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EU Accession Challenges CEE Agriculture 24240

Agricultural reform in Central and Eastern Europe (CEE) has been one of the most intractable transition issues and is now proving to be problematic in EU accession talks. Crop yields, value added per worker, and fodder/livestock conversion rates are all well below the EU average. Agricultural reform also encompasses potentially volatile social and political issues, ranging from underemployment to foreign ownership of agricultural land.

Transition economies in CEE are struggling with several structural problems in relation to their agriculture sectors, namely:

- ***Subsistence focus.*** Agriculture is still primarily a subsistence rather than market-oriented sector. In many countries the restitution and privatization of cooperatives extended families' access to small plots of land, and these have offered an important safety net for households struggling to cope during the economic transition. The European Commission's November 2001 Regular Reports indicate that the only agricultural subsector to have shown significant development is semisubsistence.
- ***Stalled restructuring.*** Structural reforms introduced in the 1990s failed to modernize farming substantively. The size of the agricultural population has not declined significantly, and several countries have actually witnessed net migration from urban to rural areas. In Poland and Romania a substantial proportion of the population relies on agricultural incomes.
- ***Market failure.*** Progress in developing land markets to create viable farming structures or in privatizing domestic food processing industries to improve efficiency and respond to increased demand has been minimal. Farms in the prevalent semisubsistence sector are below the average EU size and have little agricultural machinery and few funds for investment. After 10 years of transition, the structures that should enhance productivity and competitiveness in factor and product markets—private firms and major individual holdings—have tended to stagnate or decline. Imports from the EU have been used to meet the increase in internal demand, and except for Bulgaria and Hungary, all CEE states have growing trade deficits with the EU.

Obstacles to Reform

Several factors explain the failure to reform agriculture in CEE. **First, in the early 1990s weak governments were vulnerable to the influence of newly revived peasant parties.** Even in Hungary, where the collective sector was relatively successful, the Smallholder Party was able to insist on the rights of former owners. In Bulgaria and Romania debates about land reform oscillated between returning the full amount of land past owners had held or returning only part of it. By the mid-1990s both countries had extensive areas of tiny farm holdings.

Second, the sector remains dominated by a few large holdings and many extremely small holdings, with little in between. The Commission blames the lack of progress on the failure to issue definitive property titles and on ownership restrictions. However, sociological factors are also pertinent and several have influenced legislation: popular opposition to foreign ownership of agricultural land has led to prohibitions on ownership and demands for lengthy transition periods in EU accession talks; concerns about preventing the re-emergence of *kulaks* (rich peasants) has led to the creation of a legal ceiling on the amount of land a single family can own in some states; and in Hungary, a fear of the revival of socialist cooperatives led to prohibitions on corporations' ability to buy land (see article on page 10).

Third, the transition period saw a revival of 1930s-style rural underemployment. Since the mid-1990s farmers throughout CEE have suffered the effects of a combination of high input costs and low farmgate prices. This has rendered agriculture unprofitable and, for many potential investors, has made the purchase of agricultural land unattractive. Many smallholders subsidize production from other sources, such as pensions, child benefit payments, part-time jobs, or government input subsidies, and have little left for investment. Larger farms face similar constraints Foreign institutions have worked to create a Western-style credit market where, for

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What's Inside

instance, future crop yields are accepted as collateral. However, interest rates tend to be prohibitively high, repayment periods tend to be short, and penalty rates and clauses can easily lead to bankruptcy.

The size and state of agriculture in CEE means that the sector is in poor shape to integrate with the EU, particularly as the Commission is under pressure to limit budgetary spending increases resulting from enlargement, while current members receiving large agricultural payments are eager to protect their own farmers. The EU reports note that to reach just 50 percent of the average productivity of the EU-15, the 10 CEE applicants would have to shed 4 million agricultural jobs This underlines the difficulties of reaching a compromise in accession talks.

Scenarios in New EU Study

To sweeten the pot, a study published by the European Commission in March 2002, "Analysis of the Impact on Agricultural Markets and Incomes of EU Enlargement to the CCE Countries" (http://europa.eu.int/comm/agriculture/publi/reports/ceecimpact/index_en.htm) asserts that EU membership will significantly improve the prospects for farmers in the candidate countries. On January 30 the Commission unveiled its proposals for agricultural support to new members following their accession, whereby farm aid will begin at 25 percent of the current level and only reach the full level by 2013 (see *Transition*, January-February 2002, "The EU Commission Proposes—and Got Hit from all Sides," page 9). The announcement provoked widespread criticism in CEE and prompted high-level meetings to discuss a common approach. The March study tries to dispel those criticisms and provide an economic underpinning to the EU's proposals.

The study considers four different policy scenarios: (a) the baseline position, which assumes nonaccession and unchanged agriculture policies in the CEE countries; (b) introducing the Common Agricultural Policy (CAP) without direct payments (c) introducing the CAP with direct payments and (d) agreeing to the candidate countries' negotiating positions. Even under the most pessimistic restructuring scenarios EU accession should raise the incomes of farmers in the candidate countries. Applying EU market measures, such as intervention with zero direct payments, is likely to increase farm incomes by some 30 percent in eight Central and Eastern European candidate countries (CEEC-8) by 2007 (the study did not cover Bulgaria and Romania). Increases would be particularly significant in the Czech Republic (60 percent),

Latvia (59 percent), Estonia (55 percent), Slovakia (45 percent), and Poland (35 percent).

Without EU membership until 2007, output (value of production) in the CEEC-8 countries would likely increase only slightly in the crops sector and continue to contract in the livestock sector. In the crops sector Slovakia is likely to achieve the highest growth (6 percent), while crop output would contract in Lithuania (3 percent). The picture is far more pessimistic for livestock production, with all the countries except for Slovenia, and to a lesser extent the Czech Republic, experiencing contractions in output. This is likely to be particularly marked in the Baltics and Hungary. As a result, the CEEC-8's average income would contract by 4 percent compared with 2002. Without access to the EU's structural funds and rural development programs targeted to the semisubsistence sector to achieve full commercial standards, the required restructuring would be painful

The report argues that low levels of direct aid support could ensure that all the CEE countries experience positive income effects as a result of enlargement. As a start, in 2004 farmers in accession countries would receive direct aid equal to 25 percent of similar payments given to farmers in existing member states that would increase by 5 percent for the next three years, reaching 100 percent by 2013. The Commission argues that too much aid is unhealthy, and that 100 percent direct aid could undermine incentives for labor restructuring and create social distortions and inequalities.

An average farm of 20 hectares in the CEEC-8 generates income in the form of added value worth the equivalent of 1.2 national gross annual wage units compared with 0.9 units in the EU-15 (see the figure). Accession without direct payments would increase such a farm's income by 50 percent, equivalent to 1.8 wage units. Full direct payments based on recent reference periods increase income by 117 percent to the equivalent of 2.6 wage units. With 100 percent direct payments as requested by the CEE countries income increases by roughly 150 percent or 3 wage units. At such high levels of direct payments labor would be better served by remaining in agriculture than seeking employment outside agriculture.

Even without direct payments for the candidate countries the study anticipates an increase in cereal production, leading to increased surpluses. The effects on beef and dairy production would also be positive, but not enough to increase current production levels significantly. This is a clear indication of the ability to compete within the single market. Only pork production is expected to decline overall, highlighting this sector as one that is relatively competitive. Growth in poultry production following rapid investment is likely to meet expanding demand in new markets. Integration into the single market is likely to stimulate some specialization in agricultural production, with crop production benefiting in the CEE countries and livestock production in the EU-15.

Enlargement will not create major market imbalances. In the crop sector wheat surpluses should not cause a major problem, because EU wheat will be competitive on world markets. The maize surplus of the CEE countries could be entirely absorbed by the EU-15. Only rye and other grains (mainly oats) could have difficulties finding outlets on world markets. For livestock, beef markets in the EU-25 will be manageable if no major changes occur in consumer preferences. As long as quotas are based on recent reference periods, EU dairy markets will not encounter major disturbances after accession

Note that the report's simulations do not reflect additional positive income effects resulting from the enhanced rural development measures proposed by the Commission.

EU Candidates Not Persuaded

At a two-day meeting in Brussels in April, the latest round of EU accession talks, candidates claimed that the EU appeared to be trying to extract everything possible under the budget chapter while attempting to limit or delay agricultural and infrastructure aid. Poland's chief negotiator Jan Truszczynski said that the EU is effectively trying to selectively apply its *acquis communautaire,* the body of European community law the candidates must enact before membership. He was referring to the Commission's proposal in late January that the direct agricultural subsidies available to farmers in current member states should not be fully applied to the new member states until 2013. Nevertheless, the EU is demanding that new members make full contributions to the community budget from the day of their accession.

The EU's demand could strain budgets of the new member states in the first few years following accession. As a result of various administrative hurdles and fiscal rules applied by the EU, what subsidies the new members do receive will not show up in their budgets immediately, yet the candidates' must make their expected contributions to the EU budget early in the year. This could mean that in the first year or two following

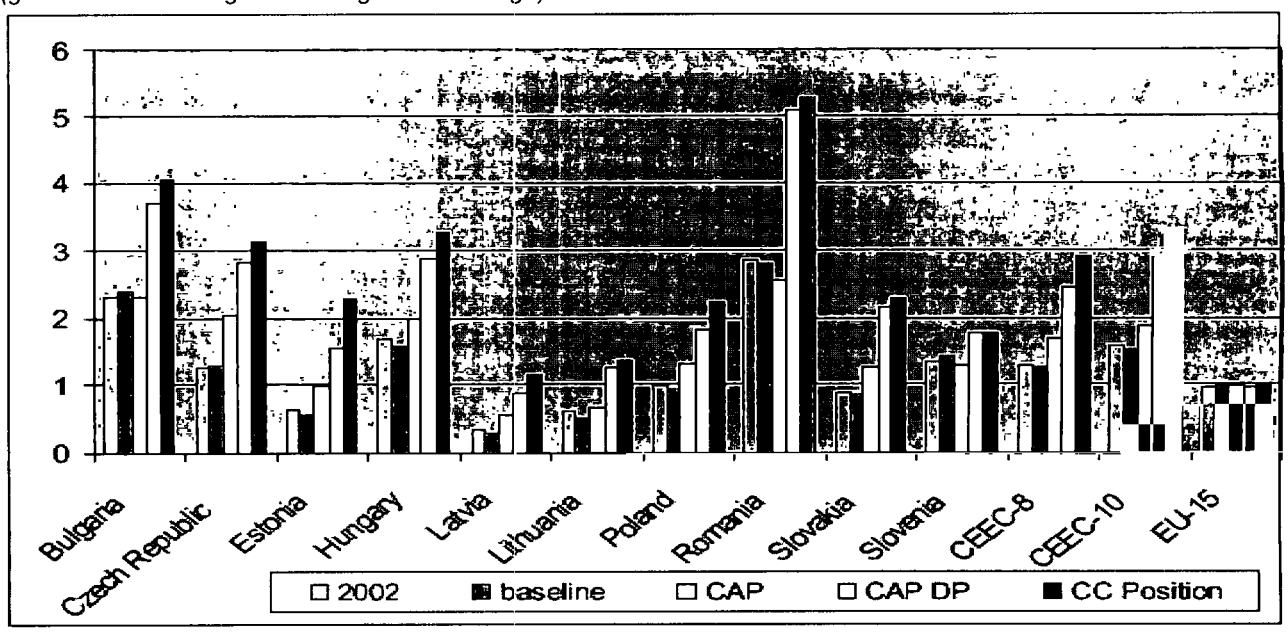
accession the new members pay more into the EU budget than they get back. It is no wonder that thus all candidates are seeking a gradual phasing in period before they must pay their full contributions to the EU budget.

