. Most countries seem to want to shed this intermediate tier, associated with the former control economy, as if to put their past behind them. In some countries the role of the intermediate tier is now limited largely to
overseeing the constitutionality and legality of local government operations (Albania and Hungary). In others, its role has become one of coordinating central government policy at the regional level. In most, however, there are few questions more in flux than the present and future role, if any, of intermediate levels of government.

The experience in some countries (notably in Latin America), is that central governments in newly decentralizing countries are becoming increasingly reliant on intermediate levels of government in order to leverage central capacities for compliance and control. Another important role for intermediate governments is to help smooth out the abrupt fluctuations in municipal capital spending driven by the short-term mandates typical of municipal electoral periods. Longer-term horizons are especially important when it comes to national priorities, and where there are important externality considerations and spill-over effects.

Various methods have been used (e.g., in Latin America, where there has been significant recent practice of "controlled decentralization") to make intermediate levels of government stakeholders in the development of national, long-term priorities. Performance standards, for instance, are defined in advance and published as part of performance contracts between central and municipal governments, with the middle tier acting as an intermediary. Credit regulations — essentially eligibility criteria — serve a similar purpose. Finally, an intermediate level of government has been found to provide an option for addressing intergovernmental disputes and regulatory issues at sub-national levels.

The Size and Efficiency of Government

Although the initial reaction against the previous “intermediate” governments as undesirable reminders of the old regime is understandable, so is the obvious concern in many countries to put something more acceptable in their place. As shown in Table 4, most of the east European countries have created a large number of small, and probably not viable, local government units. In Hungary, for example, the average population of local governments (excluding Budapest) is less than 3,000. In Romania, half the population lives in local government units with a population of less than 4,000, and such units account for 90% of all local governments.

Table 3: Decentralization and Government Organization

<table>
<thead>
<tr>
<th>Country</th>
<th>Unitary or Federal</th>
<th># of Tiers (pre-reform)</th>
<th>Emerging Structure</th>
<th># of Tiers (present)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hungary</td>
<td>Unitary</td>
<td>3: central/county/local</td>
<td>Unitary</td>
<td>2: central/local</td>
</tr>
<tr>
<td>Poland</td>
<td>Unitary</td>
<td>2: central/local</td>
<td>Unitary</td>
<td>2: voivodships/gminas</td>
</tr>
<tr>
<td>Romania</td>
<td>Unitary</td>
<td>3: central/regional/local</td>
<td>Unitary</td>
<td>2: central/local</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>Unitary</td>
<td>3: central/regional/local</td>
<td>Unitary</td>
<td>3: central/oblast bshnta/(municipality)</td>
</tr>
<tr>
<td>Russia</td>
<td>Federal</td>
<td>4: central/oblast/rayon/village soviet</td>
<td>Federal</td>
<td>3: federal/oblast/rayon</td>
</tr>
</tbody>
</table>
Table 4: Decentralization: Scale and Size of Government

<table>
<thead>
<tr>
<th>Country</th>
<th># of units of local government</th>
<th>Average Size</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hungary</td>
<td>3070 municipalities</td>
<td>2,834</td>
</tr>
<tr>
<td>Poland</td>
<td>2383 gminas</td>
<td>16,000</td>
</tr>
<tr>
<td>Romania</td>
<td>2940 urban and rural municipalities 41 judets</td>
<td>7,500 537,804</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>273 municipalities</td>
<td>30,000</td>
</tr>
<tr>
<td>CSFR</td>
<td>2843 cities in the Slovak Republic 5500 cities in the Czech Republic</td>
<td>1,867*</td>
</tr>
<tr>
<td>Russia</td>
<td>2000 rayons 88 oblasts</td>
<td>125,000 2,840,909</td>
</tr>
</tbody>
</table>

Note: * For the CSFR as a whole.

Such extensive fragmentation may be good for "getting government close to the people", but it also substantially complicates intergovernmental relations. It is, for example, impossible for the central government to maintain direct bilateral relations with so many units. This reduces the political voice of local government as a whole, and in many cases yields localities that are simply too small to provide efficiently all the public services demanded from them. At the very least, even if it is decided not to create a formal intermediate tier of government, some mechanism for coordination and consultation is likely to prove necessary. Possible models abound in the world, e.g. the "municipal federations" that exist in many of the Nordic countries, under which localities organize on a voluntary basis to provide certain local services, or the Nordic "secondary communes", county-like bodies with their own elected officials responsible for providing services of an interjurisdictional nature.

Managing Decentralization and Monitoring its Direction

More attention is needed on the functional complements to local government finance, that is, in areas of institutional design, policy formulation and decision-making, spending and management. For example, the lack of an appropriate central government structure to monitor and support the new local governments is a common problem in central and eastern Europe. In Poland, Hungary, and Albania for example, there exists no institution or designated body "in charge" of the decentralization of the localities and the Ministry of Finance still plays a lead role in the budgetary function and other fiscal issues at the local level. In Russia the formation and implementation of fiscal policy is done by the central government and three Parliamentary commissions. The budget is submitted to the Parliament for approval, the collection of revenue is done by the State Tax Service, and expenditure authorizations are under the control of the Ministry of Finance.

In Bulgaria, the Ministry of Regional Development, Housing Policy and Construction is responsible for formulating the policy on territorial divisions and local administrative functions and guiding the reform program while the Ministry of Finance retains primary control over the linked issues of local government finance.
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and budgeting. In Romania the formulation of
decentralization policy and implementation of
local government reform is the responsibility of
the Department of Local Government Affairs of
the Office of the Prime Minister and the
Department of Tax Administration and Local
Budget Management of the Ministry of Finance
and Economy. Similarly, in the Czech Republic,
both the Ministry of Finance and the Ministry of
Economic Policy and Development are involved
in shaping the intergovernmental finance system.

Despite (or perhaps because of) the
involvement of a number of central government
institutions in a number of countries, quite a lot
that should be done seems to be going undone.
Among the tasks for which responsibility must be
clearly established are monitoring and assessing
subnational finances both in total and
individually. This task might be located in the
Ministry of Finance, in a special local government
department, or it might even be given semi-
independent status with some local government
involvement (like the U.S. Advisory Commission
on Intergovernmental Relations, or the Australian
Grants commission). There are pros and cons of
each possible location that need to be considered
carefully. But what is beyond dispute is the need
to ensure that the central authorities have a better
understanding of both the existing situation and
the likely effects of any proposed changes than is
true at present.

In addition, regular and detailed financial
data, depending on the level of development,
should be maintained on subnational governments.
Indeed, since the breakdown of central planning,
central governments in most countries have
surprisingly little information about the welfare
and well-being of their residents. Good social
surveys exist only for Poland. Elsewhere,
targeted benefits are likely to entail substantial
leakages on the one hand, and oversights on the
other, due to informational deficiencies. They
also have little data about the activities of local
governments. Only in a few countries (e.g.
Hungary and Poland) do local governments now
appear to provide detailed financing reports to the
center. Reporting of data on extrabudgetary funds
and borrowing (and, as just discussed, or
enterprise spending) is especially deficient. All
these informational gaps need to be closed before
either the fiscal or the social reality, and
potential, of local distributional policy can be
adequately assessed.

While this might be a difficult task to achieve
in the FSU and Central Asia, a beginning in this
direction is feasible in most transition economies,
including Russia and the Baltics. Most East
European countries today have the capacity to
begin methodical collection and analysis of data.
Ideally, this requires:

- the establishment of uniform financial
  reporting (and budgeting) systems — perhaps
  with different degrees of complexity for
different categories of local governments; and

- the designation of an agency responsible for
  collecting and processing these data in a
timely fashion (which will probably, in a
large and complex country, require use of
some sampling techniques as well as
occasional census exercises to provide the
needed "frame").

The development of such systems and, much
more difficult, their implementation will generally
require substantial training and follow-up efforts.
Developing such "fiscal infrastructure" is neither
quick nor cheap, but it is essential if substantial
and important public sector activities are to be
decentralized — for whatever reason — without
losing sight of what is going on in these parts of
the public sector. The usefulness of such
systems, once established, can also be limited if
assignment issues are not sorted out first to ensure
the relevance of the data collected. Implementation of this recommendation may
require additional central government-supported
institutions: (i) to develop and maintain the
reporting systems, (ii) to train and support local government officials, (iii) to develop independent auditing procedures for local administrations and their revenue-earning enterprises, and (iv) to run the statistical side of the operation — with the latter being a main input into the work of the institution referred to in the first recommendation above.

An especially high-priority task for the needed central unit monitoring local finance is to analyze and evaluate intergovernmental fiscal transfers. As indicated in this paper, there are many questions that must be raised about the objectives, the design, and the effects of such transfers. There is also much to be said for encouraging much more informed and open discussion of these matters than is common in many countries, especially when the whole process is as novel as it is in the transitional economies. Regular publication of data will of course help, but one cannot rely solely on an interested party — the central government — to carry out, and certainly not to publish, all the analysis that is really needed in any country in which intergovernmental financial issues are important, whether in political or economic terms, or both. For this reason and others, there is much to be said for establishing as soon as possible in most countries one or more small non-governmental research institutes focusing on local government problems.

Performance Measurement

In addition, improved financial auditing and analysis, and the beginning of some kind of performance auditing are necessary to encourage more efficient financial management on the local level. Generally, capacities in managerial accountability mechanisms in transition countries are out of phase with decentralization. Local governments need tools and techniques to ensure accountability in spending. This however, is only possible if competencies are well established.

Managerial or "performance" audits, to help local governments assume the wider range of responsibilities that come with increased income may also be appropriate. General accounting offices of central and intermediate governments
have been suggested as a base for an expanded approach to fiscal accountability there. Performance measurement programs are a method for local governments to gather information on the performance of the services they finance and determine (through surveys, for example) the level of public satisfaction regarding such performance. Published standards and policy guidelines in the form of contract plans may be useful, if not wholly adequate tools to increase accountability for local expenditures by laying a benchmark against which constituencies can gauge management of public services.

**Management Information Systems**

At subnational levels, governments tend to be seriously lacking in financial, economic, social and budgetary information. In most cases, an overall effort to improve the management of local finance can benefit from either the establishment or the improvement of simple management information systems, to be used by local officials. Such systems would be tailored to the country's level of development, and the data collected would include information on (i) goods and services provided; (ii) financial resources; (iii) human resources; (iv) fixed assets; and (v) contracts with private/semi-private service providers, depending on local circumstances. Again, such a step is more likely achievable in the near term in Eastern Europe, Russia and the Baltics, than in the remaining FSU.

**VIII. SUMMARY AND CONCLUSIONS**

This paper has sought to review some of the pressing issues in the design of intergovernmental fiscal systems in transition economies. It also laid out the context — political and economic — in which decentralization decisions are being made. Below is an outline of the main themes in the primary policy areas.

**Why Local Finance Matters**

- Intergovernmental finance is not a "local matter." How services and goods are provided by various levels of government and who pays for them have consequences that extend throughout the economy. Despite bold moves toward autonomy and fiscal independence, few transitional governments offer their subnational governments much in the way of fiscal discretion.

- The design of a well-functioning intergovernmental fiscal system is key to many of the major reform goals of the transition economies — macroeconomic stability, privatization, income distribution, private sector development, even nation building.

- A broad framework is needed to analyze intergovernmental fiscal issues, one incorporating elements such as the likelihood of ongoing structural and economic changes and continuing political shifts, the need to undertake intergovernmental fiscal reforms while coping simultaneously with stabilization pressures, and the likelihood of continued local governance of enterprises on a significant scale.

- The trend and the dilemma, in a nutshell, are as follows. While local governments want to shake off central control and be masters in their own house, central governments assign them few taxes to reduce transfer dependence. However, even local governments seeking full expenditure autonomy still expect expenditure subsidies due to deficient fiscal bases. This
mismatch between local aspirations and financing creates both political tension and dysfunction in local finances — an untenable situation in the long-run.

**Traditional vs. Systemic Frameworks for Analyzing Decentralization**

- The traditional analysis of intergovernmental finance examines the fiscal functions of local and central governments in terms of their respective roles and responsibilities for stabilization, income distribution, expenditure provision, the appropriate assignment of tax functions, and the design of a transfer system that provides appropriate incentives.

- The need for flexibility in today's rapidly changing environment has led many central governments in transition economies to attempt to preserve degrees of freedom by continuing with the "negotiated" tax sharing systems of the past. This approach is less acceptable now in transition countries where demands for "fair treatment" and equalization are strong and where local governments are seeking greater autonomy. It is also incompatible with the efficient provision of local public services.

- "Bargained" intergovernmental outcomes need to be replaced with a well-designed, integrated fiscal framework consisting of transfers, local revenues, and local expenditure responsibilities — a framework that is firm enough to serve as a basis for action, but flexible enough to be compatible with the on-going structural changes and reform.

**The Political and Structural Context for Decentralization**

- Intergovernmental finance reforms are taking place in a context of political decentralization.

Many reforms seem to be politically driven, rather than responding to the design of a more efficient local government.

- Government reorganization is also taking place throughout the transition socialist economies, and, in striving for "local autonomy", many countries appear to be eliminating the "middle tier" of government through constitutional reforms.

- Intergovernmental finance reforms are taking place in context of overall changing and shrinking role of government and strained macroeconomic circumstances.

**Stabilization Issues**

- Stabilization and macroeconomic concerns dominate the central government's agenda. Stabilization concerns in many countries seem to be leading the center to deal with budgetary strain by "pushing the deficit down", and hoping the subnational level can do the cost-cutting. As a striking example of this shift, many countries are transferring increasing responsibility for social expenditures and the social safety net (arguably a national concern). This could result in the future in a situation where local governments cope with budgetary pressure by using economically undesirable sources of revenue (to the central government) for additional funds, or borrow.

- Intergovernmental fiscal reforms are taking place in a strained fiscal context. Care must be taken to prevent the stabilization objective from fully dominating the redesign of the intergovernmental finance regime. But first, it is crucial to ensure that the stabilization targets are correctly specified as pertaining to the consolidated public sector as a whole and not only the central government.
Expenditures

- In the course of decentralization, many expenditure responsibilities have been devolved onto local government, including many that violate the general "efficiency principle".

- In some cases, the center has shifted (potentially large and open-ended) responsibilities for "social welfare" down to the local level in an attempt to balance its budget.

- Responsibilities for capital and recurrent expenditures have been transferred, but not always in coordinated fashion.

- A likely consequence is the emergence of differentials in service provision across localities, as funding differentials determine local budgetary capacity.

- To minimize such distributional consequences there is a need to define central service provision standards for devolved or decentralized functions, such as in education and health and to reconsider the local financing of the safety net.

- Expenditure "autonomy" is enshrined in legislation, but is not really effective: there are still central controls and mandates in place, "budgetary norms" are used to define expenditure parameters for local governments and transfer dependence also impedes autonomy.

Tax Assignments and Transfers

- Attempts to make the subnational sector "independent" are desired by the subnational level and the center: the center wants "each tub to sit on its own bottom", to assign taxes and be done with further local involvements. Local governments want to reduce "transfer dependence." This is generally not possible, because the tax instruments are not sufficient, and user charges not yet at a level to contribute significantly to cost recovery.

- Subnational governments want to shake off central control, and be masters in their own house, and see appeal in the apparent autonomy that "transfer independence" provides.

Distributional Considerations

- Tax assignments typically under-fund the local sector. It is critical that subnational revenue needs and possibilities be realistically factored into national plans for tax reform.

- Distributional problems and the divergence of service provision across localities could also emerge. For example, the standard local financing rule to charge for public services whenever possible and "get the prices right" may be oversimplified. These prices (rents, transport, utilities, etc.) played an important distributional role under the previous regimes with their social contract of "free" basic necessities. Replacing price subsidies with targeted support programs (with a smaller budgetary impact) is one solution, but would involve the development of new information and tracking systems to replace those neglected since the breakdown of the socialist order. Some phasing and coordination with other national-level (wage) reforms, the social safety net or the introduction of other mechanisms is also in order if distributional problems are to be avoided.

