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Conference on Privatization and Ownership in Eastern and Central Europe

On June 13-14 a conference on privatization and ownership changes in Eastern and Central Europe took place in Washington, organized by the European Department of the World Bank and funded by the Research Committee of the Bank. Those attending included prominent academics and policymakers from each Eastern and Central European country, participants from other countries and from the OECD and EEC Commission. The agenda consisted of an overview of the conceptual issues of privatization and a review of possible strategies. This was followed by country presentations from Hungary, Poland, Yugoslavia, Czechoslovakia and Bulgaria. The second day's agenda began with presentations on the experiences of Chile and Mexico, where wide-ranging privatization programs have been carried out. Discussion included analysis of worker self-management in Yugoslavia and the impact of profit-sharing schemes in a number of industrial countries. Legal and management issues and the practice of privatization were also covered in panel discussions.

Two luncheon sessions offered an opportunity to hear "from the inside" about the Italian and New Zealand experience, with presentations by Professor R. Prodi, former President of IRI, and Roger Douglas, former Minister of Finance of New Zealand.

Indicative of the wide range of options discussed was the paper prepared by two World Bank economists Farid Dhanji of EM4CO and Branko Milanovic of CECSE. They offered an exploration of the environment for divestiture in Eastern and Central Europe and examined the advantages/disadvantages of the many "models" of ownership change under discussion. The authors did not take sides by advocating particular options, but rather pointed out the reasons behind the positions. The essence of their paper is provided below.

The plethora of divestiture options does not simplify choice. From an individual perspective the choice of a preferred model will vary depending on the weight given to possible objectives and the appreciation (or dis-

What's inside...

missal) of practical difficulties in implementation. In this respect there is no "correct" answer about how to privatize. From a group perspective, all decisions are highly political, mediated through still-emerging processes, invoking strong interests and lobbies, and with a genuine possibility of popular backlash in societies traditionally sensitive to wide divergences of wealth.

Insofar as privatization strategies emerge from this process, certain questions deserve continuing reflection. Should the process be fast or slow? Does the state need the revenues from privatization? Should enterprises be demonopolized before being privatized? Should enterprises be financially and technically restructured before being privatized, or can this be left to the new owners? How can ownership arrangements be instituted where the new owners take an interest in performance?

These questions invite multi-dimensional, not simple, answers.
Divestiture models are not exclusive. It may be perfectly possible, in fact, to give workers and managers a stake in their firms, give away a proportion of enterprise equity to the general population (either directly or through institutions), and obtain revenue for the state through general sales. These "combination" options are beginning to surface in the privatization debates and deserve considerably more elaboration and defense than they have thus far achieved.

Whether the privatization process is fast or slow is really only relative. Even in the best scenario, it is unlikely that the most state assets can be divested in less than a few years. The near complete unpreparedness of the legal, financial and fiscal environments underpin this expectation.

During this period when firms are readied for divestiture, it may be expected that governments will be besieged by requests for exemptions, concessions, protection etc., from firms about to be privatized or from new owners. It will be extremely important to resist these pressures. The improvement in overall economic performance that is one of the major objectives of reform programs will be considerably diluted if the new market economy is based on an extensive network of special privileges or other defenses against efficiency. Moreover, experience elsewhere testifies to the difficulty of removing concessions once given. It is imperative, therefore, not only that the privatization process be transparent and absolutely above reproach, but that the rules of the "market" game are also clearly enunciated and adhered to in divestitures.

Divestiture will be an integral aspect of the development of financial sectors. The continuing evolution of banking systems, pension funds, insurance companies, securities markets, etc., will depend on the decisions concerning the depth, scale, speed and mechanisms of privatization. There is great benefit in considering the two together. In particular, a pure "case by case" approach to privatization may well overlook substantial opportunities to strengthen and construct a modern and sophisticated financial system. Indeed, unless the strategies for financial sector development and privatization are coordinated, weaknesses in the former may reflect ad hoc and perhaps haphazard responses in the latter. The activities of Privatization Offices should, in this regard, be subordinated to this wider perspective.

Finally, governments will continue to need to pay attention to the majority of state enterprises that will take a long time to be privatized or are otherwise left as government wards. Encouraging a market orientation and fostering responsiveness to economic signals in these enterprises will present a major challenge. The wide variety of incentive devices—management contracts, leases, bonuses tied to performance—should be explored in this context. Equally as important, governments will need to insure that there is no discrimination in favor of state enterprises (credit allocation, state orders, looser financial discipline), as against the rules applied to the developing private sector. ■

Milestones of Transition

• **North and South Yemen** declared their unification into one state on May 22. Institutionalizing the union is well under way: on May 26, the two parliaments were merged into a single 301-member assembly; the central banks are in the process of merging; the riyal and the dinar are now legal tender at a YR26=SYD1 rate; a joint currency will be introduced by the end of the year; and the first joint budget is being prepared. A multiparty system of government is envisaged, with elections in 30 months. In the meantime, a loose federal system will enable the North and South to smooth differences in laws and regulations. Yemeni unification, with a market of 12 million people, will improve the climate for foreign investment: market-opening moves in the South, as illustrated by the new investment law in March, will be consolidated.

• The **Soviet Union**, stepping up its drive to integrate into the world economy, took a seat as an observer at GATT in May for the first time since the 96-country trade forum was convened more than four decades ago. The ruling council of the General Agreement on Tariffs and Trade agreed to Soviet observer status after Washington and Tokyo dropped its objections. However, the Soviet delegation at GATT is not allowed to take part in the Uruguay Round negotiations.
The Soviet Union is interested in becoming a full member of GATT.