Divided They Fall?

Accession candidates have been attempting to form a joint front and find a coordinated response to the Commission's proposals for agricultural aid following accession. Differences in the size of the states' agriculture sectors and the progress of sectoral reform, as well as disputes about priority and strategy, however, have undermined their efforts. Poland's agriculture sector is considerably larger than in the other candidate countries. Semisubsistence agriculture is dominant in Poland, but is relatively unimportant in the Czech Republic, Slovakia, and Slovenia. Less than 5 percent of the Czech, Slovak, and Hungarian work force is employed in agriculture, compared with 18.8 percent of Poland's work force. Individual candidate countries reacted to the Commission's proposals as follows:

- Hungary joined the initial outcry over the proposals, but has continued to emphasize that it will be able to integrate fully with the CAP by the end of 2002. Hungary is the leading CEE accession candidate and is anxious not to have its progress toward completing talks this year and becoming a member in 2004 delayed by other states' disputes over agriculture.
- Slovakia has a larger scale and more mechanized agriculture sector than Hungary and has expressed concern about the method the Commission used to calculate production quotas. Slovakia wants the basis for the calculation changed from 1995-99, when agriculture experienced a sharp downturn in consumption and output, to a more recent period.
- The Czech Republic has urged the Commission to differentiate between candidate countries, arguing that its agriculture sector is on a par with those of current EU members, and thus the rationale for low direct payments to facilitate structural reform should not be applicable. The Czech government was critical of the levels of funds offered, but its language was milder and more conciliatory than that of its Polish counterpart.
- In Poland support for EU accession has already fallen to around 50 percent, compared with 80 percent in Slovakia. The government has complained that offering a lower level of subsidies will lead to unfair competition between Polish and EU farmers, and the government's junior coalition partner, the Polish Peasant Party Coalition, threatened to leave the government if Warsaw agreed to the Commission's plan. Around 80 percent of state

Relative Income of a 20-Hectare Farm, Selected CEE Countries for 2002 and Four Scenarios for 2007
(gross value added/gross average annual wage)



Note: The four scenarios are equivalent to those described in the text. For scenario (b) in the text, denoted here by CAP, production quotas are based on a recent reference period. For scenario (c), indicated in the figure by CAP DP, full direct payments are assumed and production quotas are based on a recent reference period. Scenario (d), the CC position, is implementation of the CAP with full direct payments and quotas, with both based on the positions of the candidate countries submitted before July 2001.
Source: Commission report (March 2002).

support for agriculture is spent on social insurance for farmers. Agricultural incomes are often well below the national average, and direct payments of 25 percent may be insufficient to generate the investment capital needed to accelerate structural reform. However, the government is likely to acquiesce to EU demands to avoid the risk of stalling accession talks.

Cooperation between the Visegrad countries (the Czech Republic, Hungary, Poland, and Slovakia) had stalled after outgoing Hungarian Prime Minister Viktor Orban called on the Czech Republic and Slovakia to revoke the Benes Decree, under which Sudeten Germans, Hungarians, and other minorities were expelled from postwar Czechoslovakia and their property was confiscated. The incoming left-liberal Hungarian government promised to mend relations with its Visegrad partners before formal negotiations on agriculture between current members and the candidate countries begin in the second half of 2002. Spanish Agriculture Minister Miguel Arias Canete, representing the current EU president Spain, held out some hope for flexibility on the EU side during these negotiations

(Excerpted from reports of Oxford Analytica, Oxford, U.K. and EU Commission and Reuters).

Land Policies and Evolving Farm Structures in Transition Countries

By Zvi Lerman, Csaba Csaki, and Gershon Feder

Transition in agriculture includes abolishing central planning; reducing government intervention; eliminating price controls; developing functioning market services; and encouraging the emergence of rural credit institutions, technological improvement, new capital investment patterns, and agricultural labor adjustment. The most visible and widely debated component of this process, however, is land reform, that is, the transformation of farms operated on traditional socialist principles to operations based on market-oriented principles.

The transition countries of Europe and Central Asia account for 19 percent of the world's arable land, including some of the most fertile soils in the world, and 7 percent of its population. As a result the region has the potential to generate an agricultural surplus that it could export. In the 1980s the rural population in the transition countries averaged nearly 45 percent of the total population, while the share of agriculture in GDP and in employment averaged more than 20 percent. In the United States and the EU agriculture's share of the economy is much smaller, accounting for about 2 to 3 percent of GDP and employment in the United States and about 5 percent in the EU.

Common Heritage: Huge Collective Farms and Tiny Household Plots

The countries of Central and Eastern Europe (CEE) and the CIS began their transition in 1989-91 with a common institutional and organizational heritage in agriculture: most land was cultivated in large-scale collective and state farms. About 60,000 of these farms controlled some 95 percent of all agricultural land and produced the bulk of commercially marketed output. The average socialist-era farm cultivated 2,000 to 3,000 hectares of land and employed 300 to 500 workers Product markets and input supply channels were largely controlled by state organizations within an administrative command framework, production targets were set centrally, and budget constraints to contain underperformers were virtually nonexistent. This was the Soviet model of agriculture.

Despite pervasive collectivization, individual or private agriculture never disappeared entirely. Commercial production from the collective and state sector was supplemented by agriculture based on household plots averaging less than 1 hectare, which in aggregate controlled about 5 percent of agricultural land. The household plots relied on part-time family labor and produced mainly for subsistence, although part of the output always found its way to farmers' markets in nearby towns. Compared with the socialized farms, household plots achieved relatively high levels of productivity. In the former Soviet Union the individual sector produced 20 percent of gross agricultural output on 2 percent of the land.

On state farms the state owned all the productive assets and the farm workers were salaried state employees. On collectives (Soviet Union terminology) and

Inefficiency of Socialist Agriculture

Attribute	*Reasons for inefficiency*
Centrally prescribed production targets	Lack of consumer orientation and insensitivity to market signals
Soft budget constraints	Lack of profit orientation and reliance on write-offs and subsidies
Collective organization of production	Free-riding, moral hazard, lack of individual incentives
Large size of farms	High monitoring costs, anonymity, lack of transparency
Lifetime employment policy	Inability to control costs by shedding labor
No effective individual ownership of land and productive assets	Nontransferability of land and assets and lack of incentives associated with property rights, workers did not own the fruits of their labor

cooperatives (Eastern European terminology) the members owned the productive assets jointly. They provided the labor, and in principle were compensated through the distribution of farm earnings instead of receiving salaries.

Whether termed collectives or cooperatives, the socialized farm structure was vastly different from the Western model of a cooperative. The main attribute of cooperation—the principle of voluntary association for mutual benefit—was abandoned during Stalin's forced collectivization campaign in 1929-30. Instead, the creation of all collective and cooperative farms often relied on coercion. As a consequence, members of collectives and cooperatives never enjoyed another basic attribute of Western-style cooperation: the freedom of exit.

The centrally planned environment, which insulated the farms from market signals, imposed central targets as a substitute for consumer preferences and allowed farms to function indefinitely under soft budget constraints without proper profit accountability, which was the main cause of the inefficiency of socialist agriculture. Inefficiency also resulted from the exceptionally large farm sizes and the collective organization of production (see the table).

This inefficiency manifested itself in food shortages, rationing, and long lines at food stores in most socialist countries. New investments in agriculture were producing low returns and failed to sustain growth. (Editor's note: Hungary's agriculture was an exception. Starting in the late 1960s production increased spectacularly because of the extensive support for private plots and agricultural producers' relative freedom to market their products.)

Divergent Reform Paths

At the macroeconomic level the reform framework called for eliminating central controls, liberalizing prices, and introducing hard budget constraints. At the sectoral level it included shifting from collective to individual agriculture and corporate farms and downsizing farms in line with the experience of market economies. The abolition of collective agriculture was to be accompanied by the privatization of land rights, which according to Western thinking implies transferable property rights and functioning land markets. In addition to land, all other movable and immovable property—livestock, machinery, farm buildings—also had to be privatized as part of the transfer of all the factors of production from collective to individual responsibility. The ultimate aim was to change the entire system of producer incentives so as to achieve a more efficient and competitive agriculture sector.

Despite far-reaching commonalities imposed on societies and economies by the communist regimes, the agriculture sectors in CEE and the CIS are following divergent market reform paths. The differences are associated both with differences in the policies adopted and in the specifics of implementation stemming from cultural, social, and political differences that persisted throughout the Soviet era.

Most transition countries allow private ownership of almost all farmland, and agricultural land remains largely state owned only in Belarus and parts of Central Asia. Private ownership, however, is not synonymous with the right to transfer ownership. The 10 CEE countries and the 4 smaller CIS countries (Armenia, Azerbaijan, Georgia, and Moldova) recognize private land ownership and have no legal barriers to land transactions. In this respect these 14 countries have the most liberal land policies. Russia and Ukraine, which account for the bulk of the region's farmland, legally recognize private land ownership, but the buying and selling of land is restricted in practice, and land transactions are mainly limited to leasing. The Kyrgyz Republic recognized private land ownership following the June 1998 referendum, but immediately imposed a five-year moratorium on all land

transactions, thereby making the situation even less flexible than before the referendum, when land was state owned, but user' rights were secure for 99 years and transferable. Belarus and the other Central Asian countries generally do not recognize private land ownership, but differ in their attitudes toward land transactions. Land use rights are transferable in Kazakhstan and Tajikistan, but Belarus, Turkmenistan, and Uzbekistan prohibit any transactions in land.