- The local autonomy that has been enshrined in decentralization legislation translates into a pre-disposition, in the design of revenue sharing systems, towards "tax assignment" models, with certain taxes (usually the higher-yielding ones) assigned to the center, and other (mostly low-yielding taxes) assigned to
the local government. Where "tax sharing" was in place during the pre-reform period, there is now a strong bias toward "derivation-based" sharing models in which revenues go to the jurisdiction in which they are collected. Both systems are inherently counter-equalizing.

- There is a general absence of concrete empirical estimates of the "correspondence" of tax and expenditure assignments, and of any possible need for transfers. Legislation on intergovernmental finance relations is typically developed without a quantitative assessment of its implications.

**Privatization and Ownership**

- Local governments have become owners of an important share of formerly state owned enterprises, which have in many countries been transferred to them in the course of decentralization. Some "asset transfers" may be better thought of as liabilities, where they involve heavy subsidy and maintenance burdens (often the reason for the transfer in the first place).

- Subnational governments continue to have a major role in ownership ventures at a time when center/national priorities support privatization. This relates in part to the incentive framework defined by the new intergovernmental regimes and to the inadequate revenue base given to localities, which makes exploitation of enterprises an attractive revenue source.

- Privatization may have potentially significant negative consequences for subnational budgets as enterprises "social expenditures" are divested and go "on budget," and as newly privatized enterprises become harder to tax. Subnational governments may not want to let go of this reliable financing source.

- A major issue is how to use the transitory revenues from privatization. Options include: debt repayment, investment finance, or recurrent expenditures. How local governments should take advantage of their asset stock is an important issue.

**Institutional and Organizational Framework for Local Government Finance**

- In many transition economies, the institutional arrangements needed for dialogue on intergovernmental issues is missing, even though the need for such dialogue is, if anything, greater than in market economies.

- As most transition economies look to abolish the intermediate tier of government, the role of this level must be closely examined. Extensive fragmentation with no middle level can preclude efficient relations between the center and the various local governments.

- It is critical to introduce a body responsible for the design and ongoing monitoring of local government matters such as: (i) the collection of regular and detailed financial data, (ii) the monitoring and assessing of subnational finances and, (iii) analysis and evaluation of intergovernmental fiscal transfers.

- Managerial or "performance" audits are also needed to improve local government finance, by helping governments to assume the wider range of responsibilities that come with increased income. Published standards and policy guidelines are examples of tools that can be used to improve performance measurement.
The increase in the real power of local governments must be accompanied by a concomitant improvement of their capacity to perform supervision and oversight. Additional technical training efforts, management information systems and more efficient local councils are crucial in this area.

NOTES

1. Part of the following section was prepared by Florence Eid and draws mostly on material by Tim Campbell on Latin America (see references).

2. These are, strictly speaking, decentralized branches of the central government administration, not an independent tier. There are 88 oblasts in Russia; 9 oblasts in Bulgaria; 19 County Councils in Hungary; 49 Voivodships in Poland; and 41 Judets in Romania.

3. A regional study on decentralization in Latin America found the same; see Campbell, Peterson and Brakarz, 1991.

REFERENCES


SOME GOVERNANCE DIMENSIONS OF INSTITUTIONAL REFORM

Geoffrey Lamb

This paper is intended as a preliminary exploration. First, I will try and set out some of the objectives of the institutional reforms underway or contemplated in countries of Central and Eastern Europe and the former Soviet Union, looked at through the prism of current debates about "good governance." Second, I will try to use that perspective to indicate where some of our current problems lie, particularly with respect to timing and sequencing of institutional reforms, obvious gaps in the coverage of external efforts, and the political context of the reform process. Third, this discussion may yield some conclusions, very tentatively, about possible adaptations in the role of external assistance in the months and years ahead.

Institutional Reform Objectives

External assistance for institutional reform in the transition countries has at least three objectives closely related to "good governance."

First, it is designed to sustain the transition and reform process. This is essentially a political objective, in the sense of maintaining a government, or a group of reformers, or at any rate a program of a certain sort, in power. By its nature, it is essentially a short-run objective.

Second, an important part of the effort is to foster the creation of core institutions — and institutional values — of a market economy. In this context, I am referring mainly to economic institutions such as property rights, contract and enforcement mechanisms, labor mobility, and some sort of "Jeffersonian minimum" of government as guarantor of social order and enforcement of due process. Even this restricted set of objectives is, of course, a long-term project.

Third, external assistance seeks to support the growth of institutional pluralism and of civil society — that is, the development of powerful social, economic and political institutions autonomous from the state. This objective, again long-term in character, in fact permeates the other two, though it is a more explicit aim for some external actors than for others. It is worth considering separately, since it generates some controversies which are likely to loom large in future debates about the politics of external assistance to these countries.
Governance and Current External Assistance Programs

It may be useful here to clarify the use of the term governance, which largely follows recent World Bank contributions to the discussion of governance in the international community. Governance here refers to four principal themes:

• The clear delineation of accountability for public action — accountability, that is, of entire governments or government agencies for official action, and individual accountability of public servants within a framework of clearly understood rules and procedures.

• The open or transparent conduct of public business, which implies a clear definition of the boundary between public and private spheres of action and information.

• Predictability, or at any rate the absence of arbitrary or capricious action by the state — a reference to the system of known rules and sanctions, due process, etc., normally summed up under the phrase "the rule of law," but also, arguably, extending to stable rules of the game in the conduct and continuity of public policy.

• The sound and efficient management of government and the public sector, in the sense of effectiveness and economy in the structures and processes of public management.

If, as a first simple step, one were to survey current major programs of external assistance from the viewpoint of these four attributes of governance, some headings loom much larger than others, and some telling lacunae emerge.

Public management — perhaps because it is a portmanteau — looms very large indeed. In some countries major programs of administrative reform and restructuring are beginning or are in prospect. The EC/OECD Omega program in Poland, UNDP/World Bank/EC collaboration on administrative reform in Latvia, and the prospective collaboration of World Bank/EC PHARE and OECD/SIGMA, and UNDP on public administration restructuring in Albania are examples. The IMF has focussed its greatly expanded technical assistance program on core fiscal and monetary management functions, strengthening tax administration, budget and treasury operations and central banking in a wide and growing range of countries in CEE and FSU. The World Bank, UNDP and EC/TACIS have quickly got into the business of helping these countries formulate new public investment procedures and manage existing and prospective external aid flows, and in some countries — for example in Kazakhstan and Kyrgyz Republic — the beginnings of a welcome concerted approach are discernible. The large programs in support of privatization — with EBRD, IFC and the World Bank the major external sources — is also in one dimension a matter of public management reform.

There has also, clearly, been a great deal of activity — particularly in Central and Eastern Europe — to install a predictable framework of law and regulation to replace the arbitrariness of the old order and the legal and institutional void of the initial revolutionary period. Much of this activity seems to have been bilateral, particularly from Germany, France and the US. At the same time, the countries themselves were also often energetically copying and adapting aspects of law from other countries or indeed their own pre-communist commercial and legal codes.

In terms of transparency and accountability of government action, there has of course been a huge improvement which is entirely political in origin and has little or nothing to do with external assistance. Governments in most of these countries are now incomparably more open and more accountable — to Parliaments, if not effectively to a wider public — than they ever were in the communist period. The functioning of these new systems of accountability can be extremely problematic, or even perverse — as
when parliamentary accountability becomes the arena for the crudest of power plays unmediated by either constitutional or informal rules of the game.

For the most part, external assistance has focussed on rather restricted areas of public accountability: probably the main activity here is in the area of public finance — especially budgeting — and public procurement, with the Fund and the World Bank in the first case, and the EBRD and the World Bank in the second case, playing the main although still very limited role.

This is not, of course, a survey but merely examples of assistance efforts addressing the aspects of governance mentioned earlier. Nevertheless, some rather important gaps in international efforts seem to suggest themselves.

"Governance Gaps" in Assistance

The first of these pertains to the institutional infrastructure of the rule of law, especially in the economic field. Many — perhaps most — of the transition countries are now beginning to put in place a body of laws covering property rights, contracts, commercial codes, bankruptcy procedures, banking and so forth. Indeed, one might sometimes discern a degree of legal fetishism, in which a preoccupation with legal forms and the passing of laws becomes not only the symbol but the substitute for substantive action. What is almost universally lacking, however, are the personnel and organizations essential to give meaning to the law: trained judges, organized court systems, land registers, cadastral surveys, mortgage and lien registers, patent offices, company registers, and so forth. In the absence of this infrastructure, it is not surprising that some of the early legal disputes of the emergent market economies — for example over the issue of restitution versus compensation in property rights in Hungary, Bulgaria and now Albania — have an irresolvable air about them, or at any rate a persisting political saliency in the absence of well-grounded resolution processes.

With respect to accountability, three gaps suggest themselves. The first concerns corporate governance in the public sector. Now that the ethos of privatization is firmly established in most — though not all — countries in the region, the management of transitional and long-term public corporate assets needs to come back into the limelight. Fiscal and credit control regimes, monitoring and performance enforcement mechanisms, triage procedures, holding companies and restructuring agencies — countries, especially of the former Soviet Union, will need assistance in evaluating which if any of these way-stations en route to the private economy are appropriate to their circumstances. As the path to stabilization and sustainable fiscal regimes reveals itself to be longer and more difficult — as for example in Russia — and as privatization proceeds for the most part rather slowly, the destabilizing potential of absent or inappropriate governance of state enterprises is emerging as a problem of growing importance.

Second, the area of parliamentary accountability seems ripe for external assistance. The new parliaments are ill-educated in economic matters on the whole, and legislators are ill-informed and ill-equipped to make intelligent judgements about government policy. This is a delicate area, clearly, but in many circumstances an attempt to reach out and help parliaments to do their jobs better in "technical" fields seems no more risky, certainly, than the appearance that external donors are conspiring with governments to frustrate the intentions of sovereign legislators. International agencies have so far only infrequently become involved in strengthening parliamentary or other political structures of accountability, though bilateral donors have done so to a greater extent. (A recent World Bank technical assistance program in Chile, which provided information and technical services for
Chilean parliamentary committees, may provide some useful experience.)

A third area of accountability and transparency is the delicate one of corruption in government. Aside from the procurement and budgetary oversight aspects mentioned earlier, this especially involves the audit and control functions within governments, in which agencies such as OECD can draw on a rich bank of experience, and the much more diffuse issue of standards, ethics and individual incentives in the public service. A number of governments are looking for assistance in these areas, but are perhaps too often focussed, again, on the legal definition of proper behavior and individual responsibilities of civil servants than on working systems of monitoring and enforcement and of public pay and employment policy. Clearly this also poses two larger challenges: how to move beyond the interregnum where huge rents are extracted from arbitraging between the new system and the old, and secondly how to assist in the emergence of an accountable and properly structured government apparatus, focussed on the tasks modern governments should do, and held to normal standards of public ethics.

Timing and Sequencing

We need, however, to put a template of time over the discussion. International assistance for institutional reform needs to introduce the same concern with sequencing and time which has assumed such importance in the macroeconomics of transition in the last couple of years. At the outset of this paper it was suggested that the first objective of external assistance for institutional reform was essentially a short-term one: the political sustainability of the transition process. At the same time, most of the fundamental institutional reforms which our agencies are supporting are essentially medium and long-term in character — though no less vital for that.

What this suggests is that we need a two-track approach to support for institutional reform. The first track, to over-simplify, would be explicitly short term, contingent and emergency in character, and cannot by its nature await fundamental institutional restructuring or long-term institutional development of the agencies and organizations in which key functions are located. This is what one might term the "policy enclave" track — that is, a minimum set of institutional functions and reforms which need to be inserted within larger "unreformed" structures in order to keep the transition process on the road. The "older" reforming countries such as Poland and Hungary are probably past this stage, for the most part, whereas some of the former Soviet republics have barely arrived at the point where interventions of this sort can yet achieve much. I would suggest four candidates for transition-sustaining "policy enclaves," with a 2-3 year time horizon.

The first is budgetary control and the control of credit creation and monetary policy. This is not only obvious from the point of view of macroeconomic stabilization, but is vital because, in the short run, these are the only effective instruments most governments will have to block or least control the hydraulics of the enterprise/state bank/budget system of transfers and subsidies to enterprises, which is the diseased financial heart of the command system. It was the failure to cut those linkages, with consequent feedback into macro instability, which was a consequence of the political victory which the big industrialists scored over the Gaidar government in the summer of 1992.

Second, aid management, since this provides the reformers with one of the few clearly new economic and political resources at their command.

Third, mass privatization, to help create political constituencies with a stake in the new economy, and hopefully broaden supply-side demonstration effects. One dimension of this is the privatization of small-scale shops, workshops and the like, in which EBRD and IFC have been
active in Russia, Ukraine and elsewhere. The more difficult aspect of mass privatization is the design and execution of give-away type programs such as vouchers and the like. International agencies have frequently hesitated over this, often with good reason, but in an increasing number of countries the political calculus of the reform process appears to demand such schemes as an essential and early element of privatization strategy, and there is at least one instance — in the Czech Republic — where it appears to have been a highly effective technique.

The fourth area is the "mind of government": in most countries of the region that is the Council of Ministers structure, which functions as a sort of "super-government" overlay over both staff and line ministries. In the short run, sector ministries in most of the transition countries are notably weak, and even the economic management agencies (Ministry of Finance, Ministry of Foreign Economic Relations, Central Bank, Ministry of Economy) tend to be subordinated to the Council of Ministers and not to play the preeminent role they traditionally occupy in most other countries. It is remarkable that the Council of Ministers, with a few exceptions such as Poland, tends not to have a great deal of external advice and assistance, and to be relatively cut off from the traffic of debate and international contact which many of the more traditional but less powerful agencies are already enjoying. It is also worth noting that the Council of Ministers structure frequently tends to be the locus of control over government structures and cadres — i.e. the place where the vital job of public administrative reform must begin.

Civil Society and Path Dependence

As a final piece of the puzzle of governance which I have been trying to trace, let us recall the third objective of institutional reform outlined at the outset: the underpinning of market relations with the autonomous institutional apparatus of civil society. Here, we need to recall North's emphasis on "path dependence", and in particular to move away from the facile universalization of the political economy of western industrial capitalism. In other words, there is no reason, pace Fukuyama, to think that the trajectory of political and economic change in the transition countries will involve accelerated arrival at a sort of post-historical pluralism as a consequence of the large-scale transfer of western institutional models, personnel and techniques. Both the negative example of Sub-Saharan Africa and the positive instance of East Asia are powerful reminders of path-dependence in just this sense: in the late 20th century the pace of change constantly accelerates, but convergence of the underlying economic systems occurs with powerful institutional and cultural overlays. Three aspects of this may be particularly relevant within the time horizon of current assistance efforts.

First, most of the transition countries are entering a phase of political fragmentation which is likely to be prolonged. The anti-communist coalitions have largely collapsed under the pressures of competitive electoral and quasi-electoral politics; reformist governments face more combative legislatures and eroding popular legitimacy as economic decline enters its second or third year; and the rough beast of nationalism which slouched forth to be born in the wake of communism's downfall threatens, all too frequently, to devour the inheritors. In a few countries this is producing a conservative (I would not yet say counter-revolutionary) political reaction — as in Belarus and Lithuania. In others — Russia is the leading example — the political concessions needed to contain fragmentation at the political base are increasingly costly to the coherence of reform.

Paradoxically, this may mean that external support for reforms which are focussed on institutional development rather than explicit policy changes, can seem less threatening. Such institutional reforms frequently have an efficiency-
enhancing as well as transformational character and are thus attractive to governments (better customs administration or tax collection, for example), and therefore can be important as a way of maintaining some momentum and continuing external contacts. This is certainly part of the logic behind World Bank institution-building loans under preparation for a number of former Soviet countries which have yet to launch economic programs which merit full-scale external financial support: Ukraine, Uzbekistan and Belarus are examples.