• The Supreme Soviet, the standing parliament of the **Soviet Union** gave President Gorbachev a mandate on June 13 to speed the introduction of a more market-oriented economic system. Gorbachev may use his power of presidential decree — overriding both the parliament and the government — to de-nationalize state property, draft anti-monopoly controls, establish joint stock companies and a stock exchange, reform the banking system, and provide new legal status for small businesses and entrepreneurs. Gorbachev will likely go ahead in July with a series of presidential decrees on institutional reforms, and by autumn the government is expected to produce a legislative package to supplement these decrees.

The Road to a Free Economy

Professor Janos Kornai's short book published recently ("The Road to a Free Economy — Shifting from a Socialist System: The Example of Hungary, W.W. Norton & Company, New York/London, 1990, 224 p.) provides Kornai's vision of the road to a free economy in Hungary. For him this is a significant departure; although he is one of the most eminent writers in this generation on socialist economies, this is the first time in 33 years that he has put forth a comprehensive economic policy proposal. It was published first in Hungary before the free elections, when its potential influence was at its height. As an indication of the exhortative tone of the book (very different from his other writings), it was published in Hungarian with the title "A Passionate Pamphlet in the Cause of Economic Transformation".

The discussion is organized under three broad headings — ownership, stabilization and political economy. In all cases, Kornai brings the reader firmly back to basic economic principles.

Ownership and privatization

Kornai starts from the proposition that, with few exception, trying to make the social (state-owned) sector efficient would be a hopeless task, for a number of systemic reasons. For instance, since managers are part of a unified network of senior managers and government administrators, both decentralization and effective hardening of the budget constraint of the firm are unattainable. As for any administrator operating in a hierarchical environment, the size of the operation under his control and the satisfaction of his constituency (supervisors and subordinates) will always be the primary motive for action. Kornai is "fed up" with the "practice of simulation" of capitalist institutions grafted upon a social sector, such as "simulated price formation, capital markets or stock exchanges." ("Only westerners who hop over for a couple of weeks from, say, the World Bank, may fall under the spell of such simulations"). "Market socialism", therefore, is an impossible goal for him; not because social sector managers are corrupt or incompetent, but because the culture within which they operate has not prepared them — nor can it ever prepare them — to behave as entrepreneurs.

This leaves only three options for improving efficiency:

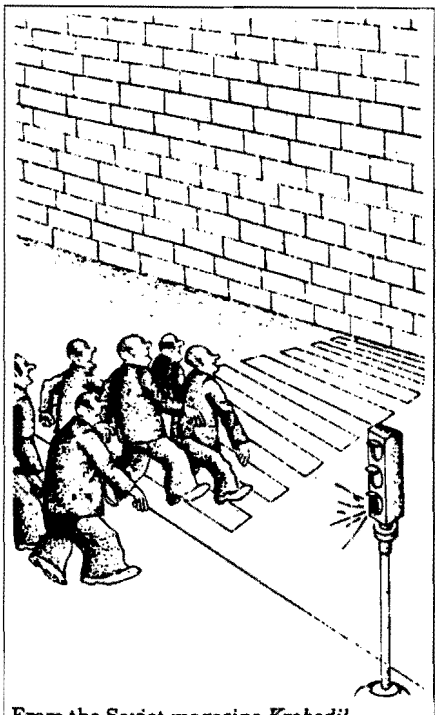
- unrestricted entry of new private firms;
- priatization of existing social sector firms;
- abandonment of fruitless attempts to turn social sector managers into entrepreneurs and search instead for a second-best approach for control.

For Kornai, these are not alternatives. The system would be transformed into a "dual economy" initially still dominated by tightly-controlled social sector firms, with a gradual transition to privatization until at some point the private sector dominates and sets the ground rules.

On the issue of ownership, he calls for full liberalization of private sector activities (entry and exit, pricing, contracts, employment, currency exchange) combined with strict financial limits on public enterprises. Although he favors privatization, he argues that the process should be careful and that all transactions should be strictly at market prices. In-between solutions to the ownership problem — such as holding companies, "cross-ownership" between public companies, or labor-managed firms — are greeted with skepticism.

To arrive at an efficient private ownership system, an entrepreneurial class has to emerge. This currently does not exist outside the small-scale service and crafts sector, and is rare within this sector. The emergence of a vibrant entrepreneurial class (in the Schumpeter mold) endowed with the technical and managerial know-how involves complex cultural and institutional changes (Kornai calls the process "embourgeouisement") that cannot be accelerated beyond a certain pace. The reason is that such an entrepreneurial class has to grow "organically," and that "mere imitation of the most refined legal and business forms of the leading capitalist countries is not sufficient to ensure their general application" and may indeed amount to "give the 'big leap' yet another try."

Another constraint on the speed of conversion is financial. First, Kornai maintains that the state cannot afford to "squander" social property (both productive assets and housing stock) by giving it away or by selling it below "realistic prices" (replacement value). In addition, he wants to transfer ownership to entrepreneurs who are willing and able to assume financial risks from the outset. Since the creation of tangible wealth takes time, the process of privatization is determined by



From the Soviet magazine *Krokodil*

the speed with which potential "tangible investors" (Kornai's term) can build up the necessary financial assets. Implicit in this consideration is another proposition: portfolio investors (investment funds, insurance funds, pension funds etc.) may have a supportive role, but they should not be the primary agents of privatization. Kornai explicitly rejects the notion that society should distribute credits to "impersonal private ownership" or through the "intangible stock market." Instead, only "hard loans" to stakeholders willing to offer their personal property as collateral.

Because of these constraints, Kornai rejects the notion that privatization "should be governed by the guiding principle of speed," which he calls "irresponsible." In the final analysis, Kornai suggests that an "organic transformation" may take over two decades or more. Until such time, a "dual economy" would prevail.