Successful market agriculture can develop on state-owned land. Consider, for example, Israel, where most land is leased by the state to farmers for terms of 49 or 99 years. Security and transferability of tenure appear to be more important determinants of productivity and efficiency gains than legal property rights. In industrial market economies many farmers are operators rather than landowners, that is, they cultivate land that they do not own. Farmers in Belgium, France, and Germany rent more than 60 percent of the land they cultivate, while the overall tenancy rate in the 15 EU countries is 40 percent. In Canada farmers do not own 30 percent of farmed land. In the United States only 35 percent of farms are fully owner-operated. Another 55 percent are a mixture of owned land and land leased from others, and 10 percent are operated by farmers who do not own any land.

Pragmatic considerations suggest that temporary moratoriums on the buying and selling of land in transition countries may be necessary because of political or social considerations. Policymakers in CEE and the CIS are often concerned that immediately exposing new landowners to the full range of land market transactions after decades of collectivism may lead to negative social consequences, such as the excessive concentration of land in the hands of speculators and foreigners. This accounts for the moratorium imposed in the Kyrgyz Republic mentioned earlier.

In some countries managers of former socialist farm enterprises took advantage of the rural population's complete lack of experience with individual farm operation to entice them to sell their shares of formerly collective land. Large segments of the rural population turned over their main asset, and land was concentrated in the hands of a small number of farm bosses. Had the government temporarily restricted the buying and selling of land and instead limited transferability to short- or medium-term lease transactions, it could probably have avoided this undesirable outcome. Such an approach to land transferability would allow rural people to postpone irrevocable decisions to a later stage, when the economic situation had normalized and individuals had become more cognizant of the implications of land transactions. To ensure that a temporary moratorium quickly achieves the intended educational effect, it should be accompanied by appropriate information campaigns explaining property rights and land market transactions to the new landowners.

All the CEE countries and the smaller CIS countries allocate land to beneficiaries in the form of actual plots. In Kazakhstan, Russia, Ukraine, and the other CIS countries beneficiaries usually receive paper shares that certify their entitlement to a certain amount of land within the local farm enterprise, without identifying a specific physical plot (though they retained their small household plots that they cultivated during the Soviet era). The allocation of actual plots is clearly a better option in terms of potential transferability and the impact on land markets. Owners of a plot of land can decide whether to farm it, sell it in return for a one-time lump sum, or lease it to someone who can operate it more profitably, thereby retaining the property rights while earning a stream of future returns. By contrast, paper shares represent partial ownership of a large tract of shared land, which in reality is managed and controlled by somebody else.

With the exception of Albania the CEE countries have chosen to privatize land by restitution to former owners. The CIS countries and Albania have adopted the "land to the tiller" strategy: land is given to those who worked it without any payment and in an equitable manner. Hungary and Romania have used a mixed strategy: land was restituted to former owners and also distributed without payment to agricultural workers in the interests of social equity.

The common explanation for the restitution versus distribution dichotomy relates to the different lengths of time since nationalization or collectivization, 80 years in the CIS and 50 years in CEE. This explanation clearly carries a good deal of weight, but a number of cases cast doubts on its general validity. In the CIS, Belarus, Moldova, and Ukraine rejected the concept of restitution, even though the western parts of these countries were integrated into the Soviet Union after World War II, at the same time as the Baltic states, and the memory of private land ownership was much fresher than in Russia. In CEE Albania deviated from the general practice of its neighbors and opted for distribution, not restitution. This was probably a strictly political decision, and not necessarily one driven by rational economic considerations.

Examination of the impacts of restitution versus distribution does not indicate anything that recommends one strategy over the other. Both are guided by principles of fairness, although the beneficiaries are obviously different.

Domination of Collective Farm Structures

Despite the reallocation of land, large collective and corporate farms still play a much more prominent role in CEE and the CIS than in market economies, where agriculture is primarily based on family farms. Various collective, cooperative, and corporate forms of farm organization continue to manage nearly 40 percent of agricultural land in CEE and 80 percent in the CIS. (In the CIS, 16 percent of agricultural land is cultivated in household plots and private farms, compared with 63 percent in the CEE countries). As a result, the distribution of farms by size in most transition countries retains the sharp duality that characterized socialist agriculture: a high proportion of extremely small farms (mainly household plots) controls a relatively small proportion of land and a small proportion of extremely large farms controls a large proportion of land. In market economies, for example, in Canada, the United States, and the EU, most land is concentrated in mid-sized farms.

Although large collective or corporate farms remain prominent throughout the region, important differences in their organizational forms are beginning to emerge in the CIS and CEE. Most large CIS farms continue to operate like the old collectives, without significant changes in size or management, although they are now registered under a variety of names that sound like market-oriented entities (joint stock societies, limited liability companies, partnerships) rather than *kolkhozes*. The corporate farms in CEE—now referred to as companies rather than cooperatives—are substantially smaller than the original collectives, averaging less than 1,000 hectares, down from 3,000 to 5,000 hectares before the transition, and are beginning to show greater sensitivity to market signals, including the ability to adjust their labor force to operating needs in the interests of higher profitability.

Overall, the CEE corporate farms appear to be developing the basic attributes of market-oriented operations that are still not apparent for most large farms in the CIS. These emerging differences in farm organization are linked to differences in the philosophy behind the agricultural transition. CIS policymakers essentially perceive market agriculture as based on the successors of the former collective and state farms, which are to be subjected to a "horizontal" transformation to improve productivity, but otherwise are to remain largely unchanged in scale and scope. Politicians in CEE, however, appear to have recognized the need for radical changes in the farm enterprise sector, including the introduction of hard budget constraints and the enforcement of strict bankruptcy procedures for failing farms, which radically changes the organizational behavior of farm enterprises and sharpens their response to market forces. While CIS policies show a definite bias toward successor farm enterprises at all levels of government, CEE policies often favor individual farms and show a negative bias toward large corporate farms, thereby forcing them to shift even further toward new market-oriented forms of behavior.

Former collective members in the CIS countries have not rushed into individual farming, and on the whole large corporate farms have not disintegrated, for the following reasons:

- ***Individual risk aversion.*** Collective or cooperative farms may provide lower incomes, but in a relatively safe, more stable environment. Overall, only a small proportion of rural residents opt for exit from collectives, and the individual farming sector is mainly growing through increased numbers of household plots assigned to collective farm employees.
- ***Leasing to large organizations.*** Many of the new landowners created by restitution left farming long ago and now have jobs and property in urban areas. They have no immediate personal use for their restituted land, yet would like to retain ownership of this asset rather than sell it. Thus entrusting the land to a corporation or cooperative in return for lease payments makes good economic sense. These new landowners also have the option of leasing their land to other private individuals, but they may perceive this as riskier than leasing to a large organization
- ***Market failure, market imperfection.*** In an imperfectly competitive environment, large farms may have easier access to input supplies, product marketing channels, and credit facilities. This gives them a practical advantage relative to smaller, individual farms and encourages the creation of large corporate farms. Such market imperfections are apparent in all market economies, and individual farmers often overcome them by creating service cooperatives, that is, large corporations that interface between the member farmers and the imperfect market to exploit the special advantages

large-scale operations enjoy. The situation is more complex in CEE and the CIS. The markets in transition countries are still far from perfect, and the established large corporate farms that have had decades of experience operating in the former socialist environment may have substantial advantages in access to these imperfect markets compared with newly created and relatively inexperienced individual farmers. Farmers interviewed in areas with a substantial number of individual farms display strong psychological resistance to the formation of service cooperatives, because they see too many similarities between the collective organization they have left behind and the cooperative organization advocated as a market solution to their difficulties.

• ***Regional and local power plays and politics.*** In many countries, especially in the CIS, the regional political system still retains many of the crude interventionist features that characterized the socialist command economy. Even though regional governments no longer command central budgets that they can distribute among their large farms, they often have access to other resources and authority mechanisms they can use to force compliance with behavior in their interests. Thus a symbiotic relationship exists between the managers of large collective and corporate farms and regional authorities. The large farms still represent the organized backbone of agriculture in each region, and even though they often produce less than 50 percent of agricultural output, they are much easier for the local authorities to control and tax than the thousands of individual households. This interplay between the managers of large collective farms and regional authorities preserves the existing farm structure, suppressing the expected shift from collective to individual farming and to viable corporate farms that act like business entities accountable to their shareholders.

Possible Strategic Directions

The current situation has a number of implications for agricultural strategies, namely:

• *Policymakers who wish to achieve a transition from the former socialist structure to an efficient and viable farm sector should promote individual agriculture.* Albania, Armenia, Georgia, Moldova, and more recently Azerbaijan and the Kyrgyz Republic are examples of countries moving toward complete individual agriculture. In these countries governments and the international community should support the process by assisting with the development of the institutional tools of individual land management, including titling, registration, extension, and farmer education.

• *Break-up of the large corporate farms into smaller and more manageable farms should be encouraged in all countries.* A level playing field is required that allows farms of all structures and sizes to operate if they can remain viable under market conditions.

• *Dismantling large farm enterprises, as implemented in Albania, Armenia, Georgia, and to a certain extent Romania, is the most direct, but not the only path to agriculture creating a sector with a larger share of family farms.* Distributing land and asset shares can serve the same purpose, as is becoming evident in Moldova. To be effective, however, the first stage of allocating paper shares must be followed by a second stage in which actual land and assets are distributed to individuals.

• *A two-tier agricultural system that combines the advantages of individual enterprises with the economies of scale of corporate organization is a possible strategic direction.* Under such a system individuals manage land and production and corporations or cooperatives provide services. This is similar to the system practiced in the Israeli *moshav*.

• *Individual farms are not necessarily small farms* To exploit the full potential of individual farming, the strategy must ensure the relatively free transferability of land from the state to private users (either in the form of ownership or of long-term leases) and, more important, among private users. This involves developing land market institutions, including titling, registration, cadastral services, and possibly mortgage banking. Land policy should aim to eliminate restrictions on land transactions (including prohibitions on corporate land ownership, which persists in some CEE countries) and to lower fiscal and administrative barriers (taxes, fees, bureaucratic requirements). As for countries that do not wish to recognize private land ownership, legitimizing rental markets and providing the legal and enforcement apparatus for long-term leases may prove to be a feasible objective in the medium term. International experience shows that as far as efficiency and productivity are concerned, in most cases the transferability and security of tenure are more important than formal ownership.