Second, very few transition countries have effectively displaced the core of the formerly dominant elite — that is, the industrial management class — nor are they likely to do so. The fiercest struggles over privatization policy and design, in fact, have at their core the issue of how much of the current asset stock, and future private economic power, can be wrested away from the current managerial holders and their implicit allies in the industrial working class.

There may be two implications for assistance policy of continuity or path dependency in this sense — and neither of them is comfortable. One implication is that assistance for feasible privatization design will need to focus, in many and perhaps most transition countries, on the mechanics of formally sanctioning the managers’ effective appropriation of control, while endeavoring to make it somewhat less inequitable and anti-competitive than outright and unmediated appropriation would be. Another implication is that the process of privatization on this path-dependent model is likely to consolidate the managerial class — with many new entrants, and a new set of economic interests, to be sure — as the social and political anchor of the new order. The initial attempts of some of these elites to assert themselves in organized political ways — Civic Union in Russia, New Ukraine in Ukraine, for example — may have been ineffective because premature, but there seems little doubt about the medium-term outcome.

Third, in many countries of CEE and the FSU it is not only government, but the central state apparatus itself, which appears to be losing effectiveness and legitimacy, though of course there is a wide spectrum as between, say, the Czech Republic and Tajikistan. The moral — as well as political — collapse of the old order has sometimes combined with the new atmosphere of freedom and opportunity to produce both primitive accumulation (mafias, nomenklatura “wild” privatization, theft of public property, etc.) and shrinking moral horizons as people become less secure and more preoccupied with immediate economic survival. Rapid decline in electoral participation, localism, regional and ethnic movements, and so forth are in this sense the symptoms of a political and ideological—sometimes almost a psychological—interregnum with uncertain outcome. The rational calculus of local governments, regional elites and enterprise managers about the resulting relative strength of the central government and centrifugal forces can then lead to selective remittance of taxes or selective compliance with central government decrees, as has happened in some areas of Russia. The consequences for political development on a “civic nation-state model” may be very serious, as separatist and authoritarian nationalist solutions compete.

This is, of course, merely to re-state the political dilemma of external assistance facing unpalatable policy alternatives thrown up by political succession — and in some cases political crisis — in transition countries. There is little that can be contributed to that question at an operational or technical level. However, it does seem clear that external support for institutional reform will need increasingly to find ways to be effective at the non-central-state level, and to respond to the emergence — particularly in the larger and more politically diverse countries — of a multi-mode and multi-speed reform process. This, certainly, will require an intellectual refocussing and a considerable culture change among assistance providers.
Conclusion

This paper has been an exploration of some aspects of our common terrain through the discourse of governance: it is appropriate only to re-state some of the contingent suggestions made along the way for external assistance strategy, rather than attempt an overall conclusion.

First, external programs should focus on some apparent gaps. The three areas suggested were:

- the practical institutional infrastructure of a law-governed economic system
- the market-based governance of long-term and transitional public corporate assets, and
- the delicate frontier of political and bureaucratic accountability, through support to parliaments and encouragement of corruption-reducing systems within governments.

Second, assistance programs should distinguish more clearly the time track of the institutional reforms they support. In particular, we need a more effective and explicit set of transition-sustaining short-term interventions — a "policy enclave track" of assistance focusing on:

- expenditure and credit control
- aid management
- locking in mass privatization, and
- the core policy structure, commonly the Council of Ministers.

Third, the political context emerging in the transition countries — with all due allowance for variations — suggests that the implicit civil-society model underlying much assistance for institutional reform will need to be constantly re-examined. This is particularly true in areas such as privatization policy and public finance, in the face of the challenges posed by the consolidation of managerial elites and the emergence of new and assertive centers of local power.
CONFLICT AND TRANSITION IN RUSSIA:
Some General Observations

Valery Pivovarov

I. INTRODUCTION

This paper draws attention to "conflict" as an integral part of the on-going transition in Russia and the ex-USSR. Conflict is a factor not to be ignored by those from the outside who are involved with the region's problems, inter alia, in international aid and foreign investment. A brief classification of socio-political groups is offered below, listing the needs and fears of each group and emphasizing the human dimension of the current strife. Ethnicity as a source of conflict is treated in more detail. Although the paper was first drafted before the October 1993 dissolution of Parliament and subsequent events, the elements of conflict it describes are still present in the former USSR and will continue to be operative in the foreseeable future — albeit with specific manifestations which are impossible to predict. Indeed, the outcome of the December 1993 Parliamentary election was heavily shaped by the interplay of conflicts described below.

In Russia and the ex-USSR "conflict" is the most frequently used word to describe the current state of affairs. Listed below are just some dimensions of the multi-level and multi-layer conflict which is rampant in the territory.

**Political:**
- Unclear and contested division of labor between the legislative and executive branches;
- "Mother Russia-ers" vs. open policy internationalists;
- Administrative and ethnic provinces vs. the "center";
- The issue of "new national borders;"
- Strong hand" vs. participatory consensus.

**Economic:**
- Equivocal government policies toward market economy and private enterprises;
- Monopoly producer vs. consumer and "new" economy;
- "New" economy (corrupt and otherwise) vs. corrupt and inept bureaucracy.
Society at large:

- Precarious balance between the divided rulers and the divided ruled;
- Attempts to stifle the media;
- "New Haves" vs. new and old Havenots (both fearful of the future);
- Lumpen-proletarization and marginalization;
- Age-old ethnic and religious prejudices, "national independence" and real issues resulting in bloodshed;
- Unprecedented rise of crime;
- Unstable mass psychology and a lack of a credible "center" in civil institutions, etc., etc.

This admittedly partial and overlapping list is presented for purposes of illustration. Any of these items can be broken down into numerous conflicts within the subject areas concerned. What these dimensions of conflict bring out is that the human dimension of institutional and policy changes (i.e., how to make "the people" an ally in accomplishing such changes and minimize transaction costs) must be reckoned with, especially by external organizations. Obviously, outside agents acting in an unfamiliar environment benefit from becoming aware about the persons and groups they deal with, their role in the transition, and whether or not they cooperate with each other or are in conflict.

The end users of any reform, program or investment initiative are individual human beings and groups. Ideally, they should be actively supportive of the proposed changes affecting their lives. At a minimum, acting through various delegate groups, they should be involved, in some appropriate form, in the process of change. In order to enlist the end users' cooperation, it is first essential to realize that they are by no means monolithic. It is thus advisable to look into the conflicting attitude to reform of the various groups. At a time when Russia (unlike some other parts of the former Soviet Union) is not afflicted by violent military conflict, which is the worse conflict — it is fitting to discuss the other major conflicts: ethnic, economic, and social.

II. ETHNIC CONFLICT

The demise of "communism" in the ex-USSR and in Central Europe, internal political shifts and loosening of centralized controls over diverse ethnic groups has brought about a significant rise in ethnic conflict in this region. Some conflicts are new, some old — but all have been severely aggravated by the Stalinist inheritance of "moving and mixing" as an instrument of control. However, the majority of such conflicts are manifestations of centuries of animosity and mutual claims and replays of the old disputes by new generations. The surfacing of these conflicts today and the often violent forms they assume are due in part to the newly-acquired freedoms of greater expression of ethnic groups and lack of feared central authority. (Table 1 shows the ethnic composition of the autonomous republics of the Russian Federation).

Ethnic disputes, of course, are not the monopoly of the region and are all too well-known elsewhere, even in relatively quiet and obviously prosperous Western Europe. Yet, the situation is unique due to the sheer size of the vast region involved — (from what remains of former Yugoslavia in the West to the Pacific in the East), — persistent fighting along part of the Southern rim of the region, and dim prospects for
### Table 1 - Ethnic Composition of the Autonomous Republics of the Russian Federation

<table>
<thead>
<tr>
<th>Autonomous Republic</th>
<th>Total Population</th>
<th>Russians (%)</th>
<th>Titular group (%)</th>
<th>Titular group within autonomous republic as % of total, titular group</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dagestan</td>
<td>1,802,188</td>
<td>9.2</td>
<td>75.1</td>
<td>77.4</td>
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<tr>
<td>Chechen</td>
<td>1,270,429</td>
<td>23.1</td>
<td>70.0</td>
<td>80.6</td>
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<td>Chuvash</td>
<td>1,338,023</td>
<td>26.7</td>
<td>67.8</td>
<td>51.1</td>
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<td>Tuva</td>
<td>308,557</td>
<td>32.0</td>
<td>65.3</td>
<td>96.3</td>
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<tr>
<td>Kabardino-Balkarian</td>
<td>753,531</td>
<td>31.9</td>
<td>57.6</td>
<td>93.5</td>
</tr>
<tr>
<td>N. Ossetia</td>
<td>632,428</td>
<td>29.9</td>
<td>53.0</td>
<td>83.2</td>
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<tr>
<td>Komi-Permyak</td>
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<td>36.1</td>
<td>60.2</td>
<td>64.8</td>
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<tr>
<td>Aginsko-Buryat</td>
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<td>40.8</td>
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<td>10.1</td>
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<td>Kalmykia</td>
<td>322,579</td>
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<tr>
<td>Tatarstan</td>
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<td>43.3</td>
<td>48.5</td>
<td>32.0</td>
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<tr>
<td>Karachaevo-Circassian</td>
<td>414,970</td>
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<td>40.9</td>
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<tr>
<td>Mari</td>
<td>749,332</td>
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<td>43.3</td>
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<td>50.3</td>
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<td>96.1</td>
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<tr>
<td>Ust-Ordynski</td>
<td>135,870</td>
<td>56.5</td>
<td>36.3</td>
<td>11.7</td>
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<tr>
<td>Bashkortostan</td>
<td>3,943,113</td>
<td>39.3</td>
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<tr>
<td>Mordovia</td>
<td>963,502</td>
<td>60.8</td>
<td>32.5</td>
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<td>30.9</td>
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<td>Altai</td>
<td>190,831</td>
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<td>Koryak</td>
<td>39,940</td>
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<td>Buryatia</td>
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<td>69.9</td>
<td>24.0</td>
<td>59.3</td>
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<td>Adygeya</td>
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<td>68.0</td>
<td>22.1</td>
<td>77.7</td>
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<td>Taymyr</td>
<td>55,803</td>
<td>67.1</td>
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<td>Even</td>
<td>24,769</td>
<td>67.5</td>
<td>14.0</td>
<td>11.6</td>
</tr>
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</table>
settlement against the backdrop of ineffective mediation and other efforts. In fact, the very real probability of a few hotbeds of tension escalating to local armed conflicts and expanding elsewhere is brought home almost on a daily basis, which makes any pessimistic forecast easy to make. (A. Chekhov: if in Act I there is a rifle hanging on the wall, it is sure to be used in Act 3, otherwise it serves no purpose).

Ethnic disputes in the former USSR involve a wide range of issues: demands for total separatism and the founding of new nation states; pressures for greater ethnic group autonomy within some kind of federal system; calls for greater representation in new parliamentary and local government structures, and in the staff of reconstituted agencies and institutions; expulsion and repatriation policies; problems with refugees; recognition of special cultural rights; competition over the location of economic development projects; provision for greater economic inclusion of minorities, provision for separate educational facilities; and the management of overt ethnic violence, xenophobia, and anti-semitism.

Ethnic conflicts in the ex-USSR are no less complex and infractible than elsewhere. They often involve years of hatred and psychological barriers between involved parties. They may also include threats of, or significant actual physical violence toward, persons and property. Ethnic conflicts may also involve complex institutionalized forms of exclusion and discrimination that make constructive and equitable interaction between the parties significantly more difficult.

Ethnic conflicts are often exacerbated, and always influenced, by the policies of neighboring nation-states whose population is of the same ethnicity as the minority in the adjoining state. Resources from outside the "dispute system" or area that might be of assistance in managing or resolving ethnic disputes are generally either unavailable, or rejected by the dominant ethnic group.

Intra-group and intra-state conflicts are extremely difficult for the international community to handle. They are no easier to manage for the "center" of the former empire, as Moscow's experiences indicate all too clearly in the Armenian-Azeri, Georgian-Abkhazi conflicts, in Moldova and in Tajikistan.

In today's context in the former USSR, a combination of factors are at play which are lumped together as ethnic but are not necessarily reduced to that. Of course, the psychological issue of "us vs. them" where "us" is superior operates in this region as in any multi-ethnic community anywhere. The new nationalist fervor is spurred by the artificiality of borders in both the big and small autonomous republics. Before 1917, the borders of the old gubernia were purely administrative, not unlike the states in the U.S.A. Current borders were established by Stalin in the 1920, supposedly along ethnic lines. The delayed-action mine put in by Stalin under the USSR is exploding now. The borders rarely surround only locations of compact settlement of titular nationalities/ethnic groups where the bulk of such group resides. Even when they do (Tuva, Yakutia, Altai), there may be anywhere up to 60% of ethnic Russians in the population of the autonomous republic (see Table 1).

Had the borders been purely administrative, the titular group and the "Russian-speaking" population would have worked out some modus vivendi and operandi — as they had done when "independence" was not at issue. Because of the ethnic criterion used (or, rather, alleged) three generations have grown up in "their own" titular republic/autonomy. Given the newly-acquired freedoms, they may feel entitled to "their" land and more often than not claim that their neighbors have chopped away sizeable chunks of "their" land. The backlash of those who find themselves in the new "ethnic minority" is immediate and often not unreasonable. For example, can Kazakhs claim that anything within the territory
of contemporary Kazakhstan is "theirs," if Kazakhs were traditionally nomads, and the existing border was invented in the 1920s and 1930s (oftentimes using a ruler)? In addition, many Russians and their other ethnic minority residents, far from being the representatives of an imperial center, are themselves former victims or descendants of victims of the same Stalinist system of oppression, exiled, relocated after a stay in the "Gulag," or moved en masse (e.g., the "Volga Germans") for reasons of political control.

Many Russians born in the newly-independent republics, including professionals and new businessmen, thus feel they are being discriminated against in favor of the local titular ethnic groups, professionals and businessmen. Such new discrimination is often accompanied by unsavory statistical games that have become popular amongst minority or slight majority titular groups. (All the figures in this section, however, are from the 1989 census which the Union Republics and autonomous territories had no interest in doctoring).

These considerations lead inevitably to the crucial question of whether the new "natural" borders can be redefined peacefully or are untouchable. Clearly, in the view of many, any redefinition of the borders would lead to bloodshed. On the other hand, the existing borders are arbitrary for practically any title nation, including the Russians. This explains why, in order to be equal, "Mother Russia-ers" urge the creation of the Russian Republic within the Russian Federation — as if being "more equal" were not enough.

The problem is that even the "Mother Russia-ers" have a point. Look at the newly "independent" Tatarstan which is landlocked within Russia. Following President Yeltsin's call "to take as much power and authority from the Center as you are able to handle," and in accordance with its "associated" status, Tatarstan independently decides on the amount of taxes to be paid to the Federation. In 1992 it did decide to pay — Rbl 93 million. However, Tatarstan received from the Federation 36 billion rubles in subventions, benefits and credits, four hundred times as much, more than was given in that year to as many as 12 central Russian oblasts.

Rightly or wrongly then, the general feeling is that the autonomous republics have long ceased fighting for their rights, of which they have as many as they are "able to handle," and are now out to get privileges, which are attainable only at the expense of other groups’ rights. Claims to special status are based on the right to self-determination: as long as the autonomous republics do not secede from the Russian Federation, they claim special privileges in consideration of the free gift of their continued presence.