On the basis of the premise that the social sector firms really "belong to the sphere of government" and "should be treated accordingly," he sketches a second-best approach: run the social sector like the civil service until the private sector is strong enough to dictate the rules. He suggests that social sector operations be made fully "transparent" and that firms be made accountable to and controlled by the parliament, not by other branches of the government administration. Managers should be appointed, their mandate and powers carefully circumscribed, and their performance reviewed and rewarded as for any other senior civil servant.

Surgery for stabilization

Kornai distinguishes between an initial "package" for "stabilization" — "surgery" in his term — (to be completed within one to two years) and a framework for longer-term development. He argues that the execution of some required tasks should not be prolonged and that they cannot be accomplished by small steps. Instead, these measures must be taken in "one stroke".

The "treatment" advocated for stabilization is quite traditional: lower inflation, a balanced budget, credit restraint, strict wage discipline in public enterprises, a unified exchange rate with currency convertibility, and liberalized foreign trade. But Kornai includes some fairly unconventional proposals in the area of taxation, arguing against a personal income tax (because of its intrusiveness) and against any progressivity in tax rates. As to the latter, he continually exhorts Hungarians to change their thinking—to understand that it is good for society if a person works hard and makes a lot of money. His preferred tax system would include a single-rate VAT with universal coverage, a linear payroll tax, a flat-rate profits tax, and a uniform tariff.

The following elements make up the core of Kornai's longer-term transition strategy in pragmatic combination:

- run social sector firms by largely relying on principles of efficient administration of public agencies;
- carry out privatization of social sector firms at a pace at which the private sector can acquire them, given its growth of managerial know-how and risk capital. The goal is ultimately to dispose of all those social assets the private sector would use more efficiently.
- carry out privatization of social sector housing stock at a pace at which private households can acquire it. The goal is to privatize eventually the whole existing stock.
- invite in foreign investors (for new ventures and acquisition of shares in existing firms).
- switch from emergency measures for social stabilization to a comprehensive social security system.
- if possible, draw trade unions into a pattern of "constructive cooperation of the trade unions with the state and the private sector."

The final section of the book on political economy admits that the transition process will be long and hard, and Kornai tries to identify potential supporters and antagonists. Many groups have much to gain; the biggest sources of potential opposition are employees in the state sector, the poor, and the newly unemployed. As he puts it in his personal postscript: "I know the tremendous forces working against the realization of these proposals. But still, the proposal has a chance." ■

Economic Transformation in Hungary and Poland

The latest issue of **European Economy** (March 1990, Number 43) is dedicated to the topic of economic transformation in Hungary and Poland. (The quarterly is published by the Commission of the European Communities, Directorate-General for Economic and Financial Affairs). The issue focuses on a selection of studies by a group of independent experts who convened at the initiative of the Directorate-General for Economic and Financial Affairs as part of PHARE (Poland and Hungary Aid foR Economic reconstruction) task force.

The work of the independent experts was coordinated by Richard Portes, Director of the Centre for Economic Policy Research, London. Four meetings in Brussels (the latest convened in February 1990) allowed the participants to comment on early drafts of their respective papers and exchange views on current developments in Poland and Hungary. The papers selected for publication in the March issue of European Economy are:

Papers on Hungary

- Subsidy reduction in the Hungarian economy by I. Abel
- Reform of enterprise regulation in Hungary — from tutelage to market by P.G. Hare
- Macroeconomic policy in Hungary and its microeconomic implications by A.L. Hillman
- Tax reform, trade liberalization and industrial restructuring in Hungary by D.M. Newbery
- The elements of policy for rapidly redressing the Hungarian balance of payments by I. Szalkai
- The reform of the Hungarian financial system by I. Szekely

Papers on Poland

- Reform and budgetary policies in Poland, 1989-90 by S. Gomulka
- Prospects for privatization in Poland by I. Grosfeld
- Energy policy and the environment in Poland by G. Hughes
- Internal and international aspects of monetary disequilibrium in Poland by D.M Nuti
- State-owned enterprises in Poland: taxation, subsidization and competition policies by M.E. Schaffer

Paper common to both countries

- Policy issues in the design of banking and financial systems for industrial finance by J. Corbett

The introduction to the issue was written by Richard Portes.

Algeria: Sequencing Liberalization

Algeria faces tough challenges in the years ahead. The economy suffers from inefficient resource allocation and a distorted incentive structure, legacies of over 20 years of rigid central planning. The result has been inflated resource requirements to sustain growth — through the 1970s and early 1980s, for example, investment of over 40% of GDP produced only about 6% average annual growth. Against the background of high population growth, job creation has been insufficient to stave off high under- and unemployment. High resource requirements have caused public sector deficits, necessitating large transfers from the private sector. Over time, persistence of this flow imbalance under pervasive price controls has created a stock imbalance in the form of a "money overhang." While high oil prices previously masked growing economic inefficiency, the 1986 collapse of world petroleum prices produced large external deficits for the first time, worsening creditworthiness. The consequent import compression precipitated a domestic crisis — characterized by stagnating output, falling per capita consumption, and rising unemployment — all of which highlighted the macroeconomic weakness of the country.

Recent reform initiatives

In response to the onset of the crisis in 1986, the authorities initiated major institutional reform, accompanied more recently by policy and incentive reforms. Institutional reforms, aimed at decentralizing economic decision-making, began with passage of legislation in the agricultural, financial and industrial sectors in mid-1986. Despite economic hardship and the social unrest that followed, the drive for economic reform accelerated. In 1989, the government embarked on a program of macroeconomic policy adjustment and incentive reform, including formulation of precise fiscal and monetary targets. While reform is far from complete, progress to date, together with firmer oil prices, has significantly improved recent macroeconomic performance.