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Hungary's Twisted Land Market

Since its election in May 1998 the Hungarian government has pursued a land policy that favors private family farmers over both Hungarian corporate and collective farms and foreign investors. In May 1999 it tightened tenancy regulations to filter out so-called pocket contracts—illegal sales generally disguised as lease agreements—concluded between Hungarian landowners and foreign investors since 1994, when a ban on foreign land ownership came into effect.

In 1991 compensation laws repriva-tized the land owned by collective and state farms, transferring plots of 1 to 2 hectares each to about 1.5 million individuals. Prior to 1989 Hungary already had 1.4 million small farmers cultivating holdings of no more than 1 hectare, thus by the mid- to late-1990s the number of private landowners had risen to nearly 3 million, most of whose plots were too small for market-oriented farming. Moreover, a large proportion of those who received land under these laws were either pensioners or the urban heirs of former collective farm members who did not wish to engage in agricultural production.

Parallel legislation adopted in 1992 privatized the productive assets of collective and state farms. Capital other than land was concentrated in cooperatives set up by the members of socialist era collective farms and by private corporations owned by the former collective farm managers. Combined with land redistribution, this effectively separated land ownership from the productive assets necessary for farming.

In 1994 the government adopted a highly restrictive land law that excluded collective farms, the new agricultural corporations, and foreign investors from the property market. This was presented as a way to help create a viable family farming sector prior to EU accession; however, banning land sales to Hungarian corporate entities and foreign investors—the only agents with sufficient capital to purchase farmland—effectively killed the newly emerging land market preventing the gap between land and asset ownership from being bridged. These restrictions also greatly depressed the price of Hungarian farmland—estimates indicate that Hungarian land is worth one 10th of the EU average—thereby creating opportunities for speculation and illegal transactions.

The 1994 land legislation benefited those Hungarian private investors who had some capital to invest in land Urban professionals probably acquired relatively large holdings that they may decide to sell if the price of Hungarian land rises after EU accession. Independent estimates suggest that speculators own some 35 percent of Hungarian farmland, or 2 million hectares of a total of 5.85 million. Meanwhile, many private landowners have sold their land illegally to foreign investors, mainly to farmers in neighboring Austria. Government sources estimate that foreigners may have purchased about 5 percent of Hungarian land through pocket contracts.

Last August the government began to buy back Hungarian farmland from foreign owners who had acquired their property through illegal land sales and redistributed the land among Hungarian private farmers at a subsidized rate. These subsidized land transfers were carried out through the National Land Fund, a state-controlled bank set up in late 2001. The fund's stated purpose is to create a new tier of medium size family farms able to withstand the competitive pressures of the internal market after EU accession.

Hungary is submitting a proposal to the EU to extend the ban on foreigners' purchase of arable land for another three years beyond the already agreed period of seven years after Hungary joins the EU if domestic land prices at the end of the seven years are less than 80 percent of the EU average. The ban on arable land purchases by foreigners resident in Hungary will last for at least three years following Hungary's accession. The EU, however, warned Hungary against trying to renegotiate the agreement on the purchase of farmland by foreigners. Eneko Landaburu, leader of the Commission's enlargement directorate, said Hungary cannot hope to get the same deal as Poland. The EU and Poland recently agreed that for 12 years Poland can maintain a system that ties the purchase of farmland by foreigners to a permit, but does not ban it.

Hungary is not alone on the issue of foreign land ownership. The Czechs and Poles have voiced similar concerns. In May the Commission proposed a seven-year grace period for the purchase of agricultural and forest land in Bulgaria, the Czech Republic, Hungary, Poland, and Slovakia following accession. Such transitional periods are not new. Sweden had similar restrictions on foreign land ownership before it joined the EU in 1995 that were eliminated by the end of 1999. Today virtually any EU citizen can buy or sell land or property within the EU.

Based on reports of Oxford Analytica, Oxford, U.K., and the Hungarian Press.

Foreign Direct Investment: Does the Rule of Law Matter?

By John Hewko

An extensive overhaul of a country's legislative and institutional framework is generally not a necessary precondition for the postcommunist countries of Eastern Europe and the former Soviet Union to attract direct investment from large, multinational investors (although certain changes are generally required to retain such investment) or from smaller, entrepreneurial investors. A significantly more important factor for investors is the existence of genuine business opportunities.

The conventional wisdom within the international development community is that a transparent, modern, Western legal system is a prerequisite for foreign investors to venture into host states. The logic of this argument derives from a neo-institutional theory of the behavior of economic actors, which maintains that efficient and transparent legal systems reduce their transaction costs, including those of foreign investors. Thus because transaction costs increase the costs of direct investment, foreign investors should be averse to investing in countries with higher transaction costs, and will therefore gravitate toward states with more effective or efficient legal regimes.

Based on this assumption, governments, multilateral institutions, development agencies, and various NGOs have expended considerable resources on legal and judicial reform programs throughout the transitional and developing world in the belief that countries could implement legal reforms and establish the rule of law in relatively short order, and in the hope that once they had completed the reform process, foreign direct investment (FDI) would finally begin to flow.

The Devil's in the Details

The experience of most postcommunist societies, however, demonstrates that legislative and institutional reform is an organic process not conducive to easy or quick solutions. Genuine reform requires that a new legal culture be developed and ingrained in a society, which takes considerable time—several generations—and effort. Unfortunately, many of the early, ambitious international development programs to, for example, "reform country X's judiciary in three years," often did not appreciate the long-term nature of legal reform. Consequently, they were doomed to fail. They produced an avalanche of reviews, studies, reports, recommendations, and other beautifully produced "deliverables" that host states often did not implement. The programs created false expectations and gave rise to an entire cottage industry of NGOs, consultants, and government advisors with noble aims, but often with few results to show for their efforts.

An extensive overhaul of a country's legislative and institutional framework is generally not a necessary precondition for attracting direct investment from large, multinational investors (although retaining such investment generally requires certain changes) or from smaller, entrepreneurial investors. Significantly more important factors for investors are the existence of real business opportunities, the potential for high returns, the risk of expropriation, the ability to repatriate profits, the existing tax regimes, and an often superficial "feel" about the host country.

The annual flow of foreign investment to the transition economies reached $5 billion in 1993 and increased to $11 billion in 1995 and $19 billion in 1997, well before the European Bank for Reconstruction and Development had granted many of these countries higher scores on its legal reform scale. Clearly the factor enticing foreign investors could not have been the legal systems in the postcommunist countries: in the early 1990s their laws and legal institutions were generally incapable of addressing the many issues that arise in a market-based economic system. Rather, early investors were drawn to these countries by their large, untapped markets; highly educated, yet inexpensive, labor pool; and tremendous natural resources.

Real Barriers

A common complaint among investors in those countries that were least successful in attracting FDI was that there was no one in a position of authority to take decisions. Nothing exasperates investors more than the need to shuffle from ministry to ministry or to negotiate a seemingly endless bureaucratic maze where everyone and no one is in a position to resolve issues or grant approvals.

As a result, an ideal legal system is not nearly as important as the existence of a clear, consistent, and unambiguous decisionmaking process.

In countries such as Russia, the onerous tax regime and inadequate accounting standards and practices served as a much greater source of investment disincentive than the lack of an ideal legal system. Anecdotal evidence from Russia indicates that most foreign investors consider the recent tax reforms instituted under the Putin administration (for example, lowering personal and corporate tax rates, decreasing social insurance contributions, and phasing out turnover taxes) as the single most important action taken to encourage foreign investment in that country.

Legislative reform efforts should emphasize the details, not the general concepts, and the specific, very often mundane, changes that need to made for existing legislation to function within the cultural, political, and economic realities of the host countries. The international development community has traditionally focused on large, general concepts, with calls to modernize bankruptcy legislation, eliminate corruption, and establish an efficient and rule-based judiciary This approach is misplaced. When faced with an attractive business opportunity most foreign investors are prepared to accept the inadequacy of postcommunist countries' legislation and legal systems.

This is especially true with respect to legislative reform and foreign investment. Once foreign investors take the leap of faith and make an investment, they are generally not concerned about corruption in general or the need for legal reform in the abstract. Rather, they focus on how specific aspects of the law and of the legal system affect their particular business, not on the fact that the ambiguity of a single word in an existing piece of legislation puts the legality of their proposed transaction at risk or that official X at window Y at ministry Z requires a bribe to issue a routine permit. As a result, most foreign investors who have committed resources to a given country are prepared to accept that, in general terms, the legislation and legal system are inadequate. They are also prepared to accept that a given piece of legislation does not fully conform to an ideal standard. Their concerns tend to center around a short list of specific complaints about the one piece of legislation or regulation that, if rectified, would greatly facilitate the success and continued viability of their investment.

Those Who Cannot See the Trees for the Forest

In the mid-1990s I spoke at a conference in London on a panel that included Ukraine's prime minister and minister of finance and several other prominent Ukrainian politicians. The topic for discussion was economic reform and development in Ukraine

One of the problems facing Ukraine was the lack of any meaningful international private sector financing. As the pool of funds available from multilateral and intergovernmental lending institutions paled in comparison with the amount of capital required to develop the country's economy, the only long-term solution was, and is, to attract considerable private sector financing. However, even if a given financing transaction made economic sense, it was difficult, if not impossible, to execute because of six or seven seemingly insignificant provisions of Ukrainian law. If these provisions could have been amended (in some cases all that was needed was adding a word or a sentence), the legal barriers to project financing in Ukraine would have been largely eliminated (of course, political and credit risk would still remain as an obstacle to be addressed).

When I spoke, I summarized the key, specific changes to existing Ukrainian law needed to facilitate private sector financing. The other participants' eyes glazed over. I finished, received polite applause, and the Western experts and Ukrainian panelists continued their discussion about macroeconomic stabilization, current account deficits, and the need to "implement market reforms and stamp out corruption" in the most general of terms. Although these are all admirable goals, those of us who were practitioners shook our heads and went back to lamenting that once again the failure to focus on the admittedly boring details was significantly hurting the cause of meaningful legislative reform.

Thus efforts to reform commercial legislation should concentrate on understanding the shortcomings of existing laws in detail and suggesting changes to such existing legislation, rather than proposing widespread changes to conform the country's legislation to an ideal model. Often problems can be resolved by adding a word or a sentence, rather than by wholesale revision or by drafting a clarification to a vague provision or term. However, urging a country to adopt a series of often highly technical and arcane changes is less exciting than proposing a wide-ranging reform package, and certainly not as conducive to developing a career as a policy guru.