It can thus be seen that a root of the on-going conflict is to be found in the one-sided interpretation of the right to self-determination. The autonomous republics interpret it as the right to secede. The opponents of this interpretation define self-determination more narrowly as the right to unrestricted cultural expression. Paradoxically, many perfectly legitimate cultural and national issues are still looking for attention against the backdrop of claims to separate statehood. Again, to use Tatarstan as an example, this republic has not provided radio programs in the Tartar language, nor has it helped in providing Federation-wide radio service for the benefit of the Tartars (most of whom reside outside their "national home") or in establishing a Federation-wide newspaper in the Tartar language.

Another root of conflict is the idea that the autonomous republics are a "national home" for the titular national group. Hence, claims to "our historic land," "our domain," etc. to the exclusion of others who constitute a majority of the population. As shown in Table 1, most of the autonomies within the Russian Federation
nolonger fit the "national home" description. The flip side of Stalinist ethnic manipulation was the dispersal of many groups outside their original territory. Titular ethnic groups account on average for less than 40% of the population in the autonomous republics. If a dual criterion were to be applied to the ethnic argument for separate statehood, i.e., (i) the majority of the population constituted by the relevant titular group, and (ii) the majority of such group residing within the relevant territory — only 6 of the 30 autonomous republics would qualify on ethnic grounds.

Of course, ardent nationalism bordering on chauvinism which is rearing its ugly face in many areas is still in a minority. This is because, while in most autonomies there are not enough members of the titular group for the sentiment to become prevalent, in others where the titular group has a clear majority it does not feel threatened. The risk of virulent chauvinism, therefore, is highest in the "marginal majority" territories. Correspondingly, it is there that manipulative or repressive polices (from statistical "games" to coerced emigration, discrimination or worse) are more likely. An exodus of "Russian speakers" (Russians, Ukrainians, Germans, Jews, i.e., groups other than the titular one) has begun from the C.I.S. member countries (excluding Ukraine and Belarus) and some of the autonomous republics within the Russian Federation. This creates shortages of skilled labor in the republics and resettlement problems for Russia where the immigrants (refugees) are not overly welcome.

The C.I.S. member countries and the autonomous republics may need a little time to indulge themselves with their newly-acquired sovereignty and independence. It may be that narrow-minded nationalism will give way to more enlightened expressions of autonomy and independence, if it is given a chance of development without external restrictions which may be resented as interference or diktat. If and when the "ethnics" realize that their claim to ethnic uniqueness is not threatened, they may increasingly look beyond their national fence. The realization may come fairly soon. In fact, it is coming, albeit painfully, from issues other than culture, language or religion. For years to come, the existing reality of an integrated economy is likely to bring the various components together at a different level of interaction, be they "sovereign" or otherwise. The chances of Russia regressing into an odd collection of principalities (a nightmare played up by Mother Russia-ers) are very remote, despite certain krai and even oblast claiming "sovereign" status.

### III. ECONOMIC AND SOCIAL CONFLICT

Table 2 provides a general taxonomy of attitudes toward economic reform and foreign assistance. A first group, usually associated with Boris Yeltsin's presidency (but this association may have been changing from the beginning of 1994), is in favor of both reform and foreign assistance. A first group, usually associated with Boris Yeltsin's presidency (but this association may have been changing from the beginning of 1994), is in favor of both reform and foreign assistance. Among other characteristics, this group needs modernization and outside support, and is active but not very creative in its tactics, nor is it very pragmatic. A second pro-reform group is skeptical of foreign assistance. It favors modernization but in "natural" forms, needs a restoration of Russian power and prestige, and fears foreign exploitation and loss of national values. A third group may be called "reform tolerant." It comprises, among others, conservative technocrats, former communists turned social democrats, and much of the general public. This group will accept reform but only if gradual and closely monitored. This is because its greatest need is stability and its greatest fear is inability to cope with rapid or "unruly" change. Finally, the anti-reform group comprises a variety of people and impulses, from the extreme right-
# Table 2 - Groups and Their Attitudes Towards Reforms

<table>
<thead>
<tr>
<th>Attitude</th>
<th>Group</th>
<th>Needs/Fears</th>
<th>Behavior</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. PRO-REFORM, pro-foreign assistance</td>
<td><em>Democrats</em> <em>Good</em> technocrats Westernized intellectuals Most &quot;New Russians&quot; Some military</td>
<td>Needs: Modernization Survival of democracy Outside support Fears: Other groups Failure Restoration of bad old ways Western indifference</td>
<td>Active but decreasingly vocal Not very pragmatic Good &quot;assault teams&quot; - poor creators Non violent</td>
</tr>
<tr>
<td>2. PRO-REFORM in Russian colors</td>
<td>Unsophisticated and &quot;patriotic&quot; technocrats &quot;Patriotic&quot; anti-communists and intellectuals Regional power groups Some &quot;New Russians&quot; Many military</td>
<td>Needs: Great Russia, a superpower, modernized in a Russian way Staying in power Some aid on &quot;fair&quot; terms Fears: Westernization, &quot;blind&quot; copying Loss of &quot;Russian&quot; values Being cheated by the West &quot;Mafia&quot; Rising crime, non-Russians</td>
<td>Active, visible, outspoken and better tolerated by groups below than above Generally non-violent, prefer law and order</td>
</tr>
<tr>
<td>3. REFORM - TOLERANT</td>
<td>Conservative technocrats Communists turned Social democrats Labor unions Many &quot;patriots&quot; CAPs, veterans General public Many military</td>
<td>Needs: Stability Gradual change Foreign aid on strict terms Fears: Unruly market forces Inability to cope Not being properly consulted &quot;Mafia&quot; Rising crime, non-Russians</td>
<td>Active, vocal (unions and some veteran groups) Generally non-violent despite strikes Wholeheartedly for law and other and strong hand</td>
</tr>
<tr>
<td>4. ANTI-REFORM</td>
<td>Old unadaptable party-government nomenklatura Old-school managers Lumpenized blue/white collar workers New communists Ultra-patriots Some military Many OAPs, veterans</td>
<td>Needs: Old-type stability Dwindling power, privileges Law and order, punishment of &quot;democrats&quot; and reformers Restoration of Mother Russia Fears: Market economy The West, non-Russians Inability to cope</td>
<td>Active, vocal Sometimes violent</td>
</tr>
</tbody>
</table>
wing reminiscences of Zhirinovski to the unadaptable nomenklatura, some nostalgic military, lumpenized blue-collar workers, and so on. It is important to stress that there is no unequivocal correspondence between these groups and the major political parties. On the contrary, most parties include some elements of all four groups — and each group include elements of the major parties. The interplay of conflict is more permanent than the current political landscape, and explains much more than the competition between existing parties.

The "pro-reform, pro-assistance" group is often defeated by a coalition of anti-reformers and "Mother Russia-ers," at the highest level of representative democratic institutions (e.g., the Duma) and within the society at large. In general, a majority still wavers with respect to what institutional change they want and what sort of international assistance they may need. There is no clarity or resolve with respect to either issue. Reform has been neither "quick" nor "clean", which is not the fault of the pro-reform groups only, but a reflection of widespread ambivalence.

This ambivalence cuts across even the best individual minds. The psychology of "cradle to grave" welfare state is not overcome overnight, nor is the superpower superiority complex. People want the care they are used to, but they want their own care, not somebody else's. And there is grave resentment at the former Soviet Union becoming "the West's raw materials supply yard." Pride as a material factor cannot be discounted. Opinion polls indicate that anything associated with the goods and services "capitalism" delivers is generally approved, including private enterprise and competition. But the word itself is not accepted, nor is the actual effort needed to produce those goods and services understood or, indeed, desired. Most Russians are in favor of a market economy, but hate the discomfort of doing anything about it. The enterprising few (who already employ and otherwise involve millions of others) are discouraged by the opposition of the "old school" and the imperfect and corrupt government machine.

The lower institutional levels of society reflect the same ambivalence. At the individual factory level very few are prepared to plunge into stormy waters of change and weather the consequences. Most of the "other-directed" individuals look up to the managers in hopes of salvation. Most of the "inner-directed" persons have left the factory to engage in private pursuits or, if they are still optimistic about publicly-owned property, continue to fight for rather obscure goals of privatization, shareholding and other arrangements amid the shambles of their daily realities. They would welcome change, provided that its fruits are not taken away from them by "the enemy." The same is true at the industry level.

A contribution to resolving conflict at these levels could be made by the use of largely western experience of participatory approaches to organizational change. There are encouraging examples of success stories with regard to collective problem-solving exercises facilitated by a new breed of "company doctors" who go beyond the confines of traditional managerial approaches and adhere to the schools of "alternative dispute resolution," "non-violent social change," "conflict management," "win-win strategies," etc.

Clearly, some input to secure attitudinal change is needed by any family/factory/industry/country wishing to change peacefully. The ways toward such input are described in manuals and papers produced by such agencies as the US Corps of Engineers, which has amassed considerable expertise in how to (i) neutralize, (ii) turn into allies, and (iii) work closely with local citizens in connection with large projects. Also, a source of practical guidance is the success of some companies whose fortunes have been turned around dramatically thanks to the use of creative and collective problem-solving techniques. Wherever institutional frameworks make it
possible, such exercises may be undertaken with positive results. Once people facilitated (not manipulated!) by experienced individuals do some decision-making of their own, they will want to cooperate in implementing it.

We in Russia have to learn that conflict is basically "good for you." For most Russians, instead, conflict means rolling up one's sleeves and teaching the enemy a lesson. The notion of addressing conflict constructively is, by and large, alien to the former USSR. Negotiations are conducted in the form of positional bargaining, at best, or plain ultimatums, at worst. Compromise is viewed as capitulation. Mediation is accepted only from a trusted few who are very hard to find because they would need to pass the ethnic purity tests or the "communist past" test or other tests. Mediation is accepted only when the risk of bloodshed (or less violent but still very dramatic outcomes) has become unacceptable. Mediation by third parties working with trusted delegates who represent actual disputants is a slow and painful process. The delegates often have to go back to their constituent disputant groups to educate them on what they have learnt and the progress they have made. Despite these shortcomings, third-party mediation seems at this time the only realistic method of conflict resolution. Thus, mediation institutions need to be promoted in order to encourage a culture of non-violent conflict management.

IV. SOME CONCLUSIONS FOR FOREIGN ASSISTANCE

The creation of mediation institutions may involve both: (i) specific efforts by external donors to sponsor conflict management and mediation entities and practices; and (ii) the incorporation of such ideas and practices into their concrete assistance programs. Training of managers, retraining exercises, etc. lend themselves logically to such incorporation. Brief training workshops either on general conflict management techniques or focused on specific institutions or areas (environment, ethnic issues, reorganization, etc.) have proved effective and low-cost even in Russia. Longer-term reorganization-oriented programs based on group dynamics may be relevant to large-scale entities or whole industries.

In general, external donors would be well advised to identify the nature of conflicts and the main players in areas to which they provide assistance. Unless conflict in target areas is understood and addressed intelligently, i.e., with heavy reliance on the players carefully facilitated into a "win-win" solution, factional and other strife will prevent any loan or technical assistance from making any difference to the people and exerting a positive influence on the transition. Creating friends in one "pro-reform" camp is not enough; just as many enemies may be created on the other side. In parallel to working with pro-reform groups, opposition groups should also be understood and accommodated. Conflict management and creative problem-solving techniques may be one of the procedures to be considered to mediate and reconcile the interests and needs of the opposing groups with respect to projects that are meaningful for all those involved in or affected by actual or imminent change. A few success stories based on the use of such methods would go a long way towards instilling a culture of non-violent conflict management in the former Soviet Union.
TOWARDS A COORDINATED FRAMEWORK OF ASSISTANCE
I. INTRODUCTION

The countries of Central and Eastern Europe (CEE) and republics of the former Soviet Union (FSU) are grappling with the challenges of nation-building and transition to a market economy. In these efforts, they are being supported by several bilateral and multilateral organizations through substantial amounts of technical assistance. Among the multilateral agencies, the EC — with a 1992 budget of $2.15 billion for the region — is the largest provider of technical assistance. The World Bank, IMF, and EBRD ($68.8 in 1992) also have substantive programs in the region, followed by organizations with comparatively smaller programs like the OECD ($17 million in 1992), UNDP and ILO. Other UN agencies like ITC, WIPO, ECE and FAO have modest programs. Technical assistance for public sector management reform is limited; the leading contributors are the EC, IMF and the World Bank. Among the bilateral donors, France, Germany, the UK and the US have the most significant programs of technical assistance for this region. Here again, support for public sector management reform is modest.

This report describes in general terms technical assistance to the region in the domain of institutional development, particularly public sector management reform. It does not purport to be a full description of each agency's activities in institutional development/public sector management reform, but to convey overall content and direction, as a basis for discussions of possible gaps in the international effort and/or areas for closer collaboration. While this report does not discuss the very extensive assistance being given to privatization efforts, the re-definition of the state and the transformation of its role vis-a-vis civil society is the fundamental task of public sector management reform. Redrawing the boundaries of state action — in which privatization in the broad sense is the most important task — must be complemented by profound changes in organization, incentives and performance within the state itself. This paper concentrates on this second aspect.

A brief clarification of the terms "institutional development" and "public sector management" merits attention at this point. As used in this report, institutional development refers to any change that improves institutions in the public, private or non-governmental/non-profit sectors. Public sector management reform is a subset of institutional development. It includes the management of economic reform; management of
public expenditures, including public investments; aid coordination and management; state-owned enterprise reform; financial management and accountability in government; civil service reform; and, the internal administrative organization of particular sectors and ministries. In this report, public sector management activities will be discussed separately from other institutional development activities so that donor attention in that area, or the lack of it, is emphasized.

This report has been drafted by Vikram Goyal with the guidance of the Public Sector Management Team of the World Bank's Technical Department for Europe, Central Asia, Middle East and North Africa (EMTPM), and is based on donor information current as of early 1993. A list of multilateral and bilateral agencies contacted is annexed. All contributions from agencies which replied are included below, albeit in edited summary form.

II. MULTILATERAL ASSISTANCE

Commission of the European Communities (EC)

The EC’s total technical assistance to the region for 1992 is estimated at $2.15 billion, of which about $1.52 billion is technical assistance to CEE and $631 million to the FSU. Technical assistance to the Commonwealth of Independent States (CIS) is managed under the TACIS program and to CEE and the Baltics under the PHARE program (originally) (Poland-Hungary Aid for Reconstruction of the Economy, later extended to the entire region). The primary objective of both programs is to help the formerly socialist countries of the FSU and CEE make a transition to a market economy.

PHARE

The main purpose of PHARE support is to strengthen economic stabilization and structural adjustment at the micro level, in each of its beneficiary countries. However, depending upon the country’s needs, the intervention may be modified. For example, in Albania, economic stabilization efforts will be accompanied with emergency food and medical support. Similarly, the Baltic states will get assistance with economic diversification. The program’s activities are expected to be concentrated in the following priority sectors: agriculture, industry, investment, energy, environment, education and trade and services with particular emphasis on the private sector. These priority sectors are agreed upon at the beginning of each year by the recipient country and the Commission.

With a budget of $1.52 billion for 1992, PHARE’s contributions would be based on the country’s agreement to spend a pre-specified proportion of funds on each funded program. The total PHARE budget for 1990 and 1991 amounted to $1.7 billion ($689 million in 1990). Agriculture accounted for the single largest amount of assistance among all sectors, followed by the environment and by privatization. Together, these three sectors account for about half of PHARE assistance. Among the countries of CEE, Poland was the largest recipient of EC assistance, followed by Hungary and by Bulgaria. The distribution for assistance in 1990 and 1991, by sector and by country is indicated in the tables below.