Institutional reform has concentrated on developing a legal framework to support decentralized decision-making. Public enterprises and banks have been granted autonomy and their ownership concentrated in eight holding companies. Financial discipline has been tightened by sharp reductions in treasury capital subsidies and by the creation of a body to oversee foreign borrowing. An ongoing program of financial restructuring will help ensure the viability of autonomous enterprises. Under a law passed recently, the central bank has been given a clear mandate to manage monetary policy. To assure independence, the central bank governor is now appointed for a six-year term and can be removed only with great difficulty in the interim. Finally, agricultural reform has extended the private sector's role by breaking up

Les Fonds de Participation

Holding companies have been widely discussed in the context of transition in Eastern and Central European countries. Yet Algeria has moved further along this road by transferring state ownership to profit-oriented holding companies. Under their reform program the Algerian authorities have distributed the shares of newly autonomous banks and firms among eight newly established holding companies or Fonds de Participation. Initially, each company is specialized in a particular sector. For those enterprises within its sector, each Fonds has been given the largest portion of shares, although not a majority. While the Fonds remain public, they have been given a mandate to maximize their financial rate of return, and compensation to holding company managers is tied to the performance of their share portfolio. To establish market values, enterprise shares can be traded among holding companies. To prevent one Fonds from dominating a particular firm, however, trading is subject to a ceiling of 40% ownership by any single company. With an eye to broadening the capital market, banks and firms can also hold shares.

The authorities expect the Fonds to isolate enterprises from the direct influence of sectoral ministry bureaucrats who have traditionally exercised substantial administrative control. As the state's fiduciary agent, each holding company has a mandate to oversee the financial health and strategic direction of those public firms within its portfolio. Fonds representatives sit on shareholder councils (Assemblee Generale des Actionnaries), which approve business and financing plans drawn up by firm staff. In the past, these plans were drafted by line ministry officials and approved by the now defunct Ministry of Planning. The Assemblee can also decide to issue stock, distribute dividends, and restructure, or even dissolve, the enterprise. The Assemblee elects a majority of the firm's board (Le Conseil d'administration), which chooses the managing director (Directeur General). While the holding companies exercise oversight through the council and board, they are expected to leave day-to-day firm management to the Directeur General and his staff.

While it is too early to evaluate their impact, the Fonds represent a key aspect of the authorities' determined effort to raise public enterprise efficiency. To complement the autonomy process, Treasury finance for new enterprise investment, traditionally available almost automatically, has been eliminated. Public firms will be forced to line up credit from the, now autonomous, banking sector.

all 3,400 state farms into 80-hectare cooperatives.

Political liberalization, following the establishment of a new constitution in 1989, has accompanied institutional reform. Independent trade unions have been sanctioned and the right to strike formally recognized. Political parties have been legalized and elections planned, beginning with municipal elections. In the June 1990 municipal elections the ruling Front de Liberation Nationale was defeated by the Islamic Salvation Front. These changes have effectively ended the 25-year political monopoly of the ruling party.

Accelerating economic reform efforts, the authorities have improved the macroeconomic policy framework, with the goal of restoring internal and external balance. Compared with the recent past, macroeconomic performance improved considerably in 1989, under the influence of higher oil prices and the reform program. Led by a rebound in agricultural output, GDP grew by a modest 2.8%. The budget deficit fell to under 2% of GDP and the current account deficit was cut almost in half in dollar terms. Per capita consumption grew for the first time since 1985.

In 1989, the policy dialogue with the World Bank and IMF intensified, culminating in Algeria's first-ever IMF purchases and World Bank adjustment loan. Establishing strict fiscal and monetary targets helped restore budgetary balance and slow growth of money and credit. Recent efforts have focused on strengthening monetary policy instruments and developing an external debt management strategy.

Within the policy framework, price liberalization and adjustment have begun. There have been recent movements in the exchange rate, interest rates, and the prices of goods and services. Despite substantial real devaluation over the past three years, however, the persistently large gap between official and parallel market rates implies that the dinar remains considerably overvalued. While real interest rates are no longer highly negative, they remain controlled and close to zero. Under a new law, the prices of some 30% of output have been freed, but the majority of prices are still subject to controls.

Future directions

The government's medium-term objective is to raise economic performance by sustained progress towards a market-oriented economy. Competitive market pricing will convey the proper scarcity signals upon which decentralized decisions can be based. To reach this goal, additional institutional and incentive reforms are necessary, along with continued policy adjustment.

On the institutional side, public enterprise restructuring and financial sector reform stand out as near-term priorities. The World Bank is cooperating with the authorities in these areas with recently approved Technical Assistance and Pilot Industry Restructuring Loans. Moreover, a financial sector reform loan and a cement industry restructuring project are in preparation.

While decentralization is well advanced, the money overhang and lack of competition among public enterprises complicate the sequencing of price liberalization. At one extreme, a one-shot liberalization of all prices could produce immediate efficiency gains; but this is likely to cause significant short-term pain in terms of enterprise bankruptcy, lost output, and increased unemployment. On the other hand, very gradual price decontrol, while likely to entail lower transition costs, would delay efficiency gains and would lack credibility.

Transition costs and credibility aside, several key features of Algeria's economy help explain the authorities' apparent preference to not liberalize too quickly or too slowly. Given the potentially large money overhang, rapid price liberalization could generate excessive inflation. Even if inflation were controlled, the present monopoly power of many public enterprises implies that many freely-set prices would still be inefficient. Reducing trade barriers represents a partial solution to the competition problem. A large increase in imports, however, would require a large dose of external resources, unlikely in the Algerian case. Moreover, the country has maintained a good external credit record that could be endangered by a rapid increase in foreign borrowing. Political constraints also weigh heavily in Algeria; the authorities may have viewed the current political climate as ill-suited to a "big-bang" approach.