Unfortunately, many investor surveys carried out by the development community tend to focus on broad areas of concern: Is the current bankruptcy law effective? Do the courts enforce contract rights effectively? Is the pledge law incomplete? Is the failure to enforce laws consistently, expeditiously, and impartially a concern? When faced with these sorts of general questions most foreign investors will tend to respond that the situation needs improvement Naturally they would prefer a better bankruptcy law or commercial code or favor improved enforcement mechanisms. Who would not? However, understanding what concerns foreign investors in general terms is not particularly relevant. What is important is to isolate specific legislative provisions that need to be amended, and this can only be done by providing the legal and accounting advisors of foreign investors active in the country with extremely detailed survey questionnaires that delve to the level of specific problematic clauses of specific laws.

New Approach Needed

Foreign investors and their advisors are much better suited to identify the exact changes needed in the legislative framework to facilitate FDI than a guru flying in for a weekend of diagnostic analysis. Foreign investors are a dynamic force in the forefront of the push for change and agents for such reform. This is particularly true in such areas as training personnel and reforming the legal and accounting professions. Serious foreign investors, largely multinational firms, play a vital role in training and educating individuals and in developing a cadre of citizens who understand and accept those practices and concepts that are critical to creating a civil society and respect the rule of law. Foreign investors are also effective in providing training and transferring know-how and play a role in civil service and judicial reforms.

The development community should address this situation by channeling funds into long-term and sustained programs for training young locals as a matter of priority. Thousands of a given country's best and brightest university graduates should be sent to the West for one- and two-year graduate study programs (but be required to return). One shudders at the thought of how many young graduates could have been trained with the millions the development community has spent on feasibility studies, diagnostic reports, foreign consultants, and traveling delegations. The development community should also work on creative mechanisms to harness the tremendous training capability of the private sector and to use it more fully. As noted earlier, foreign investment plays a significant role in creating demand for reform of legislation and enforcement institutions, something that the literature and international institutions seem largely to have ignored.

Thus a fundamental shift in how the international development community views certain aspects of legal reform in postcommunist countries is required, particularly in the area of commercial legislation and regulations. The community should shift away from a process almost exclusively driven and created by multilateral organizations and NGOs to one that recognizes and expands the role of the private sector. Working with host countries, this new approach would establish a more direct and meaningful dialogue with foreign investors, perhaps through each country's chamber of commerce, focus on specific investor concerns within the framework of existing legislation; and recognize that legislative reform is a long and tedious process subject to a continuous cycle of incremental change and trial and error.

John Hewko is a partner in the law firm of Baker & McKenzie, and has spent the last 12 years practicing law in Moscow, Kiev, and most recently, Prague. He is currently a visiting scholar at the Carnegie Endowment for International Peace. This article is a shortened version of the original Carnegie Endowment Working Paper, no. 26.

Digging Their Own Hole

"We've been talking too much about eliminating corruption in public life. Now no party wants to govern with us."

From the Hungarian magazine *Hócipõ*.

Cultural Values Are Key to Understanding Russia's Small Business Environment

By Emeric Solymossy

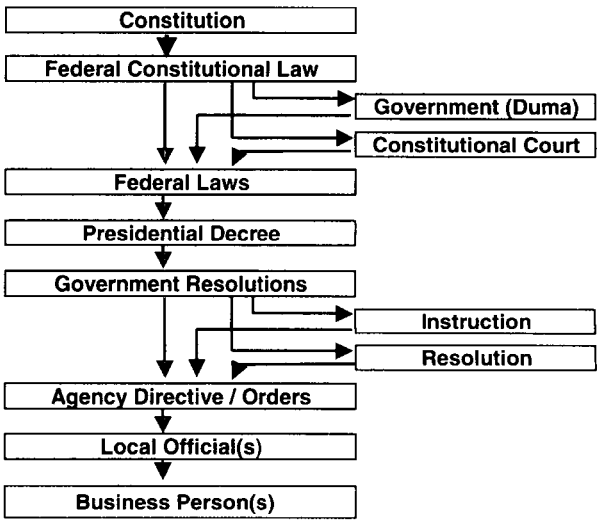
Russia's small business sector confronts over-regulation, bureaucratic controls, and complicated taxation, which reflect underlying socio-cultural values related to independent behavior, trust, and goal orientation and time. Those interested in dealing with antibusiness forces must understand these values and their origins.

Formerly socialist countries with relatively high levels of entrepreneurship (measured as the proportion of those age 18 to 65 who are involved in entrepreneurial activity) are enjoying greater economic prosperity than those with lower levels of entrepreneurship. The Russian government recognizes that a vibrant small business sector is crucial for revitalizing the country's economy, but small and medium enterprises' contribution of 12 percent to overall GNP is still lower than in many other formerly socialist countries, even though it has doubled since 1997. The *Global Entrepreneurship Monitor* reported that Russia's total entrepreneurial activity is less than three-quarters that in Poland; about half that in Hungary and the United States; and less than one-third that in Mexico and New Zealand, the two most entrepreneurial economies.

Observers have suggested many reasons for Russia's low levels of entrepreneurial activity. The three cited most frequently are the complex and hostile environment for businesses, the elaborate taxation system, and the cumbersome business registration processes.

While the national government is comparatively stable, it is still in a state of transition. The concept of private ownership is still new, and the infrastructure for supporting small and medium enterprise competition on the global marketplace is deficient. Nevertheless, the greatest hurdle to small business growth may be Russia's legal system, which lacks the checks and balances permitted by the separation of executive, judicial, and legislative authority. The overriding standard is the constitution, which serves as the apex of a hierarchy that rests upon agency directives and orders and their administration by local officials (see the figure). Deputies or legislators write laws, but cannot interpret them. The constitutional court is empowered to interpret the law, but cannot enforce it. Local administrators cannot write or interpret the law, but enforce it. Entrepreneurs must interact with the legal system at this lowest, local level.

Hierarchy of the Russian Legal System



Bureaucratic obstacles prevail at this lowest level. While the legal system mandates that the laws shall not conflict with federal laws and that only the constitutional court is empowered to interpret the constitution, local officials have significant discretionary powers and great flexibility in how they administer the laws. This situation does not appear to have changed from the former system. Personal connections and money can improve opportunities for maneuvering successfully through the bureaucratic maze. Because of the variability in administration and differing interpretations of the law, business regulations are not administered uniformly. This can be viewed either as an absence of the rule of law or as inconsistent enforcement. While entrepreneurs can appeal to the constitutional court if edicts are administered in contradiction to the constitution, the process is complicated and time consuming. Successful challenges are the exception rather than the norm.

Inconsistent enforcement persists in part because the business community lacks a strong lobby for affecting legislative change. According to a report by the Institute

for Private Sector Development and Strategic Analysis prepared in Moscow for the U.S. Agency for International Development, the average business uses 49 person-days and $357 to register the business and 47 person-days and $576 to license the business, and receives an average of 9.4 visits per year from various monitoring and inspection agencies. Economic and Trade Minister German Gref has proposed reducing state control so as to lower businesses' administrative burdens, but permitting more interpretation of the law at the local level could lead to even more inconsistent administration.

This regulatory complexity is compounded by the taxation system. Entrepreneurs had to prepare 12 different forms to pay their taxes in 2000, 16 forms in 2001, and must now complete 24 forms and present them to a tax official in person. This latter process averages three days every three months. As part of their tax liability trading businesses are also required to undergo a quarterly registration process. The reasoning behind this frequent registration is that small trading enterprises have difficulties monitoring their sales, earnings, and taxation; however, this system, which is tantamount to a quarterly audit, appears to be based on distrust rather than trust and places no value on entrepreneurs' time.

A proposal by the Ministry of Economic Development and Trade calls for simplifying the tax system for small businesses. Businesses would be classified as small based on the physical area the business occupies, for example, the square footage of its buildings, and not on the number of employees. The tax base would be determined based on a single formula applied nationwide, rather than applying different formulas in different regions as is the case today. The tax rate would be cut from 20 to 15 percent by eliminating the social tax. Businesses would, however, pay a 14 percent tax for social pension insurance, which had previously been fully funded by the state.

Certain small businesses, primarily those providing personal and business services, would be able to choose between two approaches to taxation. Both choices would involve payment of a single tax that would replace the profit tax, value added tax, property tax, and local sales tax. They could choose to pay an 8 percent tax on imputed revenues (8 percent of all estimated income as estimated by the tax administrator regardless of offsetting expenses, without reconciliation, that is, without pledging any later reimbursement for adjusted income), or a 25 percent tax on imputed profits (again, estimated by the tax administrator and without reconciliation). U.S. small business owners would find the concept of paying a business tax based on gross revenues incomprehensible, and would find the idea of paying taxes in advance based on a bureaucratic administrator's "calculation" of what their sales or profits for the coming period would be even more troubling. This suggested method of calculating taxes suggests that the system is based on social mistrust. It is founded on anticipation of abuse, and encourages the creation of a shadow economy and evasion.

Entrepreneurs made several recommendations for the government to consider as it deliberates ways to improve the vitality of Russia's small business sector, namely:

- *Simplifying the tax system.* Not only do reporting requirements need to be simplified, but entrepreneurs should not have to submit tax forms in person
- *Distinguishing between existing enterprises, new ventures, and the self-employed.* New business should be encouraged by allowing them to operate for one year tax free rather than mandating that they pay their first year's taxes before they have started operating.
- *Setting up information/advisory centers staffed by competent personnel that offer free or inexpensive services to the business community.* Numerous such centers were established early in the transition with financial support from the U.S. Agency for International Development, among others; however, because of decreasing external funding and economic difficulties, most have closed shop or become ineffective.

Studies have repeatedly confirmed the role of education and support in encouraging small business formation and growth. Russia's sociological factors and circumstances are, however, unique, and call for even broader education and support. The need for education in the functional skills of business management is unquestioned, but educational programs that promote cultural change so that all those involved accept and embrace the economic principals and social expectations that foster and promote a market-oriented economy must also be provided.

The important issues are philosophically and culturally based. While social structures, trust, and time valuation are distinct from each other, they interact to create a daunting challenge to reform.

During most of the 20th century a collective social order was enforced in Russia and deviation by independent action was not tolerated. Entrepreneurship,

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Ukraine and the New Fad: Corporate Governance

By Alexander Krakovsky

The World Bank in cooperation with SITE and WDI

When the Berlin Wall fell, the first economic advice the former Soviet bloc countries received was to decentralize, deregulate, and mass privatize. Often multilateral institutions would set objective privatization goals for each country to achieve before it could obtain the next tranche of aid or financing. The multilateral institutions also sent consultants to help the countries distribute privatization vouchers to their populations, run voucher auction centers, and distribute the shares of newly formed companies. Now these same consultants are often criticized by "transitologists" for focusing on share distribution and failing to address corporate governance.