In the area of institutional development, PHARE was involved with several sectoral projects. These include financial sector development, labor market development (Bulgaria, Czechoslovakia), restructuring of the agriculture sector (Bulgaria, Hungary), restructuring of the energy sector (Bulgaria,
### 1990 & 1991 Projects by Sector

<table>
<thead>
<tr>
<th>SECTORS</th>
<th>AMOUNT ($ MIL)</th>
<th>NO. OF PROJECTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>309.7</td>
<td>10</td>
</tr>
<tr>
<td>Environment</td>
<td>258.0</td>
<td>12</td>
</tr>
<tr>
<td>Civic</td>
<td>67.45</td>
<td>7</td>
</tr>
<tr>
<td>Privatization/Restructuring</td>
<td>204.4</td>
<td>8</td>
</tr>
<tr>
<td>Small- and medium-sized Enterprises</td>
<td>131.5</td>
<td>6</td>
</tr>
<tr>
<td>Banking &amp; Finance</td>
<td>106.0</td>
<td>6</td>
</tr>
<tr>
<td>Education and Vocational Training</td>
<td>166.4</td>
<td>12</td>
</tr>
<tr>
<td>Health</td>
<td>89.5</td>
<td>4</td>
</tr>
<tr>
<td>Infrastructure-Energy, Transport, Telecom</td>
<td>108.7</td>
<td>13</td>
</tr>
<tr>
<td>Other-Statistics, Customs, Etc.</td>
<td>175.0</td>
<td>18</td>
</tr>
</tbody>
</table>

### 1990 & 1991 Projects by Country

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>AMOUNT ($ MIL)</th>
<th>NO. OF PROJECTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>145.9</td>
<td>11</td>
</tr>
<tr>
<td>Czechoslovakia</td>
<td>165.3</td>
<td>8</td>
</tr>
<tr>
<td>Former German Democratic Republic</td>
<td>46.7</td>
<td>2</td>
</tr>
<tr>
<td>Hungary</td>
<td>278.2</td>
<td>23</td>
</tr>
<tr>
<td>Poland</td>
<td>449.7</td>
<td>26</td>
</tr>
<tr>
<td>Romania</td>
<td>145.9</td>
<td>8</td>
</tr>
<tr>
<td>Yugoslavia</td>
<td>48.3</td>
<td>1</td>
</tr>
<tr>
<td>Regional</td>
<td>95.0</td>
<td>11</td>
</tr>
</tbody>
</table>

Hungary, Czechoslovakia), modernization of the financial system (Hungary, Poland), development of private farming (Hungary), modernization of research infrastructure (Hungary), promotion of local community development and social welfare (Hungary), modernization of the infrastructure for foreign trade (Hungary), restructuring of transport sector (Hungary), upgrading education and training (Poland, Hungary), municipal development and training (Poland) and, restructuring the health care system (Romania).

In the area of public sector management, two PHARE programs are especially noteworthy. One is OMEGA or the Public Administration Reform program for Poland. This $5.5 million program's broad objective is to support the process of reform in the old central state
administration and improve the Polish government’s capacity to develop policy and manage its resources effectively. The specific objectives are to ensure that there are effective mechanisms to oversee and implement public administration reform; improve the managerial skills of senior civil servants; and, implement a general restructuring program of at least one ministry. PHARE also has a joint program with the OECD called SIGMA (Support for Improvement in Government and Management) which supports public administration reform in Central and Eastern Europe at a regional level. The $4.1 million program provides long and short term technical assistance to cover issues like central policy coordination systems; architecture or machinery of government delegation and accountability; budgeting; financial control and procurement; personnel policy; managing devolution of responsibilities; and, non-administrative institutions such as audit agencies. SIGMA’s activities are offered to Bulgaria, Czechoslovakia, Hungary, Poland and Romania.

**TACIS**

TACIS activities are implemented under the auspices of Indicative Programs designed for each recipient country. These involve the provision of expertise and training towards the development of local capabilities required to effectively manage a market-based economy and the establishment of formal and informal organizations which foster a democratic society; the EC considers the latter aspect to be a vital pre-requisite for the successful evolution of a market economy. In addition, the programs seek to ensure accelerated private sector development by creating an environment favorable to private investment. The programs are expected to reflect inter-sectoral actions and objectives and are to be implemented on a decentralized basis by a Coordination Unit outside the government bureaucracy.

Within the overall aid management organizations set up by the governments, the EC is setting has set up Coordination Units in each of the independent states to manage EC’s total aid to that republic. Key tasks would be to inform potential recipients of the aims of EC’s program and the terms of access to EC funding; assist with the identification of priority sectors for assistance; prepare aims and objectives for TA programs; receive and examine all financing applications; submit to the Commission all official financing requests; and; assist with the implementation of projects.

The EC has identified the following priority areas for its intended activities in the CIS, of which it expects to concentrate on no more than four sectors for any one country:

1) **Human Resources Development:** Potential activities include management and economic training in the private and public sectors and provision of advice to design essential social, health and educational policies. There is emphasis on building modern and efficient public administrations.

2) **Food Production and Distribution:** Activities could be supported at two levels — institutional and policy reforms at one level and programs in agricultural production, agro-industry, storage, transport, wholesale and retail markets at the other.

3) **Networks:** Activities include measures to improve management systems, and the organizational, legal and regulatory framework in the following sectors - energy, transport, and telecommunications.

4) **Business Support Service:** Activities include support for privatization, conversion of defence related industries, encouragement of foreign investment, and development of policy, legal and institutional mechanisms supporting the creation and growth of small- and medium-sized enterprises (SMEs).

Of the $587 million program of TA for 1992, $16.6 million would be for establishing 12
1992 SECTORAL ALLOCATION

<table>
<thead>
<tr>
<th>SECTORS</th>
<th>$ MILLIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>ENERGY</td>
<td>158.6</td>
</tr>
<tr>
<td>MANAGEMENT TRAINING</td>
<td>142.1</td>
</tr>
<tr>
<td>FOOD DISTRIBUTION</td>
<td>102.1</td>
</tr>
<tr>
<td>TRANSPORT</td>
<td>63.3</td>
</tr>
<tr>
<td>FINANCIAL SERVICES</td>
<td>51.7</td>
</tr>
</tbody>
</table>

Coordination Units in each country; $7 million for expertise to prepare the 1992 program, and $514 million for program activity in the 12 states. $101 million would be spent on regional projects and $413 million would be distributed among the 12 states according to the following criteria: population (50%); GDP per capita (20%); share of each state in the industrial production of the FSU (30%); and, compensation for the relatively high share of EC assistance received by Russia in 1991. The sectoral allocation for the 1992 program was as follows:

The Indicative Programs suggest that the majority of the independent states have prioritized the following areas for EC technical assistance:

1. **Government Advice for Macroeconomic and Sectoral Reform**: Policy advice will be given in the areas of trade, payments, inter-state economic relations, tax reform, budgetary procedures and techniques, mobilization and use of external funding, debt management, sectoral policies and privatization.

2. **Support for Enterprises**: The Program will support the development of SMEs by providing assistance to establish a basic legislative framework, establishing a business communication center to facilitate cooperation between the country and the EC, supporting the creation of an SME development agency and providing training for new and potential entrepreneurs. In addition, government officials will be advised about privatization.

3. **Food Production and Distribution**: A comprehensive TA program will support the agricultural sector with activities including a complete sectoral survey, preparation of a long-term sectoral master-plan, and training and advice for the establishment of an agricultural extension service.

In the area of institutional development, intended activities include management training ($74 million) focussing on improvement of management institutions, development of capability of individual managers, and restructuring of enterprises and regional economies; reorganization of customs offices; training in transport management; establishment of supervisory bodies for the financial sector; and, restructuring of the energy sector.

Emphasis is placed on public sector management in the area of civil service reform. Specifically, assistance to design and develop a modern and efficient civil service will be provided, which will include recruitment systems, career management and training of civil servants. This training will begin with support for taxation and employment services. Activities in this area also involve advisory services to the governments for macroeconomic and sectoral reform. These activities are expected to be implemented under a
$12.35 million umbrella contract with the international consulting firm of Coopers & Lybrand.

**European Bank for Reconstruction and Development (EBRD)**

EBRD's total technical assistance to the region in 1992 is estimated at $68.8 million, of which about $38 million is technical assistance to CEE and $30.8 million to the FSU (mainly to Russia).

In 1991 EBRD presented a short-term Action Plan for the FSU with particular emphasis on assistance to the Russian Federation and indicated that it intended to play an active role in the reform process in the region. In June 1992 EBRD submitted a Country Strategy for the Russian Federation; Country Strategies for each of the Baltic States have also been approved. EBRD has indicated that at least 60% of all funding to any country will be steered towards private sector enterprises or privatization projects and not more than 40% towards public projects.

In the FSU, EBRD’s technical assistance activities are currently concentrated in Russia, with some assistance to Belarus, Kazakhstan and Ukraine. The principal areas of focus in Russia and the other republics are privatization and enterprise promotion, military conversion, financial sector development, energy sector development, nuclear safety, and agriculture and agro-business. Technical assistance in the privatization and enterprise promotion area is being provided in the form of privatization advisory assistance and privatization training, which includes an extensive privatization program for Russia in cooperation with the World Bank.

In the area of institutional development, EBRD is involved with capacity building exercises in several sectors. In the financial sector, institutional development activities include a program towards the establishment of an International School of Finance and Banking in Moscow to train professionals throughout the former USSR in financial services; the development of a government securities market in Russia and the provision of relevant training; training of senior commercial bankers in the FSU; training for stock exchange development; and, advising SMEs in the Baltic States. In the agricultural sector, EBRD is establishing a project preparation unit within the Russian Ministry of Agriculture. In the energy sector, institutional development activities include training in the CIS and planning management in the Baltic States. Other activities include implementation of an institutional framework for municipal services in St. Petersburg and environmental management in the municipal, industrial and agricultural sectors of the Baltic Sea region.

**International Monetary Fund (IMF)**

In CEE and the FSU, the IMF emphasizes changes in the fiscal, monetary and statistical systems which can be implemented quickly and which improve the prospects for the success of stabilization and economic reform programs. In addition, the IMF is providing substantive assistance for some long-term institutional development issues. Technical assistance is concentrated in the following areas: central banking and monetary policy instruments; exchange arrangements and exchange control systems; statistics; monetary aspect of public debt management; tax policy and administration, budgeting, fiscal reporting, cash management and social security; legislation related to banking, taxation and foreign exchange regulations; and training in the areas of macroeconomic policies, financial programming, and statistics. Technical assistance is provided through the coordinated efforts of the Fund’s European and functional departments, notably the Fiscal Affairs, Monetary and Exchange Affairs, and Statistics Departments.

Technical assistance to the individual European countries is concentrated on activities related to the following issues:
Albania: Currency convertibility; taxation, including customs; State Bank operations and transformation (in conjunction with other central banks); central banking, banking, corporate and individual tax, and tax procedure legislation; price, balance of payments, trade, and money and banking statistics; public expenditure management.

Bulgaria: Public finance assessment; tax reform; tax legislation and administration, with emphasis on the VAT (in liaison with PHARE); monetary, price, and national account statistics; compilation of balance of payments system; overhaul of reporting system; National Bank operations and modernization (in conjunction with other central banks); central banking and financial institution legislation; foreign exchange repatriation and control system; and, control of capital flight.

Czechoslovakia: Tax reform; VAT introduction; public financial management; State Bank operations and modernization (in conjunction with other central banks); central banking and financial institution legislation; tax legislation; and, balance of payments, money and banking, and government finance statistics.

Hungary: Tax reform; tax administration; expenditure monitoring; institutional, technical and regulatory modalities for foreign exchange market development; and, government finance and money and banking statistics (in close conjunction with the World Bank on a new chart of accounts for financial institutions).

Poland: Tax reform; tax administration; expenditure planning; public expenditure management; social safety net; National Bank operations and modernization (in conjunction with other central banks); monetary and money and banking statistics; and, privatization, securities markets and related foreign investment, customs, payment and settlement systems, and export credit legislation.

Romania: Public finance assessment; tax reform; compilation of balance of payments system; overhaul of reporting system; National Bank operations and modernization (in conjunction with other central banks); central banking and financial institution legislation; and, foreign exchange repatriation and control system.

In several of the countries of the former Soviet Union, IMF programs for technical assistance are considerably larger than in some Eastern European countries. However, because the direction of assistance is similar, this summary can be brief. TA to the countries of the former Soviet Union is focussed on the following: all major institutional and structural aspects of the financial and exchange markets, including central bank functions (in collaborative TA arrangements with central banks of industrial countries), payments systems, and foreign exchange market policies; policy advice on tax and administrations; strengthening tax administration, expenditure control, and the treasury and cash management function; and, revision of monetary statistics and establishment of bases for compilation of balance of payment statistics.

Concerning TA on central banking functions, the Monetary and Exchange Affairs (MAE) Department of the Fund administers a program involving the cooperation of 22 central banks, which is jointly coordinated by the MAE and the Bank for International Settlements (BIS). Under the program, in addition to collecting and disseminating information on central bank activities in the FSU, meetings have been organized to coordinate general approaches as well as meetings to discuss specific topics (such as payments systems and central bank accounting); other such meetings are envisaged for the future.

The IMF, through the IMF Institute, also provides training courses and seminars for government officials in macroeconomic financial policies, public finance and macroeconomic
statistics. The Fund is also heavily involved in training central bankers, through the Institute as well as the new Vienna Institute and through bilateral and multilateral initiatives which also involve the Fund.

In the area of public sector management, IMF support is centered on issues related to institutional development in central banking and public sector financial management. These include central bank operations, public debt management, public expenditure management, and tax administration. In several of the countries of the FSU, the IMF has strongly emphasized the need for institution-building, particularly in the areas of tax administration, budget reporting systems, accounting and auditing of public expenditure, and treasury functions for cash and debt management. Public expenditure management activities in Russia involve the formulation of revised budget classification, regulations governing local level budgets, and the preparation of an operational blueprint for a type of a General Accounting Office.

The following areas of reform have been prioritized by the OECD: restructuring existing large enterprises, the development of SMEs, and related key areas of privatization, investment, and trade; the social consequences of adjustment, particularly labor market aspects, including the provision of a social safety net and building a base for sustained job creation; and, associated legal and institutional changes. CCEET's activities are undertaken under an "Integrated Program" which has three components: the General Program of Work open to all the countries in CEE and the FSU; the Partners in Transition program (PIT) for Hungary, Poland and Czechoslovakia; and, the Program of Technical Assistance for the FSU republics — Russia, Ukraine, Kazakhstan and Belarus, in particular. The activities involve seminars, workshops, surveys, economic studies, policy advice, technical missions and training activities.

Organization for Economic Cooperation and Development (OECD)

The OECD's total technical assistance to the region in 1992 is estimated at $17 million, of which about $11 million is technical assistance to CEE and the Baltics and $6 million to the CIS.

The OECD provides policy advice and TA to the region through its Center for Cooperation with European Economies in Transition (CCEET). CCEET is responsible for designing and managing all TA activities, which are administered by the various directorates, and also for coordinating OECD activities among the recipient countries, member countries and international organizations. The Center maintains the CCEET Register, a database designed to provide information on TA from OECD member countries and multilateral organizations to the CEE and FSU regions (data on financial assistance is provided by the EC sponsored "Scoreboard" project); this is intended to prevent duplication of assistance efforts and promote cooperation and coordination among the various donors.

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The General Program is directed to issues common to all the countries in the region. The PIT program was designed to assist Czechoslovakia, Hungary and Poland, the farthest advanced in establishing market economies, in meeting their reform needs and to help them meet the conditions for possible future membership of the OECD. The PIT projects include regular country and sectoral reviews, on the same lines of those carried out annually for member countries. The Program of TA for the former Soviet republics was kept separate from the General Program because it was assumed that the substantially differing economic conditions prevailing in the republics would entail assistance tailored to a particular country's requirements.

In the area of institutional development, proposed activities concern industrial restructuring with emphasis on conversion of military industries, agricultural policy reform,
transportation and telecommunications infrastructure development; training of labor market policy makers; improving the efficiency of tax administrations; financial policy training programs; rehabilitation of the banking systems; and, assistance in monitoring the economy.