Phased liberalization

Despite prudence dictated by economic and political realities, the need for tangible progress requires immediate action in priority areas. While the authorities are still formulating a liberalization sequence, the main structural feature of Algeria's economy, its access to substantial hydrocarbon rents, could be used to underpin a phased liberalization. If backed by tight fiscal and monetary policies, this strategy could reduce the risk of excessive inflation and develop private competition to public enterprises.

The central idea is the rapid introduction of competitive foreign exchange sales to public enterprises. Under tight fiscal policy, hydrocarbon rents accruing to the Treasury from the ensuing real devaluation could generate budget surpluses, reversing the historical private sector resource drain and absorbing liquidity. Against a background of private enterprise development and reduced liquidity, gradual removal of remaining domestic price controls would carry a smaller risk of monopolistic public enterprise pricing and runaway inflation.

Whatever economic liberalization strategy will be chosen, maintaining supportive policies will be necessary throughout the transition to harden the public enterprise sector's budget constraint and ensure reversal of external and internal imbalance. The government's ongoing public investment review and planned domestic tax reform should help sustain tight macroeconomic policy by rationalizing public investment and reducing the treasury's dependence on petroleum tax revenues.

James Parks, EM2CO

The Bank's Eastern and Central European Program

The World Bank's Eastern and Central European Program (ECEP) is an initiative originally designed to deepen understanding of the problems confronting economies in transition from central planning to market institutions. The Bank launched the ECEP in February 1989 with the specific objective of enriching the analytical dimension of policy advice and, more generally, strengthening the quality of the assistance programs. The following approaches were endorsed:

• First, intensify work on critical aspects of economic reform where little is known, or where solutions to policy problems are not evident.

• Second, widen the Bank's contacts with outside researchers and institutes engaged in work on Eastern and Central Europe.

• Third, increase the Bank's capacity to advise governments on appropriate policy reforms.

The Chief Economist of the Europe, Middle East, and North Africa Region has formed a steering group to help design and guide the program. Members represent the Bank's research complex, including the Socialist Economies Reform Unit (CECSE), EDI, Strategic Planning, the Sector Policy Department, and the China Department.

In the wake of last year's revolutions and the tremendous interest and work in Eastern and Central Europe, the ECEP has now taken on a more formal role. As part of the ongoing reorganization of the World Bank's European department, a full-time position for ECEP administrator has been established in the Director's office. It is now the locus for establishing priorities for the Bank's analytical and research efforts — it funds important comparative work on transition problems and disseminates information on what the Bank and others are doing. Repeated urgings at G-24 meetings to avoid duplicating efforts while dispensing reasonably consistent policy advice underscore this preoccupation.

In its first year of operation, after convening an "expert group" of policymakers from Eastern Europe, distinguished academics, and IMF and Bank staff, the ECEP has concentrated on three main areas:

• Macroeconomic management during the transition to a more market-oriented economy, particularly the associated questions of how to abandon central control of prices while avoiding excessive inflation, and how to sequence policy changes to minimize economic costs.

• Enterprise behavior and reform, including issues of monopolies, restructuring, and privatization.

• Safety nets to deal with the social costs of adjustment, including severance and unemployment compensation, pension reform, and housing.

Much has been accomplished in these areas, both in developing analyses as well as through disseminating information through conferences and workshops (e.g., the Privatization Conference, reported on the first page of this issue of our newsletter).

Analytical priorities

Over the next year the ECEP intends to focus on the following work:

• The most urgent analytical and research priority is *enterprise reform*. The responsiveness of micro-units to the changing economic environment in reforming socialist economies is problematic: it is not clear that market structure, internal enterprise organization, technology, management, and attitudinal patterns are conducive to a strong supply response once prices are liberalized and financial constraints are applied. Without a strong supply response at the enterprise level, however, reform programs will flounder.

• *Privatization and ownership issues* are likely to be proceed slowly. In a broad sense governments will need to manage and "regulate" not only their "natural" monopolies but also firms that will be privatized. While considerable knowledge exists on the regulation of natural monopolies, little work has been done on mechanisms for managing other firms as central controls fall away.

• *Reform of the CMEA* is another area of concern. CMEA trade will be conducted principally at international prices and settled in convertible currencies by early 1991. Because the most substantive proportion of this trade is the exchange of Soviet oil, natural gas and primary commodities for inferior manufactures from East and Central Europe, the smaller CMEA countries will likely experience substantial terms of trade losses. The Soviet Union may well need to finance the ensuing balance of payments deficits to smooth adjustment over a few years. In the process, however, countries will become more heavily indebted, raising new issues for the continuing flow of Western commercial bank credits.

• The *role of the state* in all the reforming countries of Eastern and Central Europe can be expected to undergo major changes as governments withdraw from numerous activities. This will be reflected in a major reorganization and reorientation of fiscal systems as both the content and composition of expenditures change, and as revenue sources are shifted from turnover taxes and archaic company and payroll taxes to more modern systems of consumption, profits, and income taxes. The manner in which this transition will be accomplished and its relationship to the other reforms that are being contemplated are a continuing focus of an analytical work.

• Very little work has been done on *local government*. Not only are local governments responsible for the delivery of vital social services (including housing), they are often the effective owners of a large number of enterprises. Their role is likely to change significantly as reforms accelerate.

• Work on *social "safety nets"* is a major focus of attention and will continue to be part of the economic and sector work program. In each country, policy advice will cover such topics as unemployment compensation and retraining schemes, old-age pensions and social security schemes, and financing and delivery of health care. (Housing sometimes falls under this heading.) In addition, however, the ECEP will sponsor comparative analytical work and disseminate the information to the countries.

• The *environment* is a major issue. The Bank is playing a very prominent role in assisting countries in developing standards and regulations, incentive policies, and upgrading management capacity. Much of the Bank's effort is through sector and project work, for instance, in the recent loan to Poland. An increasingly important topic is assessing the macroeconomic costs of reducing pollution in Eastern Europe.