Several centrally planned economies were replaced not by free markets, but by "kleptocracies." In the new economy what mattered was control over assets, not ownership. This led to two negative results: first, the much-touted investment boom did not materialize; and second, populations, who were sold on the idea of a market economy and private ownership, were disillusioned as their shares became worthless. Just like they pushed mass privatization in the 1990s, the new focus of the multilateral institutions has become corporate governance and all are actively pursuing corporate governance projects in Ukraine. Armed with a bag of corporate governance cures, consultants are talking accounting reform, independent boards, company law, and shareholder rights. But are the consultants keeping an eye on the big picture, or are they overlooking something again?

Motivate and Regulate

The free enterprise system is based on the premise that businesses are too complex for central planners to control and run efficiently. Instead, individuals allowed to freely pursue their own interests are better equipped to run businesses, because their performance is directly linked to their individual utilities. In doing so, they produce goods and services and pursue cooperative networks based on the free exchange of goods and services. The pressures of the marketplace direct the selfish activities of individuals as if by an invisible hand—using Adam Smith's terminology—into socially responsible paths. As he observed: "It is not from the benevolence of the butcher, the brewer or the baker that we expect our dinner, but from their regard to their own interest."

Of course, Adam Smith observed individual entrepreneurs of his time. The butcher, the baker. and the brewer are now large corporations. Consequently, corporate governance is a component of modern economics. Just as classic economics deals with the nonbenevolence of the butcher, brewer, and baker toward their customers, corporate governance takes things one step further and deals with the nonbenevolence of corporate CEOs, board members, and other agents toward the corporation.

To be sure, if having full and costless information or the ability to make perfect contracts that spanned every possible state of the world were possible, then society could contract with a central planner just as readily as with a butcher or a CEO. But life is not so simple, which is why modern economic theory tries to balance the motivating factor of free enterprise with the role of governments and other mechanisms in bringing about efficient outcomes. Correspondingly, corporate governance tries to address the separation of ownership and management to bring the behavior of management as close as possible in line with that of its constituency, the shareholders.

The World Bank defines corporate governance as that blend of law, regulation and appropriate voluntary private sector practices which enable the corporation to attract financial and human capital, perform efficiently, and thereby perpetuate itself by generating long-term economic value for its shareholders, while respecting the interest of stakeholders and society as a whole. This is an excellent definition, because it recognizes that good corporate governance is a carefully crafted balance between motivational forces and the forces that constrain or direct certain types of behavior. Just as the free enterprise system relies first on entrepreneurs' voluntary, self-serving actions, a well-structured corporate governance regime must also first harness the voluntary behavior of corporate agents and stakeholders. Regulations must enable the invisible hand to work, not hinder it, and not enable the grabbing hand of regulators.

How Public Are Public Companies?

The choice between having a public or a private company is a perfect example of balancing the need to

regulate and the need to allow as much free choice as possible. A public (publicly listed) company is one that at some point issued securities to distribute to the public without regard to the ability of those acquiring the securities to understand, evaluate, or control the enterprise. Furthermore, public securities are usually sold to diversified investors, each of which holds a relatively small stake in each enterprise, thereby not making it worthwhile for them to defend their rights on their own.

National laws usually define public companies as those that distributed securities either to more than a certain number of shareholders (100 in the United States) or to unsophisticated investors. Regulations governing public companies usually focus on the proper disclosure of public information and the proper use of insider information, with the investing public free to choose which companies to invest in. This is a perfect example of a balance between the free market's need to allow people to choose and the incomplete market's need to address inefficiencies through regulation.

By tapping a public market the entrepreneur can access capital at the lowest possible cost because of competitive participation by a large pool of diversified investors. The entrepreneur must decide whether the lower cost of capital justifies the added expense and constraints associated with regulation and disclosure, compared with the disclosure and structure options of privately financed companies, which depend entirely on their owners.

The problem with the mass privatized companies is that the only participants who influenced the creation of corporate contracts were the general directors and bureaucrats. They were not particularly interested in attracting shareholders, because shareholders or debt holders did not form the capital base of the corporations. Potential shareholders merely traded in their vouchers and had no freedom to choose any kind of alternative. There was no self-interest on the part of the bureaucrats or directors to collect more vouchers, and therefore no motivation to constrain themselves, or even to form viable businesses. Instead, they did everything possible to lift controls and perpetuate their entrenchment in collecting rents from the enterprises.

Equally, the decision to go public was not based on a rational choice. In Ukraine, all 30,000 enterprises that underwent mass privatization were corporatized and their shares distributed to the public in exchange for vouchers. The enterprises received no financing in return for the shares. The public cannot effectively control the companies. Without regulation shareholders are forced to rely on the insiders' benevolence. The insiders are unlikely to willingly constrain themselves.

Clearly such companies will not attract international or national capital flows in a transparent way. This leaves Ukrainian regulators with the task of trying to protect the interests of shareholders in a large number of companies that do not even have the structure to provide proper disclosure. While the Securities Commission could, of course, bring back Soviet era controls, that leaves the question posed by Joseph Stiglitz: "Who is guarding the guards?"

Flawed Remedies

Much of the talk about corporate governance reform focused on institutional and legal mechanisms and the corruption-ridden judicial and regulatory systems. Stamping out corruption and building institutions brings us back to "Who is guarding the guards?" Without appropriate regulation, the new market oligarchs will do everything possible to preserve corruption. Institutional development cannot take place in a vacuum. It must go hand-in-hand with market solutions to corporate governance problems. To demonstrate just how sick the patient is, the following are some examples of how even the most commonsense remedies, if unqualified, would actually make the situation worse:

- ***Remedy 1: Require that all publicly listed companies adhere to International Accounting Standards (IAS).*** Ukraine has 30,000 public companies, and in 2000 had 50 IAS certified accountants. Let us say that this number has now increased to 200. However, accountants who are qualified to be controllers or audit managers need to have roughly 10 years of experience. Without the requisite institutional and human base, this requirement will simply reduce IAS accounting to the lowest single denominator: accounts would be reported in a form that appears to be compliant with IAS. The insiders would still be able to run parallel structures lacking transparency.
- ***Remedy 2: Impose strict personal liability on board members and managers and permit class action suits.*** Any acquisition is normally followed by a radical restructuring effort. Restructuring companies

is even more perilous in Ukraine than buying them. Restructuring usually means stripping away parallel structures as well as suppliers, customers, and rent collectors who have been bleeding the company. Such restructuring efforts are rare without a major conflict with the entrenched structures, and opponents of restructuring can turn to the judicial system. However, neither the judicial system nor companies have the capacity to handle law suits against directors. A newly formed majority shareholder currently needs to give fired managers 45 days notice, which gives such managers the time to take all kinds of extraordinary measures to entrench themselves. For example, to date the management of the JSC Hotel Lybid has stayed in power for four years in this way.

- ***Remedy 3: Require that majority shareholders offer a buyout to minority shareholders.*** This entails several problems, including agreement on how to reach an objective price. Most majority stakes were acquired in a less than transparent manner, with brokers making a huge margin. Furthermore, some large sums may have been paid for swing votes. Also, majority stakes can be split to seemingly unrelated holdings. The State has no capacity to investigate those cases, let alone enforce the rules.
- ***Remedy 4: Educate "red" directors about corporate governance.*** These directors are most likely those who designed their companies' corporate governance system (not the owners or shareholders) in a way that would protect their jobs and rents. Raising financing was not their concern. Improving the corporate governance system would prevent them from collecting rents, and could even cost them their jobs, thus they eagerly study corporate governance not to improve the company, but to perpetuate their positions.

The solution is a mixture of voluntary (market-driven) legal and regulatory actions. Mass privatization and concurrent development of the securities market did not take into account the impracticality of pure share trading to accommodate the mass transfer of controlling stakes. A tendering mechanism could provide transparency to all shareholders, enabling them to sell their shares under clear conditions. An independent body should supervise the fairness and honesty of the tender, which should create a level playing field for all participants.

The author is president and CEO of Ukraine Investment Advisors, Inc. He can be reached at akrakovsky@aol.com.

The World Bank/IMF Agenda

More Support to the CIS-7

During their April meeting in Washington, senior officials from four international finance institutions—the World Bank, the IMF, the European Bank for Reconstruction and Development, and the Asian Development Bank—decided to increase their support for the seven poorest CIS countries, namely, Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, Tajikistan, and Uzbekistan. First announced during their London meeting in February, the London Initiative will help these nations accelerate poverty reduction and economic growth and stabilize their fiscal and external debt positions. Nearly 20 million people in the CIS-7 countries continue to live in extreme poverty. Provided that the CIS countries make serious efforts to reform their economies, the international community is prepared to provide more financial aid, including grants, debt restructuring, or, if necessary, debt relief; easier access to industrial countries' markets; coordinated support for country-led poverty reduction programs; technical assistance; and policy advice.

Wolfensohn in Central Asia

An eight-day, five-country visit to Central Asia, preceded by a stop in Russia to meet President Vladimir Putin, left World Bank President Wolfensohn impressed by the region's pivotal importance in terms of energy, trade, security, and culture. During an account of his trip to a World Bank audience, Wolfensohn said that he had set out particularly interested in the region's Islamic history and its resurgence in recent years. He came away with the sense that life in the five countries of Central Asia is not driven by religious considerations. Rather, the more militant Islamic movements appear to be filling a political gap in those countries.

Beyond politics, energy and natural resource management loom large in this region of 55 million people. With their large reserves of oil and gas, Kazakhstan, Tajikistan, and Turkmenistan are eager to build pipelines and capitalize on potential regional and global markets. Turkmenistan's government broached the possibility of a natural gas pipeline to Afghanistan, Pakistan, and India. Water-rich Tajikistan has significant hydroelectric

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Why Is Foreign Direct Investment in Ukraine Trailing Behind?

Ukraine has one of the lowest levels of foreign direct investment (FDI) per capita in Eastern Europe and the CIS, and inconsistent government policy militates against improved levels of FDI. During 1992-2001 FDI totaled $4.4 billion, or around $88 per capita, compared with $3,100 per capita in the Czech Republic. Net FDI flow for 2001 was $531.2 million. According to estimates by the Economist Intelligence Unit, as things stand now, Ukraine's FDI prospects will not improve much during 2001-05: FDI per capita will equal $21, the same as in Belarus. Of 27 transition countries, only Tajikistan ($5), Uzbekistan ($10), and the Kyrgyz Republic ($18) trailed behind Ukraine.