In the area of public sector management, OECD has activities under the General and PIT programs. The General Program is involved with public procurement systems and decentralization of regulatory responsibilities. The former exercise is intended to develop a framework for public procurement systems based on transparency and effective competition, aimed at encouraging demonopolization and privatization and stimulating public sector effectiveness. The activity comprises of a two day colloquium for interested countries followed by a report laying out institutional, organizational and legislative guidelines. The decentralization efforts are aimed at determining the suitable locus of responsibility for the new regulatory decisions (i.e., whether they should be made at the central or sub-national level) and comprise of the following activities: identification of priority issues for detailed study; analysis of the relevance of regulatory practices in OECD member countries to reform efforts by recipient countries; and, a review of specific proposals for regulatory reform, with input from OECD member countries.

The PIT program is involved with the following public sector management related activities: assistance in the design of a training program for senior civil servants for the National School of Public Administration being established in Poland; completion of "Public Management Profiles" and update of other public sector management information for Poland, Czechoslovakia and Hungary; policy advice to the Office of the Prime Minister for strengthening policy coordination in both Czechoslovakia and Hungary; assistance to Hungary to manage plant closures; and, training managers of state-owned enterprises in Hungary as a step towards developing a blueprint for management training in other reforming countries in the region.

In addition to public sector management activities under the Integrated Program, OECD’s directorate for Public Management Service, PUMA, administers the joint EC/OECD SIGMA program to support public administration reform in CEE at a regional level. The OECD also publishes two sets of documents in this area, the Public Management Studies and the Occasional Papers on Public Management series, which focus on specific issues of administrative modernization in areas such as budgeting, human resource management, regulatory reform, and management information systems.

**United Nations Development Program (UNDP)**

UNDP’s total assistance to the region is programmed at $85 million for the 1992-96 period. Of this amount, about $45 million is technical assistance to CEE and $40 million to the FSU. Assistance for institutional development accounts for roughly 70% of total funds committed by UNDP.

UNDP has been providing technical assistance to Poland, Hungary and Czechoslovakia since 1989, and to Albania and Bulgaria thereafter. It has extended its TA activities to the CIS and the Baltic States and has submitted country programs for most countries in 1993. In the interim period, UNDP proposes to provide the countries with operational support with emphasis on program development, national capacity-building and "practical" advice. A sum of about $3 million has been allocated for administrative costs towards setting up offices in each of the FSU countries.

The country programs for the CEECs reflect UNDP’s preference to restrict assistance to a few selected objectives, deemed to be of major importance to the country and of particular
relevance to UNDP's mandate (support to the private sector and human development) and expertise (management development and local capacity building). UNDP expects all projects to be integrated into the country's overall strategy and external technical assistance. Further, all project proposals are to be evaluated against criteria that measure their impact on human development, impact on national capacity-building, consistency with the country program's priority themes, extent of contribution to the project sector, potential for catalyst role in attracting additional external assistance, rationale for and appropriateness of project design, placement of the project within the country's institutional framework, and the synergy between country and inter-country activities.

UNDP's Indicative Planning Figure (IPF) for Hungary is $1.9 million for the 1992-96 country program, 45% of which is for private sector development; 25% for management development; and, 10% each for environmental protection and human development monitoring (10% is on reserve). The IPF for Poland is $3.9 million for 1992-96; 37% is for human resources development and 21% each for market economy institutions, ecological infrastructure and an ongoing umbrella project for the provision of advisory services to facilitate economic reform. Czechoslovakia's IPF is $2.4 million for 1992-96; the principal areas of concentration are the restructuring of the economy and private sector development; management development, training and human resources development; environmental management; telecommunications development; national statistics; and, umbrella advisory services. There is also a modest UNDP program for Romania. In addition, UNDP has committed $4.2 million for TA activities for a regional program for CEE; 45% of this amount is for private sector development; 33% for the environment and energy sectors; and, 22% for transportation and communications.

In the area of institutional development, UNDP is involved with several activities in CEE, including addressing the issue of local capacity-building for environmental management and consulting in Hungary, and participating in management education and training in Poland by helping develop a system for monitoring and evaluating management training programs at the national level - it is expected that future activity will concern capacity-building for teaching and research in economics and management and the management of science and technology.

In the area of public sector management, UNDP is involved with some comprehensive programs. In Hungary, UNDP has been requested by the government to prepare an extensive management training program for local government officials which will be integrated into the human resource development program of Hungarian public administration. In Poland, it is providing support for public sector restructuring at the central, regional and local levels by assisting the government in developing a strategy for implementing public service reform and assisting in designing and implementing training programs for civil servants. It is also designing and implementing management training programs for managers of state-owned enterprises. In Albania, UNDP's efforts are being concentrated on foreign investment related issues and the restructuring of the Ministry of Industry, Natural Resources and Energy. UNDP anticipates future activity in the area of administrative reform, including decentralization and local government.

World Bank (IBRD)

The World Bank provides technical assistance to the countries of CEE and the FSU, through the coordinated efforts of the Europe and Central Asia Region (ECA) and the regional Technical Department. As with other countries, technical assistance is provided through three broad channels: (i) project-financed technical assistance, including free-standing TA loans and TA components of non-TA loans and credits; (ii) technical assistance financed through the administrative budget; and, (iii) technical
assistance financed by Bank-administered trust funds, including Bank-executed UNDP projects. TA components of non-TA loans and credits to CEE and the FSU, for projects approved in FY92, amounted to $55.4 million; for FY91 the amount was $171.76 million. Free-standing TA loans, in progress in FY92, amounted to $17 million. In addition, the Bank is preparing free-standing TA loans to several countries, and providing for TA components in rehabilitation loans to the other countries.

In 1991 the Bank established the Technical Cooperation Program to provide technical assistance to the Soviet republics. Russia, Belarus, Kazakhstan and Kyrgyz Republic were signatories and were eligible for support under the program. Signed technical cooperation projects, include the provision of advisory services for general economic reform (Russia, Belarus, Kyrgyz Republic, Kazakhstan); privatization and private sector development (Russia, Belarus, Kyrgyz Republic, Kazakhstan); foreign direct investment (Russia); financial sector development (Russia, Kazakhstan, Kyrgyz Republic); food sector reform; energy sector reform (Russia, Kazakhstan); housing reform (Russia); social safety net issues (Russia, Belarus, Kyrgyz Republic, Kazakhstan); inter-government fiscal federalism (Russia); and, municipal revenue and budget administration (Russia). Assistance for training Russian public officials in macroeconomics, banking and privatization is also being provided under this program.

Subsequently, the Bank established in 1992 an Institutional Development Fund (IDF) for financing upstream institutional development activities, mostly in public sector management, which can form the basis for a variety of eventual analytical and lending efforts by the Bank and other donors. The IDF provides small grants of up to $0.5 million which are complemented by local resources and, where appropriate, by parallel financing by other donors. The IDF project proposals are important elements of the Bank’s support for upstream institutional development work in the countries concerned and respond quickly and flexibly to opportunities both to advance reform in the present and to establish frameworks for longer-term improvements. While most of the institution-building project proposals submitted for IDF financing in countries of CEE and the FSU focus on institutional development and public sector management reform (and particularly on aid management), some deal with the design of privatization programs and strategic legal reforms critical to market transition.

In the FSU, the Bank has institutional development lending programs for Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Ukraine, Uzbekistan, and others to come. These cover assistance for privatization and private sector development, financial system reform, aid management, public procurement, economic management, and more broadly, social safety net design and other key elements of systemic reform. Furthermore, in Russia, the Bank has approved a project for strengthening the agency responsible for privatization and a project for strengthening the country’s employment services; there is also the possibility of a loan to Russia for public administration re-training. The Bank is providing Economic and Sector Work (ESW) and IDF funding for assessment of the government’s capacity for economic management and restructuring of the legal and regulatory framework in the Baltics. IDF grants for assisting the newly established aid management organizations have been approved for several countries.

In CEE, the Bank is providing ESW and IDF financing for civil service reform in Poland; technical assistance for aid coordination and project management in Romania; IDF funding for local government reform in Bulgaria; and, IDF grants for civil service reform and strengthening of economic management in Albania. The Bank
is also involved with providing assistance for establishing regulatory frameworks in the energy sector in Poland, Czechoslovakia and Hungary; establishing banking institutions for the housing sector in Poland; strengthening capacity in the transportation sector in Hungary; and other institution building activities in the telecommunication sector in Czechoslovakia, Poland and Hungary.

**Other United Nations Agencies**

**International Labor Organization (ILO)**

The majority of ILO's activities are financed by third parties, including the World Bank, UNDP and several bilateral agencies. Contributions from bilateral donors for projects in CEE for 1991/92 amounted to about $7.4 million, which included $3.2 million from the Netherlands alone. ILO's own regional budget for technical assistance only covers a few advisory missions and workshops and is estimated at $2 million for 1992.

Though support from the ILO has thus far been focused on the countries of CEE, the ILO is now moving relatively fast in the FSU region with its traditional forms of assistance. ILO activities, which include workshops, advisory missions, seminars, fellowships, and consultancy advice, are carried out on a regional and country basis and cover several different categories including international labor standards, employment, enterprise and cooperative development, training, industrial relations and labor administration, social security, working conditions, labor information and statistics, employers' activities, workers' activities, project design, and computerization.

In the area of institutional development, ILO's activities include training for government officials in the use of computers for matters related to international labor standards and technical cooperation (Poland); consultancy missions to assist the government in strengthening its organization structure (Albania); consultancy missions to assist in the establishment, strengthening or management of employers' organizations (Baltics, Bulgaria, Hungary, Russia, Poland, Romania); and, reorganization and improvement of the public employment service (Hungary). Except for a seminar on public service, no ILO activities are underway in the area of public sector management reform.

**International Trade Center (ITC)**

ITC's program of technical assistance to the region is modest and budgetary figures are insignificant at this time. Though ITC has been working with the CEE countries for a while, it has done so in a limited capacity. For the countries of the FSU, it is still in the initial stages of establishing technical cooperation programs with them; the republics (all but Armenia and Tajikistan) only became eligible for ITC assistance in 1992.

ITC provides two forms of technical cooperation to the region: access to extensive publications and databases on trade and market opportunities, which are followed up by staff visits, seminars, etc., and technical cooperation projects. As of mid-1992, several country and regional projects had been prepared but only one, a $412,000 trade development project for Romania in cooperation with UNDP and the French government, was approaching implementation. ITC has also developed framework documents for technical cooperation in trade development and promotion for Russia, Belarus, Kazakhstan and Ukraine.

In the area of institutional development, proposed projects include integrated trade promotion, including institution building, human resource development, trade information services and specialized services in Hungary ($1.3 million); development and introduction of an export financing system in Hungary ($2.3 million); strengthening institutional capacity to identify, develop and appraise export oriented
projects in Poland ($1.43 million); and, strengthening the institutional infrastructure in foreign trade in Romania ($0.4 million). None of the projects cover public sector management reform.

**United Nations Economic Commission for Europe (ECE)**

ECE's total assistance to the region, from its own resources, is estimated at $2.7 million for 1991 and 1992. Of this amount, about $2.2 million is technical assistance to CEE and $500,000 to the FSU.

ECE has undertaken a special program of activities to provide the formerly socialist countries and assistance for transition. Typically, ECE's activities involve intergovernmental meetings, training symposia, databases, seminars, publication of documents and workshops on issues related to its priority areas: environment, transport, statistics, trade facilitation and economic analysis, human settlements, science and technology, energy, industry, agriculture, and timber. However, ECE is now concentrating its activities in the FSU and CEE region and this has given its program a new dimension.

ECE, in consultation with the transition countries, began a series of workshops in order to focus on specific needs of the countries in transition, facilitate contacts with the business community, and generate technical know-how and expert advice. The workshop program has grown from 9 workshops in 1990 to about 50 planned for 1992/93. The issues that are intended to be addressed by the workshops include privatization and restructuring of enterprises, application of statistical practices, market adaptation of transport systems, and development of the energy and agricultural sectors.

While ECE has not arranged any workshops on public sector management, it held a limited number of workshops in the area of institutional development in 1991.

**World Intellectual Property Organization (WIPO)**

WIPO is providing technical assistance to the countries of CEE and the FSU in the form of legal expertise, comments on draft laws, the provision of model laws on intellectual property, and consultative meetings with the recipient governments. The following countries in the region are members of WIPO: Czechoslovakia, Poland, Hungary, Bulgaria, Romania, Russia, Belarus, Ukraine, and the Baltic States. WIPO had already been working with some of these countries before the recent political and economic changes, but has now revised its activities to help them adapt to a market economy. WIPO has also extended its activities to its new member countries of the FSU and is in the process of securing membership for Slovenia and Croatia.

WIPO's stated objectives are twofold: to promote the protection of intellectual property throughout the world through cooperation among countries and, where appropriate, in collaboration with any other international organization; and, to ensure administrative cooperation among the intellectual property Unions.

**International Civil Aviation Organization (ICAO)**

The ICAO has conducted several evaluation studies in CEE, in coordination with the EC, UNDP and the European Investment Bank, on the performance of existing public sector organizations responsible for civil aviation, airports and air traffic, and navigation. The studies have included recommendations for the creation of autonomous, self supporting authorities and outlines of organization structures, training needs and legislative and regulatory requirements. As of mid-1992, ICAO had not undertaken any detailed studies in the FSU.
Food and Agriculture Organization of the UN (FAO)

FAO's priorities, with respect to activities in CEE, are focused on restructuring the agricultural and forestry sectors towards establishing a market-oriented rural sector. TA activities involve sector studies, training seminars, workshops, research, and advisory services. Projects have included agricultural sector reviews (Albania) and rehabilitation/study of food control systems (Hungary, Bulgaria and Czechoslovakia).

Future FAO assistance is expected to build on previously provided assistance for agricultural restructuring. Specifically, FAO will support the governments in identifying priority areas, strategies and means to transform the food and agricultural sector.

In the area of institutional development, FAO intends to pay close attention to strengthening the technical and institutional capacities of the concerned ministries and policy analysis units.

III. MAJOR BILATERAL ASSISTANCE

The major sources of bilateral technical assistance to CEE and the FSU are France, Germany, United Kingdom and the United States. Altogether, they account for the bulk of TA to the region. Other countries, notably Italy, Sweden, the Netherlands, Canada and Turkey, also have significant assistance programs to the region, but are limited in amount or in geographic scope.

France

All French assistance to the region is being coordinated by the Interministerial Mission for Eastern and Western Europe (MISECO), which was created in 1990 for this purpose. MISECO's role is to coordinate the various programs of French assistance, public and private, at the national, local and regional levels and to respond to requests from the relevant countries.

Assistance from France is intended to support the creation of a democratic society and help the formerly socialist countries move to a market-based economy. The sectors which have been targeted for assistance to CEE are agriculture, energy, transport, environment, health, tourism and certain industries. MISECO intends to achieve the following objectives: (i) to set up a legal framework for a democratic society, by providing assistance from the Ministries of Justice and the Interior, the Institute of Public Administration and the press; (ii) to restructure the economy by providing technical expertise on monetary, budgetary, fiscal and banking systems and financial markets; (iii) to revitalize the key economic sectors; (iv) to reinforce the presence of the French language and culture by modernizing cultural establishments, increasing bilingual educational institutions and teaching the French language; and, (v) to develop exchange programs, by providing scholarship grants to young students and researchers. As of mid-1992, of all the countries in the area, France had the most comprehensive program for Poland.

Germany

Germany's total bilateral technical assistance to the region is estimated at $204 million for 1992 and $279 million for 1993; the distribution among regions and countries is still undecided. Although several ministries have technical assistance programs with different countries in the region, the Ministry of Economics coordinates assistance to Hungary, Czechoslovakia, Poland, Bulgaria, the Baltic States, Russia, Ukraine, Belarus and Kazakhstan and the Ministry of Economic Cooperation, which deals specifically with bilateral aid, coordinates assistance to Romania, Albania, the ex-Yugoslav states, Georgia,
Moldova and the remainder of the Central Asian states. Advisory support is provided by the Ministries of Agriculture, Economics, Economic Cooperation, Environment, Finance, Foreign Affairs, and Transportation. The Ministry of Economy has entrusted Kreditanstalt fur Wiederaufbau (KFW) with the task of administering the implementation of its programs.