For more information on ECEP, contact Farid Dhanji in EM4CO, (202) 473-2968 or Christine Kessides at (202) 473-2962. ■

Quotation of the Month

"Recognizing political constraints, I would urge five economic initiatives [for Eastern Europe], some of which may be out of sync with our allies.

"The first is debt forgiveness, a new Bush Plan for Eastern Europe to complement the Brady Plan for Latin America. Neither political party is contemplating foreign aid increases or granting the Executive Branch anything like the flexibility it needs to manage prudently our existing foreign aid program. While geostrategists within the leadership of the majority party have propounded the stunning thesis that the United States should proffer direct aid to an economically unreconstructed Soviet Union, my sense is that the driving priority ought to be for the United States to emphasize, above all, the need to preserve the gains for freedom in Eastern Europe. In this context, we have little choice but to emphasize reducing old debt rather than raising false expectations about substantial new commitment.

"Accordingly, I have introduced legislation that authorizes the President to write down public sector debt in Eastern Europe on a case-by-case basis.

"Attendant to such an approach are three perplexing issues: the obligations of the commercial banks; the attitude of Western European official creditors; and the problem of precedent.

"Treasury is particularly concerned that the cart not come before the horse, that commercial banks not have their credit liabilities strengthened at official expense. However, that is unlikely, in part because official debt is so much larger than commercial debt in Eastern Europe, that the private sector will go first. The strategy should thus be to induce commercial debt reduction in tandem with official.

"Western Europeans, who hold the brunt of current debt, have misgivings, but despite this it is the obligation of an American Presidency to lead. Precedent exists with the Brady Initiative, with the mutual decisions of the past several years to write down sub-Saharan Africa debt, and with the London Accord of 1953 in which the allies agreed to reduce $2 billion of German debt in order to strengthen democratic governance in Bonn.

"Given the Marshall Plan and post-war German debt restructuring, we have every right to speak to our allies with moral force. If the Europeans are discomforted, so be it. The fact is that just as the Brady Plan changed the landscape of international finance with its very introduction, a personally stamped Bush initiative of this nature would so change the expectational framework in Eastern Europe that in one form or another Western European governments would be hard-pressed not to accede. We can't prudently go it alone; we can insist on allied unity, not for our sake, but for the sake of stability on their continent.

"The second initiative, on which the U.S. Congress has already made a down-payment, is to provide modest direct aid, preferably to advance private sector development rather than bolster social programs or debt service.

"Third, the President and Congress should exhort American business to invest in Eastern Europe. The President has agreed to help orchestrate private sector volunteer efforts, but there is no substitute for real American entrepreneurial commitments. Investments in jobs as well as ideas are in order.

"Fourth, and perhaps most important, the United States ought to negotiate a free trade agreement with the countries of Eastern Europe and the Baltics, beginning with Poland.

"Fifth, despite budget problems at home and the contingent liabilities implicit in lending through international financial institutions, the United States should become a constructive partner in the proposed European Bank for Reconstruction and Development. At a time when substantial troop reductions are under serious consideration in the European theater, the United States should replace military leadership with economic. Now may be a time to reduce troops; it isn't time to reduce economic ties. America cannot turn its back on Europe, especially at this time of such wrenching — and hopeful — economic and political transition."

Remarks delivered by US Representative Jim Leach at a seminar on Eastern Europe sponsored by the IMF and Georgetown University, May 18, 1990.

On the World Bank/IMF Agenda

Credits to Tanzania

Tanzania will rehabilitate its primary and regional road networks, which have deteriorated to the point of undermining the nation's economic recovery program, with an IDA credit of SDR 139.9 million. The project will assist Tanzania's economic recovery by reducing transport costs and allowing agricultural products better access to markets. The $871.1 million project includes rehabilitating about 2,890 kilometers of unpaved primary roads and about 3,000 kilometers of regional roads, restoring 30 bridges, and improving 10 vehicular ferry crossings. Various countries and international organizations are cofinancing the project.

More than 200,000 primary and secondary school students will benefit from a project to rehabilitate and revitalize the education system. IDA is supporting the project with a credit of SDR 29 million ($38.3 million).

Tanzania's education sector, once exemplary, is on the brink of collapse. Primary school enrollment has dropped from 96 percent of all eligible children in 1979 to 78 percent in 1987. Secondary school enrollment is among the lowest in the world, with only 3 percent of those between the ages of 14 and 17 attending school.

The $63.6 million project aims at improving the government's capacity to plan, manage, and finance education services. The project will train education managers at the national and local levels. Support will be provided to the Ministry of Education for collecting and analyzing information and in updating the country's educational strategy. Measures will be taken to encourage the private sector to assist communities and local authorities in improving educational services.

Poland Expands Production of Natural Gas

Poland will increase production of natural gas through a project supported by a $250 million World Bank loan. The loan will finance development and rehabilitation of existing gas fields, evaluation of recently discovered gas fields, the expansion of transmission and storage facilities, and the adoption of new gas processing and desulfurization technologies.

Technical assistance and staff training will be provided to energy-sector agencies to help them improve management and increase efficiency. In support of the project, the Energy Sector Management Assistance Program (ESMAP) of the World Bank and the United Nations Development Programme will conduct studies on energy-sector restructuring, gas pricing, gas-sector development, and the environmental impact of energy use.

Loans to Algeria

Viable public enterprises in Algeria will gain greater access to necessary technical and financial resources through an industrial restructuring project that is being supported by the World Bank with five loans totaling $99.5 million. The loan beneficiaries are the Algerian government, three industrial companies, and a data processing and management consulting company. The project will help the three industrial enterprises define their medium- and long-term corporate strategies; identify inefficiencies in management, marketing, financial management, pricing, production and technology; and define and carry out actions and investments to implement their strategies within the framework of a detailed restructuring plan.