Last year, as in previous years, the largest share of investment technically came from the United States (16.6 percent), Cyprus (10.8 percent), the United Kingdom (9 5 percent), and the Netherlands (8.4 percent), followed by Russia and Germany (5 percent each). However, around 25 percent of all joint ventures have been created using offshore capital that originally came from Russian and Ukrainian businesses, therefore actual investment from other countries is not as significant as these figures suggest.

The following factors explain the low levels of investment:

- *Lack of investment instruments.* The collapse of the Treasury bill market in the aftermath of the 1998 ruble crisis has continued to discourage foreign investors. Despite some recovery and recent growth, foreign investors still consider local debt and equity instruments to be too risky and illiquid.
- *Lack of adequate corporate governance.* Investors generally regard the ability to control an enterprise as the only way to secure an investment, with a 70 to 75 percent stake considered to be a safe share. Therefore foreign buyers strived to attain majority stakes in enterprises rather than the minority shareholdings or portfolio investments typical in emerging markets.
- *Complex and high taxes.* Taxation is now the single most important policy area affecting foreign investors (in 1996 foreign investors were afforded the same right to invest as national investors). Adoption of the new Tax Code was postponed until mid-2002. Once implemented, it will radically change the taxation system to a consistent and convenient one. Value added tax rates could fall from 20 to 17 percent and profit taxes from 30 to 25 percent. Implementation of a new system, however, is likely to take a considerable number of years.
- *Lack of incentives and transparency in the privatization process.* The government has been criticized by the reformers for the slow pace of the process and for not privatizing any large enterprises via open and transparent tenders. Insider and asset-stripping deals are alleged to dominate the privatization process. The State Property Fund, the government's main privatization arm, put privatization revenues at just Hrv 2.1 million ($395,000) in 2001, against a projected level of Hrv 5 9 billion. In December 2001 the Rada expanded the list of companies that are not to be privatized by adding several strategic enterprises, the potentially most valuable being the Zaria plant, one of the largest producers of turbines for ships and gas compressor units in the CIS. Strategically important enterprises still on the list to be privatized in 2002 include:
- A 25 percent stake in Ukrainian Mobile Communication at the preliminary starting price of Hrv 266.3 million
- A 37 percent stake in the telecommunications monopoly Ukrtelecom at Hrv 1.732 billion
- Large stakes in 12 power distribution companies for a total of Hrv 1.9 billion
- Stakes of 25 percent in those power distribution companies privatized in 1998, to be offered for sale via stock exchanges for nearly Hrv 172 9 million.

Attracting much-needed capital by setting up special economic zones (SEZs) has proved to be controversial. The authorities have tended to address the issue of tax privileges and support for the establishment of an SEZ on a case-by-case basis, provoking criticism from the IMF and the World Bank, because this approach means that such privileges vary for each SEZ. Typical privileges granted to SEZs include exemptions from customs duties and sometimes from value added taxes for imported goods and services as well as a lower corporate profit tax (usually 20 percent as opposed to the current base rate of 30 percent). The outgoing government started a review of SEZs and suspended the creation of new ones.

Based on reports of the international consulting firm Oxford Analytica, Oxford, U.K., and the Economist Intelligence Unit, London.

The Challenge of Addressing Roma Poverty in Slovakia

The World Bank
in cooperation with
SITE and WDI

Life is difficult for many Roma in Slovakia. Although the overall poverty level is low—6 percent according to the most recent World Bank poverty assessment—the country does have severe pockets of poverty. Living conditions are especially poor for Roma living in isolated settlements. Poverty in these areas is multidimensional—related to high levels of unemployment, poor housing conditions, and lack of access to basic public services—and is exacerbated by social exclusion. A recent joint report by the World Bank, the Open Society Institute, and two Slovak NGOs, "Poverty and Welfare of Roma in the Slovak Republic," coordinated in the Bank by Dena Ringold and Helen Shahriari, analyzes the major ingredients of Roma poverty and vulnerability and suggests policy measures to improve living conditions and reduce poverty among the Roma minority.

The Slovak Republic has one of the largest Roma populations in Europe. Although the 1991 census identified only 76,000 individuals as Roma, or just 1.4 percent of the population, informal estimates suggest that Slovakia actually has 420,000 to 500,000 Roma, accounting for 8 to 10 percent of the population. Because of higher birth rates among Roma than other population groups, this share is likely to rise in coming years.

Ghetto-Like Settlements

Slovakia's Roma are among those hardest hit by the process of transition from central planning to a market economy. Overall, Roma are poorer than other population groups and are worse off in terms of nearly all basic social indicators, including education and health status, housing conditions, and access to opportunities in the labor market and within civil society. However, limited information on poverty among Roma in Slovakia and their living conditions is available. To address this gap the study included a qualitative survey of conditions in Roma settlements.

In contrast with the situation of Roma living in other countries in Central and Eastern Europe, more Roma in Slovakia—an estimated 25 percent—live in settlements on the outskirts of villages and towns, mostly in the poorer eastern regions of the country. In these completely segregated settlements formal unemployment is close to 100 percent, and many settlements lack access to electricity, water, and sewage and garbage collection. Most Roma do not own their homes or land.

Few Roma youth continue on to secondary education. According to the 1991 census, 77 percent of Roma had completed primary education, 8 percent had completed vocational training, and fewer than 2 percent had completed academic secondary education or university (though a 1990 study found that even fewer Roma had completed basic education). Roma children often face stiffer challenges in accessing education than other ethnic groups. In addition to factors common among other poor households, such as economic constraints, limited access to quality education, and parents' education levels, Roma children face additional barriers, including low demand for education within the community, geographic isolation, poor Slovak language proficiency, and low expectations on the part of teachers. Roma children are also more likely to end up in special schools for the mentally and physically disabled, which limits their future education and labor market prospects.

A 1997 survey by the Ministry of Labor, Social Affairs, and Family estimated that in 1996 Roma accounted for 17 to 18 percent of the total unemployed, with this figure running as high as 40 to 42 percent in eastern districts with large Roma populations. Many Roma are forced to work in the informal sector. Despite legislation prohibiting discrimination, many Roma cite it as a significant barrier to employment and as a rationale for not searching for work outside their communities and villages. Long-term unemployment is particularly high among Roma. Nearly all the long-term unemployed Roma interviewed for this study, and especially those living in poorer segregated settlements, depend on social assistance benefits for income support. This dependency reinforces negative stereotypes about Roma among the non-Roma population.

Social exclusion and discrimination against Roma severely affect access to employment opportunities, education, and public services. There are indications that negative perceptions of Roma are worsening for a number of reasons, including their declining social status, growing unemployment, and increasing dependency on social benefits. Negative stereotypes are also reinforced

by their geographic separation from the rest of the population and the limited contact between Roma and non-Roma.

A central question the study raises is how to develop an effective strategy for addressing the needs of Roma living in settlements. The most segregated and geographically isolated settlements face the greatest challenges on all fronts, including access to employment opportunities and public services, while conditions in integrated settlements are more favorable. While adopting measures to meet the immediate needs of residents of the poorest settlements in the short run is important, investing in settlements over the long term may lead to further entrenchment of segregation and continued marginalization and impoverishment.

There are no easy answers to this dilemma. The failure of socialist-era policies, which aimed at forced assimilation of Roma, indicate that encouraging Roma to leave settlements is not a viable solution. At the same time, lessons from ongoing projects in Hungary and Slovakia illustrate the importance of community involvement and participation in policies and projects. Thus a balanced package of short- and medium-term measures aimed at improving immediate living conditions for Roma in the poorest settlements and expanding possibilities for Roma to take advantage of opportunities through education, employment, and access to public services should be considered.

This does not imply that programs and policies should revert to the type of forced assimilation prevalent during the socialist period. Rather, policy and project design need to be sensitive to Roma culture and communities' desire to maintain their cultural identity. A number of successful projects use Roma mentors as liaisons between Roma and non-Roma communities, for example, Roma teacher assistants who work with parents or Roma peer advisors who assist with job placement can facilitate integration while simultaneously strengthening the Roma community. Addressing the negative impacts of exclusion and segregation also involves overcoming divisions between Roma and non-Roma communities. One important vehicle for doing this is education, which can help overcome cultural barriers through multicultural education and inclusion of the history and culture of Roma and other minorities in the curriculum. Training teachers, local government officials, and other social service personnel can be an important mechanism for addressing discrimination within public services. Public information campaigns can also promote multiculturalism and raise awareness about discrimination.

Slovak Roma History

The oldest references to Roma living on the territory of the Slovak Republic date back to 1322. The origins of Roma throughout Europe have long been a mysterious and controversial topic. Historical records indicate that Roma arrived in Europe from northern India in waves between the 9th and 14th centuries, although some Macedonian legends place Roma in Europe at the time of Alexander the Great as early as the 4th century BC. Linguistic roots and limited documentation suggest that Roma first came via Persia and the Caucasus through the Byzantine Empire into southern Europe. The reasons for their migration into Europe and the paths they followed in moving into the continent are unknown. Alternately tolerated and persecuted since their arrival, the Nazis viewed Roma as enemies of the state and relentlessly persecuted them. Estimates indicate that some 500,000 European Roma died in Nazi concentration camps.

The Czechoslovak socialist regime, which came to power after World War II, adopted policies aimed at assimilating Roma and eliminating ethnic differences. The government refused to officially recognize Roma as an ethnic minority, but rather identified them as "citizens of gypsy origin." In 1959 the government embarked on a violent campaign against nomads, and drew up plans for "dispersal and transfer" that aimed to resettle Roma from areas with large Roma communities in eastern Slovakia to Czech lands. This latter program was never fully implemented, although many Roma families were transported to the Czech Republic against their will.

Following the 1989 Velvet Revolution, in April 1991 the Slovak government adopted the Principles of Government Policy Regarding Roma, recognizing them as an independent ethnic minority with equal status to that of other minorities. One of the most significant recent developments in Roma affairs was the establishment of the Office of the Plenipotentiary for Roma Communities following the 1998 elections. The office is charged with implementing government policy regarding Roma. The EU accession process has also focused attention on Roma issues in the Slovak Republic as well as in other countries in Central and Eastern Europe that have large Roma populations. Roma issues are addressed under the political criteria for accession, and the EU's PHARE assistance program is providing substantial support in this area.

Programs to Be Targeted or Not?

A serious dilemma is whether programs and policies should be targeted toward Roma, directed more broadly at poor communities, or aimed at the population at large. Targeted programs can be tailored to meet the specific needs of Roma, but could create divisions among communities because of resentment that some groups are receiving special treatment. Broadly based programs may be easier to administer, may be more popular politically, and may facilitate integration and cohesion; however, untargeted programs could be ill-suited for reaching the poorest and most isolated Roma settlements.