Germany's program of technical assistance for economic reform focuses on the creation of an institutional framework for enterprise development, privatization, banking and insurance services, agriculture, training for managers, and improvement in the security of nuclear power plants. The principal instruments of support are the provision of experts; facilitation of cooperation between academic institutions; establishment of offices in the host countries; and, the mobilization of consulting services for specific activities.

In the area of institutional development, activities include advisory support for the financial sector; about $55 million has been allocated for the development of capital markets and stock exchanges ($21 million in 1992 and $34 million in 1993). Support is also provided for the modernization of the agricultural sector and the development of institutional infrastructure for the transportation sector.

**United Kingdom**

The UK's technical assistance to CEE and the FSU is administered by the Joint Assistance Unit of the Foreign and Commonwealth Office, which was set up in November 1989 by the UK Foreign and Commonwealth Office and the Overseas Development Administration to manage technical assistance to the region. UK's technical assistance is provided through the Know How Fund (KHF), the Chancellor's Financial Sector Scheme and Defence Related Assistance program.

KHF supports technical assistance programs in CEE and the FSU in collaboration with other UK based institutions, including British businesses, Parliamentarians, trade unions and academic institutions. KHF's primary objective is to finance the transfer of expertise towards establishing a framework of democratic institutions and market-based economies. The Fund has sought to target activities which catalyze further changes and has therefore focused on the development of the framework for economic transition. In 1989/90 the Fund spent $4 million, entirely on Poland; in 1990/91 it spent $25.6 million on Poland, Hungary and Czechoslovakia; in 1991/92 it had a budget of $61.5 for the whole CEE and FSU region; and, for 1992/93, the total budget is about $85.5.

In CEE, KHF programs are focused on the financial services sector (advice on privatization, accountancy and audit, and banking training); cooperation between the respective employment services; advice on the establishment of small businesses; management training; and the training of civil servants and local government officials. Some support is also provided for the energy, environment and industrial sectors. In the FSU, support is concentrated in Russia, Ukraine, Belarus and Kazakhstan, with a focus on management training, small businesses, food distribution, financial services, and energy. KHF has also committed about $1.7 million towards projects in the Baltic States.

The $15 million Chancellor's Financial Sector Scheme was developed in 1991 to provide the FSU, particularly Russia, with expertise in the financial and economic sectors. Under this scheme, which is intended to develop a cadre of professionals in the FSU and to promote linkages between UK businesses and the FSU, UK companies agree to host managers/participants from the FSU for periods ranging between six months and one year to help them enhance their
understanding of an operational market economy. The scheme is managed by the British Council on behalf of the Joint Assistance Unit through offices in the UK and Moscow. The UK government incurs the administration costs of the scheme while the host companies pay a salary to the participants. The Scheme aims to place about 1000 participants with UK-based financial and business service firms including professional societies, securities firms, insurance companies, accountancy and law firms, actuaries, fund managers and property advisers.

In the area of institutional development in CEE, TA projects funded by KHF, include support for the establishment of new banks in Poland; development of auditing standards and capability in Poland; insurance restructuring in Poland; establishment of a private insurance company in Czechoslovakia; development of employment services in Czechoslovakia; development of employment services in Hungary; assistance to the Budapest Stock Exchange; and, management training in the telecommunications sector in Hungary. In the FSU, technical assistance for institutional development from KHF has been limited and with the exceptions of accountancy trainer training in Russia, development of commodities exchange in Russia, and business training for small entrepreneurs in Russia, mostly for small projects.

In the area of public sector management, projects include assistance to Polish local government officials; treasury management seminars in Poland; advice to the Hungarian Parliament; public administration assistance in Hungary; and, assistance to the Hungarian Central Statistical Office.

United States of America

The US’s technical assistance to the region is estimated at $1.37 billion for 1991 and 1992, of which $738 million is technical assistance to CEE ($369 million each in 1991 and 1992) and $635 million to the FSU.\(^8\) Assistance for institutional development accounts for a small proportion of these funds. The budget for the FSU includes a $400 million program of technical assistance for the destruction of nuclear weapons, which is administered by the Department of Defence. All other US technical assistance is coordinated by the State Department through the offices of the Deputy Assistants to the Under Secretary of State (one each for the CEE and the FSU). Projects are administered by the US Agency for International Development (USAID), Environmental Protection Agency (EPA), US Information Agency (USIA), and the Departments of Treasury, Transportation (USDT) and Agriculture (USDA).

In CEE, the US has prioritized different areas of activity for each country. However, the emphasis on democratic institution building, economic restructuring through privatization, and the development of the energy and agriculture sectors, is common to all. TA is also provided for the environment, health, labor, banking and financial services, infrastructure, management education, and housing. Activities include the design of a private sector component for a World Bank health sector loan for Hungary, representing a clear departure from the Bank’s traditional public sector approach to health issues, and the Department of Treasury’s financial advisor project ($13.6 million for 1991/92).

For the countries of the FSU, USAID has set up Task Forces in some of the republics to coordinate activities related to technology transfer/democratic and economic initiatives, energy efficiency/market reform, health care improvements, private sector/defence conversion, food systems restructuring, democratic pluralism initiatives, housing sector reform and economic restructuring and financial sector reform. Through USDA and USAID, the US is involved with several programs of TA that are intended to develop the agricultural and agribusiness sectors and support the transition to a private agriculture system. The Department of Treasury provides technical assistance in macroeconomic policy,
Technical Assistance for Institutional Development

government financial operations, and financial sector reform to support development and operation of central and commercial banking institutions through a $4 million (for 1992) program. The EPA has about 25-30 joint environmental projects with the FSU countries in areas such as air, water, and marine pollution, forest ecosystems, and environmental education. Other TA activities include the Special American Business Internship Training Program, International Resident Adviser Program, Bureau for Refugee Program, US-Russian Hospital Program, Peace Corps Volunteer Program, and a $25 million program for the establishment of the International Science and Technology Center in Russia.

In the area of institutional development in CEE, TA activities include power sector management and reform in Romania and Czechoslovakia; guidance for private and public commercial bank management in Poland; development of a deposit insurance system in Poland; restructuring of the petroleum sector in Romania (joint venture between USAID and the World Bank); the provision of equipment, training materials, and training courses for local governments and associations in Czechoslovakia; short-term assistance to support decentralization of environmental management in Czechoslovakia ($9.5 million), Bulgaria and Poland ($9.5 million); institutional reform for business promotion and industrial restructuring in Poland; and, improvement of the unemployment compensation payments system in Poland.

In the FSU, institutional development related activities undertaken by USAID include an efficiency increasing program for the energy sector; reorientation of industries towards the civilian sector; food systems restructuring; the development of market-oriented housing sector; institutional development of the Ministry of Environment in the Baltic States; establishment of customs organizations in each of the Baltic States; and, financial sector reform. Institutional development related projects by USDA concern stabilizing and modernizing the food marketing system and strengthening of farm management. USDT is involved with the modernization of air traffic management and training for highway policy makers. The Department of Treasury finances long-term and short-term advisers to strengthen the financial sectors in Russia, Ukraine, Kazakhstan and Belarus.

In the area of public sector management, activities include a USAID administered public policy/administration program in the FSU; a program for strengthening of regional institutions that design and deliver training for public administration in Czechoslovakia; and, a program of intensive training for local government officials in the areas of intergovernmental relations, personnel systems, management, and local finance in Poland ($1.3 million).

IV. CONCLUDING REMARKS

It is evident that several bilateral and multilateral agencies have committed substantial resources to technical assistance support to CEE and the FSU. It is not clear whether the countries’ absorptive capacity will match the supply. Certainly, without close coordination of efforts, local capacity will be particularly strained. The EC is the largest single contributor and is expected to remain so in the foreseeable future. Some agencies have supported institutional development activities related to privatization and financial sector management and to particular sectoral institutions, and some have noteworthy programs in the area of public sector management reform, including programs for better fiscal management, clarifying relationships between
central and local governments and aid management. Despite the substantial technical assistance for institutional development as a whole, however, only a modest amount of total support is being directed towards public sector management reform. Though there are signs that support (including that from the World Bank), is increasing, it is being delivered in a partial way and in most countries there is no comprehensive program of assistance. On the whole, there is inadequate consideration given to restructuring the public sector beyond privatization efforts, and as yet no explicit or emerging consensus on a strategy for transforming the public sector to play a new and quite different role in a market economy.

The international agencies followed an agenda where they concentrated on assisting formerly socialist countries in attempting a rapid transition to a market economy. Privatization was rightly seen as critical, and the primary objective of most external assistance was to move ownership and management to the private sector as rapidly as possible. Resulting assistance efforts — and also the preoccupations of most recipient governments — have lacked the needed emphasis on changing the role of the public sector itself. Other factors have also been at work. Many donors feel that reform in this area is complex and politically difficult, especially for external actors. Many also think that effective public sector management reform must be preceded by other forms of institutional development, especially the establishment of an adequate legal framework. Furthermore, political change is still underway and the structure and role of government has not yet crystallized in many countries. All these considerations may have caused the international agencies to limit involvement in public sector management reform.

As the recent experience indicates, the transition is not rapidly achieved. During this extended transition, management of public assets and changing an institutional apparatus which in many ways is still entrenched in a command-type economy will be critical for the sustainability and effectiveness of reform over the longer run. Indeed, a well-functioning public sector is essential for productive economic activity and effective development of the private sector itself; among other things, the key challenges facing the transition countries include strengthening the capacity of core government institutions to effectively manage a market-based economy; restructuring the machinery of government and the civil service to enable and regulate private sector activity; and, redefining the boundaries and functions of the central government vis-a-vis local governments and other constituents of the public sector.

Broad consensus on reform priorities aimed at facilitating the transformation of the state to play a different role in a market economy is an essential first step towards more effective action. Reaching that consensus, however, is also a major intellectual challenge, both because of the lack of precedents for the political and institutional "transition from socialism", and because of the complex influence of national history and culture on state structures and on institutions more generally. Practical collaboration and shared intellectual innovation need to be closely combined. This will need a painstaking effort, already partly underway, to establish institutional reform priorities — in the first place in the dialogue with the leadership of the countries themselves, and also in discussion and operational collaboration among external sources of assistance.
NOTES

1. All currency conversions are based on exchange rates as of 8/13/92. Here, 1 ecu = 1.38 US $.

2. Discussed earlier in the section on the EC.

3. Unlike other multilateral agencies, UNDP’s operations are not based on fixed budget financing. They depend on voluntary contributions from bilateral donors depending on the nature and type of projects. The dollar amounts here reflect UNDP’s “seed money” or Indicative Planning Figures (IPF) for 1992-96 which are expected to be supplemented with cost-sharing contributions.

4. This includes about $1.5 million made available by Germany for extra-budgetary resources.

5. WIPO is unable to provide financial estimates for its activities in the region.

6. The latest document made available by the French authorities does not provide financial details on French technical assistance.

7. All conversions from pounds are at the rate of 1.71 dollars per pound.

8. The State Department anticipated approval for an additional $470 million for TA to the FSU, by early 1993.
Annex
List of Organizations Contacted for Information

Multilateral Organizations

Commission of the European Communities
European Bank for Reconstruction and Development
Food and Agriculture Organization of the United Nations
International Civil Aviation Organization
International Labor Organization
International Maritime Organization
International Monetary Fund
International Telecommunications Union
International Trade Center
Organization for Economic Cooperation and Development
United Nations Conference on Trade and Development
United Nations Development Program
United Nations Economic Commission for Europe
United Nations Educational, Scientific and Cultural Organization
United Nations Environment Program
United Nations Industrial Development Organization
World Intellectual Property Organization

Bilateral Organizations

Australia, International Development Assistance Bureau
Austria, Ministry of Finance
Canada, Ministry of External Affairs and International Trade
Denmark, Ministry of Foreign Affairs
Finland, Ministry of Finance
France, MISECO
Germany, Kreditanstalt fur Wiederaufbau
Korea, Ministry of Finance
Luxembourg, Department of Treasury
Norway, Ministry of Foreign Affairs
Sweden, Ministry of Finance
Thailand, Ministry of Finance
United Kingdom, Foreign and Commonwealth Office
United States of America, State Department
INTERNATIONAL COOPERATION FOR INSTITUTIONAL DEVELOPMENT IN THE PUBLIC SECTOR

Salvatore Schiavo-Campo

As noted in Chapter 1, external assistance can make an important contribution to institutional change and organizational development in transition economies — particularly in areas where formal rather than informal rules predominate. There are, however, two key requirements for the effectiveness of such assistance. On the donor side, activities of the different donors need to be coordinated, at least enough to prevent contradictory efforts and at best to take advantage of complementarities and comparative advantages of the various donors. On the recipient side, external assistance must be managed well — not only in order to guard against waste, diversions and theft, but also to ensure that external resources are used in pursuit of national economic objectives in the context of an integrated policy framework. This concluding chapter summarizes the recommendations of the March 1993 Multilateral Workshop on the topic of donor coordination, and the lessons of experience concerning the recipient governments' organization of aid management.

I. THE PRAGUE WORKSHOP AND ITS GENERAL CONCLUSIONS

The World Bank's Technical Department for the Europe, Central Asia, Middle East and North Africa Regions (EMT) organized the Multilateral Workshop on Institutional Change and the Public Sector in Eastern Europe and the Former Soviet Republics, held in Prague in March 1993. The workshop was attended by senior staff from the multilateral agencies most active in technical assistance activities in the region1, and by four eminent scholars as resource persons. (See Annex for names and institutional affiliations.) The workshop produced the following common view regarding the direction of cooperation and a number of concrete possibilities for closer contacts and improved cooperation among the agencies concerned. Because the workshop could not cover the entire range of relevant issues, and participants did not attend as official representatives of their respective institutions — the following is only a partial and informal consensus.
Development Impact and
Donor Agencies' Mandates

The workshop stressed that the magnitude of the transformation challenge in the region and the reality of path dependence make inter-donor cooperation an institutional necessity as well as healthy development practice. The active cooperation of all donors is necessary for a well-functioning aid management organization on the governments' side. So far, donor coordination activities have taken place at the "macro" level (i.e., G-24 meetings, Consultative Groups, etc.) or, depending on the efforts of individual project staff, at the "micro" level concerning specific activities and on a case-by-case basis. There is a need for systematic cooperation at the "meso" level, i.e., mid-management. It is at that level that better contacts can have the highest return in terms of aid effectiveness as can be influenced on the donors' side. The benefits of "meso-level" cooperation will flow upward — in terms of better informed decision-making at the top — and downward — in terms of providing "cover" and legitimacy to cooperation among individual staff members.

The objective of cooperation must be to raise the efficiency of assistance in the interests of the recipient countries. However, to be realistic, initiatives for closer cooperation must be mindful of the mandates and constraints of the respective donor agencies — and should carry demonstrable benefits also in terms of the internal objective of each agency. It is sometimes possible, however regrettable, for these objectives (development impact and donor agency priorities) to be in conflict. However, such conflict can be avoided if both objectives are recognized, and if modes of cooperation are deliberately designed to maximize potential complementarity that respect. Indeed, development impact depends partly on recognizing the specific responsibilities and characteristics of the different agencies, and exploiting the comparative advantage of different donor agencies.

Also, it is important to involve the recipient governments as much as possible in donor coordination activities. In this light, the role of resident offices and local donor representatives is key.

The stakes are substantial. The visible effects of lack of coordination are duplication, confusion, waste of resources or contradictory policy advice. A less visible but equally serious effect of lack of coordination is that important issues may simply not be addressed by any donor agency and will receive neither policy attention nor resources.