To increase agricultural productivity and reduce food imports, Algeria will carry out a project to develop strong and responsive research and extension services. The World Bank is supporting the project with a loan of $32 million. The project includes support for INRA, the national agricultural research institute, in coordinating programs and carrying out basic research. Five experimental farms will be upgraded into regional research centers. The five-year, $75 million project will help generate jobs, stem urban migration, and reduce Algeria's dependence on imported food.

Yemen Expands Health Care

Yemen will expand the coverage and quality of health care services through a project to be partly financed by an IDA credit of SDR 11.7 million ($15 million). The project will train about 600 people in the country's 11 governorates in administrative and support services, including personnel administration, accounting, statistics, and computer skills. The project includes constructing pharmaceutical facilities as well as maintenance shops for biomedical equipment, and providing technical assistance to strengthen the Al-Thawra hospital in Sana'a as a national center for health management.

Bank Supports Reforms in Hungary

Hungary's drive to stimulate economic growth and establish a competitive market economy is being supported by a $200 million structural adjustment loan from the World Bank. The loan will support the new government's medium-term economic reform to revive economic growth by reducing inflation and improving the country's external creditworthiness. Policy reforms to improve the performance of enterprises form the core of the economic program. Measures include reform of ownership of state enterprises to facilitate their transformation into modern corporate form and to promote their privatization. Other measures include import liberalization, price decontrols, financial system reforms, and promotion of financial discipline in enterprises and banks.

Measures will be taken to restructure or liquidate unprofitable enterprises, reduce subsidies to public enterprises, and promote a dynamic private sector as well as small- and medium-scale enterprises.

Book and Working Paper Briefs

Wlodzimierz Brus and Kazimierz Laski
FROM MARX TO THE MARKET: SOCIALISM IN SEARCH OF AN ECONOMIC SYSTEM
Oxford University Press, Oxford/New York, 1989, 177 p.

In this book two distinguished Polish economists working in the West discuss the theoretical and practical aspects of efforts to change the socialist economic system in such a way as to avoid the worst excesses of both market capitalism and central planning. The authors, both of whom were involved in the process of reforming the Polish economy in the 1950s and 1960s, examine the Marxist claim to socialism's economic rationality and study the application of this concept in the "real socialism" of Communist Party orthodoxy as well as in the tentative attempts at "market socialism" in Yugoslavia and Hungary. Concentrating on common features in the evolution of socialist economic practice rather than on factors peculiar to individual countries, they draw on national experiences to pinpoint the advances that have been made and the flaws in models that have been developed. They also assess the possibilities of synthesizing socialist principles with the exigencies of the market.

In their concluding remarks the authors say that a cruel East European wisecrack defines socialism as "the painful road to capitalism. It may be premature to see in market socialism simply a stage on this road (or a slide, as many would say), but there is little doubt... that the distinctions between capitalist and socialist economic systems, as hitherto perceived, become thoroughly blurred under market socialism. If, therefore, marketization is accepted as the cure for the economic ills of 'real socialism', not only the original Marxist promise has to be cast aside as anachronistic, but also the very concept of transition from capitalism to socialism. The evolution of 'real socialism' complements in this respect the reverse regularity: while advanced capitalism fails to display the expected propensity to transform itself into socialism, the more 'real socialism' matures the more it is compelled to borrow from the capitalist armory.

"The recourse to market socialism means that socialism should actually cease to be perceived as a bounded system, transcending the institutional framework developed in the past and, hence, by definition, postulating its total replacement by a new institutional foundation...Recourse to market socialism means, on the contrary, that the very idea of the grand design of a supremely rational economy has been acknowledged as utterly fallacious and that the true and most difficult problem is how to restore the continuity broken by the revolution from which the 'real socialism' economy emerged."

Wlodzimierz Brus was Professor of Modern Russian and East European Studies at the University of Oxford until his retirement in 1988. Kazimierz Laski is Professor of Economics at the Johann Kepler University of Linz, Austria.

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Mary Shirley
THE REFORM OF STATE-OWNED ENTERPRISES: LESSONS FROM WORLD BANK LENDING
The World Bank, Policy and Research Report #4, Washington D.C., 1989, 64 p.

The World Bank has over the past decade shifted much of its work on state-owned enterprises from strengthening individual organizations to addressing wider institutional and policy concerns. This report reviews the Bank's experience with these enterprises and provides recommendations for future reform.

The author examines the changing role of state-owned enterprises in the economy of developing countries. She also looks at the mixed experience of developing countries in introducing divestiture programs.

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Alan Roe and Jayanta Roy
TRADE REFORM AND EXTERNAL ADJUSTMENT: THE EXPERIENCES OF HUNGARY, POLAND, PORTUGAL, TURKEY, AND YUGOSLAVIA
The World Bank, EDI Policy Seminar Report #16, Washington D.C. 1989, 32 p.

Centrally planned economies face fundamentally different problems when reforming trade policies than do market economies. This report examines the progress of, and constraints to, trade reform in five countries of eastern and southern Europe. Seven broad themes are considered: the origins of the need for adjustment; the nature of the necessary adjustment; the role of trade reform during adjustment; the unique problems with trade reform in socialist countries; the policy content of adjustment and the role of devaluation; the sequencing and the characteristics of successful trade liberalization; and the international environment for trade reform.

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Letters to the Editor

To the Editor:

Your first articles and your request for contributions inspires me to make a few remarks, which may deserve your consideration.

First: Could you present a matrix-like summary, by region, of the Socialist-Marxist economies your group plans to deal with, divided into (i) socialist economies in transition, (ii) socialist-like economies moving toward or showing indications of change, and (iii) established socialist economies, differentiated between "member" and "nonmember" of the World Bank?