Limits and Modalities of Cooperation

The timing element. Time lags between project conception (or government request) and final approval vary between donor agencies, because each agency has specific procedures for preparing projects and presenting them for approval by its governing body. Procurement and disbursement procedures, too, are different, entailing wide disparities in rates of implementation and disbursement. Particularly in the case of integrated technical assistance programs, it is important to take these differences into account when designing joint or cooperative activities, in order to prevent the slower component from determining the progress of the entire project. Thus: (i) coordination should generally be project-specific, not merely programmatic; and (ii) if a reasonable degree of synchronization appears impossible or improbable, parceling out the job among the cooperating agencies may be preferable to an integrated program and could be equally effective, to the extent that there is an agreement on objectives and division of labor.

Aid-tying. Aid-tying by source is mandatory in the procedures of several donors. At the theoretical limit, with perfect programming and ideal coordination, aid-tying is inoperative. In practice, aid-tying is known to carry significant costs and to generate distortions. It is important to underline that fungibility of aid and donor
cooperation are directly related. The costs and distortions of aid-tying are highest when there is no cooperation or exchange of information among donors (and aid management by recipient governments is weak.) Instead, aid-tying is likely to carry lower costs when inter-donor cooperation is close and a coordinated financing package is assembled early in the project preparation process. In turn, as shown by past experience with the untying of counterpart funds, donor willingness to cooperate is stronger if their confidence in the soundness of the program is higher. (This is a major reason why an effective aid management organization by the governments is important — see section II.) Nevertheless, aid-tying and different procurement procedures will continue to present the hardest coordination challenge. There is no clear consensus on how to approach this challenge.

**Cofinancing.** Concerning financial cooperation, co-financing (in the strict sense) should generally be avoided in institutional development assistance projects, as it is time- and staff-intensive and hard to put together. However, parallel or coordinated financing can have the same results and should be encouraged. The risk of coordinated financing is that by the time one agency is ready to disburse, changed circumstances may prevent cooperating agencies from finalizing their contribution. To the extent that the integrity of the project depends on the financing package, this can seriously compromise the success of the project as a whole. There is no practical solution to this difficulty other than the gradual build-up of confidence and credibility that can result from good examples of collaborative financing. It is therefore crucial that the initial efforts be genuinely successful, and visibly so.

**Some Promising Cooperation Possibilities**

The obvious requirement for improved cooperation among donors is a willingness to cooperate. If multilateral agencies are to be more effective in helping institutional change in the region, they must undergo some institutional transformation of their own — especially concerning their "informal rules", i.e., the prevailing "culture" of their organization. Among other things, they all must develop some willingness to concede terrain to other agencies. In the absence of such willingness, urgings to cooperate are tantamount to demanding that other agencies simply tag along with one's own predetermined agenda. Consultation is different from information. In turn, the prerequisite for a successful dialogue with other organizations is a clear in-house understanding, among the several offices and individuals within the same agency who are working on the same problems or countries.

**Informal Networks.** In this light, it can be very useful for mid-management staff responsible for institutional development in the various agencies to establish and maintain their informal and personal network, by close and frequent contact. Participants to the Prague workshop did comprise the individuals most directly responsible for institutional development programs in the multilateral agencies most closely involved in assistance to the region. Since the workshop, informal exchanges among them have already produced beneficial initiatives and resolved potential coordination problems in some countries at an early stage. Both "macro-level" and "micro-level" coordination difficulties have been slightly eased as a result.

**Information.** Beyond personal networks, systematic sharing of information, experiences and intentions is an equally obvious but essential element of successful cooperation. There are four aspects to the information question:

- institutional development meetings can be organized on the occasion of Consultative Groups and other donor gatherings on country assistance programs;
• sharing of experiences and intentions can take place in the context of specific events focused on key issues — as for example the 1992 Ljubljana meeting on privatization;

• there needs to be a reliable and comprehensive database of ongoing assistance activities. This is the objective of the Data Register established by the Centre for Cooperation with European Economies in Transition (CCEET) of the OECD. In addition, a user-friendly and standard database of assistance activities at the country level is essential. An important practical guideline for choosing the country-level database is to remember that "the best is the enemy of the good". State-of-the-art, sophisticated systems should be eschewed in favor of good, workable systems. Not only is a simpler system easier for local staff to learn and use, but — more fundamentally — "optimal" software is by definition country-specific, while some standardization at the country level is an obvious requirement for cost-effective assistance and for comparable reporting to donors. The Development Cooperation Analysis System (DCAS) developed by the UNDP over a period of years, is one such user-friendly tool. It is designed for reporting to donors. However, with a few adaptations, it can be modified into an "Aid Management Information" system (AMI) at a very low cost. In turn, such a system provides the database needed for efficient programming and monitoring of public investment.

The Lead Agency Notion. As part of the design of a "joint" project or program, cooperating agencies can develop a consensus on a lead agency — i.e., which among them will be asked to take the lead responsibility during the preparation stage, which will take the lead during the implementation stage (the two may but need not be the same), and how to assure periodic joint review of the project's execution. During such review, the "executing agency" would report to its partners. The lead-agency option can be approached on a project-by-project basis. However, there may be scale economies and substantial "synergy" in using a similar approach on an issue-by-issue basis, through the mechanism of informal working groups outlined below.

Informal inter-agency working groups could be assembled, covering each of the several major areas of public sector management — e.g., public administration, civil service, corporate governance, aid management, legal reform, public expenditure organization etc. An initial convener would be selected by consensus as the "anchor" of the working group, based on the importance of his/her agency's programs in the subject area, and would organize and host the first meeting. In consultation with counterparts in the other agencies, the convener would invite the appropriate competent individuals identified from each agency; propose the agenda; assemble the required documentation; select discussion leaders, etc. The first meeting would decide, among other things, how often the group would meet and when. The chair and location of subsequent meetings would rotate to the other agencies. Preparation of each meeting would be the product of consultation between the initial convener (the "anchor") and the chairman of the meeting in question. Continuity would be assured by the anchor, and topicality and different agency perspectives would be provided by the rotating chairs and venue of meetings. (This mechanism could be tried with reference to one particular area of public sector management. Subsequently, based on the experience of the first working group, the mechanism would be abandoned, modified, or expanded to other areas.)
II. THE MANAGEMENT OF EXTERNAL ASSISTANCE

The Context

Recall from Chapter 1 that transaction costs can be reduced at the external interface — between the country and the rest of the world. In addition to trade, exchange and transport liberalization, and other policy areas, the organizational arrangements for managing external resources are a major subject of attention.

Recall, too, the "efficient nucleus" and "strengthening linkages" approaches to institutional development. These approaches are particularly applicable to the management of external assistance, because often such assistance provides the only degree of financial freedom to hard-pressed transition governments confronted with the need to curtail expenditures at a time of shrinking domestic revenues. In turn, this means that new efficient organizational arrangements in this area are particularly visible and a more likely source of positive demonstration effects.

In most countries of the region, the transition to a market economy with accountable governance requires substantial technical and financial assistance. However, most of the governments have little direct experience with external assistance, and the organizational framework is rudimentary or non-existent. As a consequence, duplication, complication and disbursement delays are the norm. More damaging is the governments' lack of effective supervision over the aid process, which is essential to assure that external resources are integrated with domestic resources in pursuit of national economic policy.

The mobilization and effective utilization of external resources crucially depends on creating the institutions and the organizational capacity needed to coordinate internally and manage the different kinds of aid. (It should be emphasized that the term "aid management", instead of "coordination", is used to prevent confusion with the separable issue of coordination among donors, and not to suggest a resource allocation function).

The organizational arrangements for aid management should be as far as possible country-specific (including on the key issue of institutional location). However, a review of past country practices and recent experience shows that certain minimum criteria must be met. These "musts" of aid management are also consistent with the conceptual basis of the economics of institutions — as presented in Part I — and with the lessons of institutional change in the key public sector areas, as discussed in Chapters 3-6. Consequently, the key criteria are listed below in the form of a checklist with a minimum of elaboration and explanation. That many of these criteria are obvious and intuitive should not mislead the reader into thinking that they are normally applied.

The Ten Commandments of Aid Management

1. Responsibility for managing external resources rests with the recipient government. External donors often have in practice an undue influence on project choice and the allocation of assistance. This first commandment in no way excludes the requirement and utility of donor participation in supervision of the use of aid funds and implementation of aid-financed activities.

2. Aside from sovereignty considerations, the essential reason why aid management must be driven by the recipient government is that external resources must be integrated within overall resource utilization, in pursuit of national economic policy. It is clearly impossible for a government to formulate coherent economic policy if decisions on the...
allocation of a major portion of available resources are made elsewhere.

3. At the central government level, there should be one aid management entity covering all external economic assistance (including technical assistance) except only emergency aid and some humanitarian aid, perhaps, even though there is a clear need for conceptual and organizational linkages between emergency assistance and development. In theory, good coordination among central ministries charged with different aid management responsibilities is possible. In the past, such a system has even worked in practice in a few countries in the past. At this historical juncture in Eastern Europe and the former Soviet republics, however, split aid management responsibilities have proven to be a recipe for confusion, waste and conflict. The frequent "two-way" split of responsibilities between a ministry of finance and a ministry of economy is problematic enough. The occasional "three-way" split which includes a role for the ministry of foreign affairs is next to impossible to administer. The practical outcome of split aid management responsibilities is that the government loses control of the exercise altogether and aid decisions end up being driven by competing donor agendas.

4. The aid management entity should normally be an office in a core ministry (e.g., the aid management unit in Latvia's Ministry of Finance). Because it is a key regular function of government, aid management should in principle be exercised by a regular organ of government — preferably the ministry of finance, owing to its responsibility to develop a coherent budget covering all available financing. In transition economies, when the structure and division of responsibilities between new ministries is still fluid, it is possible to consider an autonomous aid management agency outside the regular structure of government, provided it is placed high enough to perform its role credibly, and reports to a regular structure of government such as the Prime Minister or an interministerial body from which legitimately emanates development policy guidance (e.g., the Commission on Foreign Resources — GOSKOMINVEST — in the Kyrgyz Republic.) However, longer-term institutional development requires that the autonomous agency solution be explicitly transitional and incorporate a sunset clause. As time and organizational capacity permit, the aid management function should devolve to one of the core economic ministries.

5. Aid management should be organized along donor lines (e.g., a World Bank "desk", an EC "desk", a UN-system "desk" etc.), to build up expertise on procedural requirements of different donors, match different terms of aid with different projects, and help keep all donors "in the tent" — collaborating with a single government organization on an equal footing with one another. The aid management entity can also contain a sector coordination unit structured along types of assistance, where investment projects and technical assistance can be more effectively integrated within and across sectors, thus also facilitating the interface with the line ministries concerned.

6. The aid management entity should be the sole focal point in the government for contacts with donors regarding aid programs, and must be systematically informed by both donors and end-users of on-going activities. This recommendation is often misunderstood as counseling centralization of decision and a monopoly on information and contacts. On the contrary, as the next criteria makes clear, the purpose of having a single focal point for aid management is to support, not substitute for, the decision-making process of sector ministries.
7. The aid management entity must function to facilitate not obstruct relations between donors and their counterpart ministries. It should assure the availability of timely and complete information of aid, and help the flow of missions and delegations "traffic" in the interest of all concerned. Thus, while the entity must be regularly informed of donor missions and of ministries' requests, it should not have authority to "clear" donor missions.

8. It follows that the existence of a central aid management entity does not exclude sectoral coordination mechanisms. On the contrary, effectiveness of the central entity depends crucially on good decision-making in each sector ministry, which in turn requires an appropriate coordination capacity specific to the sector in question. To assure that the central aid management agency acts to facilitate and coordinate, and not to obstruct or supplant, there needs to be careful specification of limits and provisions for accountability and transparency. At the same time, as noted, if sectoral aid coordination units do exist, it is essential to prevent them from making "end-runs" around the central agency, and to ensure that they work in cooperation and in support of the central agency.

9. Similarly, the aid management entity should not interfere in project selection decisions. It does need to be regularly informed of such decisions; to have authority to approach the "right" donor for financing the various projects; and to participate in budget discussions in order to help ensure the adequate provision of local funding complementary to aid resources. However, project selection decisions are the responsibility of the sector ministry concerned within the overall programmatic priorities of the country; investment program is the responsibility of the competent core ministry (usually, a ministry of economy or of planning); and budget formulation is the responsibility of the ministry of finance.

10. Finally, the aid management entity should act to strengthen links with other agencies of government and help build financial planning and aid coordination capacity in the sector ministries. Without such sectoral capacity, central aid management is built on sand, reform is a mere shuffling of organizational boxes and titles, and donor preferences in effect dominate the allocation of aid funds.

**Minimum and Optimum Organizational Architectures**

The above criteria translate into the two organizational charts shown below. To provide the full range of constructive possibilities, the "minimum requirements" are shown alongside the optimum, most ambitious, form of organization.

The actual organizational structure will normally be intermediate between the two depicted in the charts, depending on country-specific circumstances and capabilities. The links to other agencies of government (shown here as information/communication or guidance/instruction arrows) are not, strictly speaking, part of the organization of the aid management entity. It is important to stress once again, however, that the interagency links are essential ingredients of the aid management function, which must be exercised within the context of a coherent economic policy framework and public investment program. Thus, and to conclude with the keynote of this entire volume, it would be futile to focus on the organization of aid management without at the same time defining and enforcing the rules — the institutions — of aid management, among which those governing the interaction with other agencies of government are paramount.
THE ORGANIZATIONAL ARCHITECTURE OF AN AID MANAGEMENT AGENCY (AMA)
MINIMUM REQUIREMENTS
(Last update: 05/05/93)
THE ORGANIZATIONAL ARCHITECTURE OF AN AID MANAGEMENT AGENCY (AMA)

LAST UPDATE: 05/05/93
NOTES

1. The European Commission, U.N. Economic Commission for Europe, the International Monetary Fund, the Organization for Economic Cooperation and Development, the U.N. Development Programme, and the World Bank. The European Bank for Reconstruction and Development, while expressing interest, was unable to designate representatives in time for the workshop, but remains, of course, among the multilateral agencies most closely concerned with the region — and the only one whose mandate includes specifically the promotion of democratic and accountable forms of governance.

2. At the time of writing, this possibility was being explored for Belarus, Kazakhstan, Kyrgyz Republic and Ukraine and — outside the region — for use by the Palestinian Economic Council for Development and Reconstruction (PECDAR), the public investment and aid management agency established following the September 1993 peace accords and subsequent developments.

3. An informal interagency working group on financial sector reform already exists. Also, the donor liaison group assembled to advise on the SIGMA program (funded by the EC and administered by the OECD — see Chapter 7) has some of the features of the mechanism described here.

4. I am very grateful to Yves de San of the United Nations Development Programme for his contributions to developing the following principles — including during a "trilateral" Bank/European Commission/UNDP mission we conducted jointly in Kazakhstan and the Kyrgyz Republic in February 1993 — and for his “translation” of the principles into the charts presented below.

5. The practice of aid management in a large number of developing countries has been reviewed in an internal World Bank working paper of early 1992 by Stephen Lister and Michael Stevens. A second important general reference is the UNDP’s “Capacity Building for Aid Coordination in the Least Developed Countries” (CEO Evaluation Studies No. 4/91; New York, May 1991). More recently, extensive direct experience has been gained, including by this writer, in advising on the appropriate organizational arrangements for aid management and public investment in Eastern Europe and the former Soviet republics. The aid management “musts” summarized here are consistent with the lessons of past experience as well as recent experience in countries as disparate as Albania, Kazakhstan, the Kyrgyz Republic, Latvia, Ukraine.
ANNEX

WORKSHOP ON INSTITUTIONAL CHANGE AND THE PUBLIC SECTOR IN EASTERN EUROPE AND THE FORMER SOVIET REPUBLICS

Prague, March 22-24, 1993

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