Second: What would the Bank's attitude be in terms of establishing priorities and allocation of resources, first regarding the socialist economies as a whole, and then among the three categories? It seems evident that one cannot adopt a "common working agenda" and technical assistance approach when dealing with countries with such different degrees of political commitment, ideological dependency, and cultural, social, and development interaction.

Third: Would it be feasible and operationally convenient to create a new Socialist Economies Regional Office (SERO) in the Bank? It would include the three categories mentioned above. SERO, that is, EM4 plus, would be pervasive enough so that the current socialist economies in transition may be withdrawn from SERO in the future and returned to their natural geographical region once they graduate to a market economy, after passing through the necessary and conventional structural changes. I see more pros than cons with the adoption of this scheme:

- Rational optimization of Bank resources by reserving and allocating a budgetary ceiling for all the socialist countries. The available funds would be distributed in accordance with their effective response to change—the role of the "parliament" in creating the legal infrastructure is a "sine qua non"— and an inventory of priorities established by the respective governments with Bank cooperation.
- Operational experience gained from investment projects and programs in the first category — perhaps with a workable understanding with the new European Bank, as well as with structural and sector adjustment lending, would be more efficiently translated to the second category countries.
- Bank staff could develop a homogenous specialization in a new socioeconomic environment, thus facilitating the necessary dialogue with the new European Bank.
- CECSE policy and research specialists in the PRE Complex would interact more comfortably with the pragmatists in Operational Divisions whose aims and interests would be directly compatible with similar CECSE concerns.

Finally, an observation that is probably a reflection of one's own background and professional interests. I notice that a fundamental concept in any democratic system established in freedom and leading towards a market economy, has not been explicitly mentioned among the wide range of programs awaiting the architects of the reform process: accountability — that legal and ethical obligation that any democratic government has to inform the people what it is doing with the public funds entrusted to it. Accountability is found in a proper division of powers and in a truly independent — administratively and financially — external control body reporting to the parliament about the financial behavior of the executive.

To assist the new democracies in designing, organizing, staffing, and training must be a necessary engagement the Bank cannot but embrace and support. This is only a part of a more comprehensive task. Bank management would be wise to resume the "country studies" that were recommended in 1985 as a way to improve financial management, accounting, and auditing to promote the concept and practice of accountability. A market economy cannot function properly without market accounting: financial, cost and managerial. Any agenda for financial reform in the socialist economies should contain a country financial management study, including:

- Assessment of accounting principles, standards, and practices and how they can be used to establish the concepts of market accounting: revenue, income, cost, and profit
- Regulations affecting corporations and public enterprises, banking accounting practices (including such considerations as the treatment of delinquent accounts), insurance and allied industries.
- Estimation of the demand for financial management and accounting graduates by the emerging private sector and government entities.
- Training in financial management, budgeting and accounting at both private and public sector levels; an assessment of the institutional assistance needed for creating management and business schools.
- Plans to disseminate, at both private and public sector levels, the meaning, purpose and application of the accounting and auditing standards issued by the International Accounting Standards Committee and similar bodies.
- Inventory of the existing availability of independent accounting and auditing services in the country; plan to train local auditors to become heads of the national offices of the international firms. In the meantime, the existing international audit firms in those countries could be used by the Bank as consultants.

A separate topic is: what type of external control organization is appropriate? Should it be patterned on the French "Court De Comptes", currently adopted in the Mediterranean countries and some other in the South American continent? Or should it resemble the executive and audit firm-like National Audit Office in the U.K. or the U.S. comptrollership agency (GAO)? What about the double control systems of Canada: an office auditor general reporting to parliament and a comptroller general within the executive branch for internal audits and evaluation—there is a difference between the terms. Or perhaps, the Swedish approach could be tried, according to which the national audit bureau would not report to the parliament but is no less efficient, effective and independent?

Should we recommend to the new brand of state auditors that they emphasize the economy, efficiency and effectiveness (value for money) type of modern public auditing, or should we tell them that the most imperative objective that they should try to achieve, in the short term, is the performance of an efficient financial audit? How much do the properties or inventories really cost? Do they exist? Are these receivables really collectable? Who owns the assets? Who are the creditors? Are these all the outstanding obligations? Are there contingent liabilities? As you can see, the country study approach has important applications for the evaluation of the socialist economies in transition.

Angel Gonzalez-Malaxechevarria - LATPS

Your letter raises many thought-provoking points. On the first question of presenting a matrix by region and type of socialist countries, we have often been asked to define exactly which countries are considered "socialist" and whether these are seen as a homogeneous group. There is no simple answer here: some countries terming themselves "socialist" have, in fact, well-developed institutions of private property; others that might not consider themselves socialist carry a major legacy of socialist organization. In fact, it may be more appropriate to consider economic systems in a continuum rather than in clear categories; many of the features found in the commonly-called socialist countries are present in other countries, too. Together with the Socio-Economic Data Division (IECSE) of the Bank we are putting together a short reference book covering "socialist" and comparator countries. This will require such a classification, but it is already clear to us that in the end any choice will be quite subjective and will not please all.

This bears on your second point, the desirability of consolidating work on socialist countries under one Region within the World Bank. There are clearly externalities from comparative analysis, but given the continuum referred to above and the similarity of many policy issues across socialist and other countries, (including the area discussed in the last part of your letter, accounting and auditing standards, which are weak in many countries) my guess would be that the benefits of centralization would not outweigh the many difficulties this would cause — not to mention the problems associated with "typing" of countries and economic systems. But your point certainly does suggest the desirability of encouraging flexible assignments of Bank staff across regions to enhance cross-country comparative experience of similar issues.

Alan Gelb, CECSE

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