In a number of areas policy approaches toward Roma that differ in focus and are more intensive than those aimed at the majority population are justified. For example, specific interventions are needed to address the most immediate issues of poverty in settlements, low school attendance, and lack of employment opportunities. Because Roma comprise a large and increasing share of the Slovak population, the risks of inaction are high, including the growth of an underclass, which has the potential to undermine economic growth and increase social inequalities.

The multifaceted nature of poverty in Roma settlements also highlights the need for interventions that cut across policy areas. For example, a housing project could involve Roma in constructing and upgrading infrastructure, thereby providing participants with training in construction, as well as employment, during the course of the project. Similarly, an education project could include exposure to public health issues or the provision of social assistance support through school lunches and access to educational materials.

Regardless of whether or not programs and policies are explicitly designated for Roma, Roma involvement in program design, implementation, and evaluation is essential. Roma NGOs and the Office of the Plenipotentiary for Roma Communities will be important elements of this process. Non-Roma involvement is also critical. Roma who lack opportunities for interaction with other Roma communities and non-Roma are cut off from wider society, including the labor market, education, and a wide range of public services. Increasing contacts and partnerships between non-Roma and Roma will facilitate the inclusion of Roma and address the mistrust and miscommunication that limit local and community development.

Proposals

Programs at the national policy level should:

- ***Address the unemployment problem*** by supporting micro, small, and medium enterprises and improving small entrepreneurs' access to credit. Encouraging self-employment and entrepreneurship can have a positive impact on Roma as well as on non-Roma households.
- ***Lower the nonwage costs of labor*** by reducing the currently high payroll taxes and nonwage labor costs, which discourage employers from hiring unskilled labor because it makes such labor proportionately more expensive than more skilled workers.
- ***Improve housing conditions*** by bringing isolated settlements into the mainstream utility networks, thereby enhancing their access to utilities and public services. While inhabitants should be charged for utilities, subsidies may be needed for low-income households. Other important measures could include clarifying property rights and introducing incentives for local governments and communities to provide services in settlements.
- ***Expand income-generating opportunities*** for Roma workers by enforcing antidiscrimination legislation, reducing the nonwage costs of labor and other biases working against unskilled labor, and improving on-the-job training and re-training opportunities.
- ***Increase the educational attainment*** of Roma by reducing the barriers that keep children from starting school, addressing the language constraint, training teachers (including Roma teachers and teachers' assistants), increasing preschool attendance, and facilitating secondary school attendance.
- ***Improve access to health care in remote areas*** by improving local infrastructure such as roads and telecommunications; increasing outreach activities; and enhancing public health awareness, particularly about reproductive health and contraception.
- ***Address exclusion*** through antidiscrimination legislation; public education and information campaigns; multicultural education; and training for public officials such as mayors, health practitioners, and other public servants.
- ***Improve access to credit,*** an important aspect of increasing opportunities for Roma and other low-income groups to engage in entrepreneurial activity. NGOs can play an important role in training and capacity building Partnerships between these organizations and banks are needed to establish credit mechanisms.
- ***Reform social assistance*** to improve incentives to work and reduce the risk of falling into a dependency trap. Reducing disincentives to labor market participation is a reform priority for Slovakia. This could be achieved

by adopting a scheme to phase out benefits so that employed workers earning low wages would still be entitled to a smaller fraction of their benefits. The reform also needs to focus on enhancing the roles of social workers working with poor communities. For many Roma in the most isolated settlements, social workers function as the main contact point with the outside non-Roma world. Social workers can serve as referral agents to other social services and provide information about employment opportunities, counseling, and other types of support.

Hungary's Autonomia Foundation, which provides grants and interest-free loans to Roma entrepreneurs undertaking livestock breeding, home gardening, and other small enterprise activities has pursued one of the more successful antipoverty programs in the region. The success of Autonomia's projects, as measured by the repayment rate of its loans, has increased greatly since it was established in 1990: in 1998 repayment rates reached nearly 80 percent, compared with 10 percent during the first year. Autonomia attributes this improvement to the involvement of trained monitors, some of whom are Roma, who work closely with project teams throughout the implementation process. Autonomia is now expanding its programs to other countries in the region, including Slovakia.

The full report is available on http://www.worldbank.sk/news.htm—romaseminar.

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potential and could be a source of water for the entire region.

Wolfensohn noted that a great deal of work would need to be carried out in such priority areas as developing the countries' financial sectors, implementing legal reforms, and improving the investment climate through more transparent regulation and investments in social infrastructure. According to Wolfensohn, aid to Central Asia as a whole could reach $1.5 billion over the next three years.

Recent World Bank Loans

China: Sustainable Forestry Development, IBRD Loan, $93.9 million, with $16 million Global Environment Facility grant (grace period 7 years, maturity 16 years). The project's goal is to protect some of China's most important remaining natural forests and associated biodiversity. It also aims to protect vital watersheds and reduce the risk of downstream flooding and to ensure a supply of wood to meet China's growing demand in a way that takes pressure off forests elsewhere in Asia. The forestry sector plays a critical role in the Chinese economy, providing 40 percent of rural household energy, almost all the lumber and panel products for the large construction sector, and raw material for the large domestic pulp and paper industry.

Vietnam: Regional Blood Transfusion Centers, IDA Credit, $38.2 million (grace period 10 years, maturity 40 years). This project will increase the quantity of safe blood available at the busiest hospitals in the country's main urban centers. The project will also extend the provision of safe blood services to other smaller hospitals in the country.

Romania: Rural Development, Adaptable Program Loan (APL), Phase 1: $40 million (grace period 4 years, maturity 17 years). During the first phase of up to four years the project will focus on building local capacity for making rural investments in a limited pilot area and providing investment grant funding for road and water and sanitation subprojects. Total project cost is $53.42 million, including $8.78 million from the Romanian government and funding from local communities. Romania joined the World Bank in 1972, and since 1990 commitments to the country have amounted to more than $3 billion for 31 projects. The APL loan, approved by the Bank's Board of Executive Directors in September 1997, permits greater flexibility than traditional instruments for supporting long-term, complex reforms and programs

Ukraine: Private Sector Development, Adaptable Program Loan (APL), Phase 1: $30 million (grace period 8 years, maturity: 20 years). The objective of this loan is to increase the competitiveness of Ukraine's enterprise sector, focusing on improving the regulatory environment for private business, and to provide intensive training to Ukrainian business managers and consultants to support enterprise restructuring, in collaboration with the government of Ukraine. The first phase of the project will be initiated in four pilot *oblasts*—

Chernovtsy, Khmelnitsky, Volyn, and Zhitomir—and will be extended to further *oblasts* and enterprises in the second phase ($30 million). Since Ukraine joined the World Bank in 1992, commitments to the country have totaled more than $3.4 billion for 24 operations.

World Bank Loan Helps China Combat Tuberculosis

On March 21 the World Bank agreed to provide a $104 million loan to China to treat hundreds of thousands of people suffering from infectious tuberculosis and support a sustainable work program for the country's strengthened National Tuberculosis Control Program. The U.K. Department for International Development is providing a £28.3 million grant to enable the Bank loan to be on-lent to the provinces at a concessional rate. Despite remarkable improvements in overall health status in the past decades, China's health services remain inadequate and regional disparities in access are large. Tuberculosis is the leading infectious cause of death in China, with more than 400 million infected people, and with 1.3 million new cases and 150,000 tuberculosis deaths each year.

Albania in No-Man's Loan-Land

The World Bank may cut back its aid to Albania over the next three years, as the country's economy has grown steadily and per capita income is now above the threshold for the world's poorest states. Between July 2002 and June 2005 the Balkan nation of 3 million people—according to the World Bank's base-line scenario—will receive $131 million from IDA, whose soft loans are destined for the poorest countries. This figure is lower than the $158.3 million that Albania received in the previous three-year period ending in June 2002. If Albania's economy performs well, it will receive the same amount as it has during the previous three years. Since Albania joined the Bank in 1991 it has received some $570 million for 43 projects. As Eugen Scanteie, the World Bank representative for Albania, pointed out, GDP growth has been solid and the income per capita is higher than the $885 IDA threshold. However, even though Albania has posted annual growth of more than 7 percent in the last four years, it is not yet wealthy enough to qualify for the IBRD's "semi-commercial" loans.

Russia Probes Fate of 1998 IMF Loan

Based on Audit Chamber inspections, the misuse of federal budget funds last year totaled Rub 14 billion, the chamber's chief, former Prime Minister Sergey Stepashin, told the Duma's Budget and Taxes Committee on April 22. Inspections included the distribution of World Bank loans. Russian prosecutors are still investigating what happened to a $4.8 billion IMF loan received in 1998 that some claim may have been laundered through a New York bank, said the head inspector of the Russian parliament's audit agency. "This work is not finished," Stepashin said on April 20 on Russia's state-controlled Mayak radio. "The sum remains very serious. It's more than $4 billion that we cannot seem to find." He predicted that the investigation by the Russian Prosecutor-General's Office would be completed this year.

Russian investigators have not commented publicly on the case. Stepashin also said that Audit Chamber investigations had revealed financial violations by government officials at the time the IMF loan was received in 1998, just months before Russia defaulted on tens of billions of dollars in debt and plunged into financial crisis. Stepashin gave no details of the violations. The IMF has said that an audit found no evidence that the Fund's loans had been misused or involved in alleged corruption and money laundering. The audit came after U.S. federal prosecutors alleged in 1999 that the Bank of New York had served as a conduit for $7 billion in Russian money. Some reports alleged the funds included IMF loans.

IFC Helps Small Businesses in Romania ...

The International Finance Corporation (IFC), the private sector arm of the World Bank Group, has invested $2.025 million to help establish Microfinance Bank MIRO S.A., a bank that will provide credit and other financial services to micro- and small enterprises in Romania. The IFC investment consists of a share purchase of $2.025 million in MIRO amounting to 22.5 percent of the bank's shareholding. The Bank's paid-in capital will be $9 million, which includes IFC's share purchase and investments by IFC's partners. the European Bank for Reconstruction and Development, Deutsche Entwicklungsgesellschaft, Commerzbank AG, and Internationale Micro Investitionen AG.

...Invests $25 Million in Bank of Shanghai

IFC has signed an agreement with the Bank of Shanghai (BOS) to invest $25 million in the bank, raising its stake from 5 to 7 percent. BOS was established in 1995 through the merger of 99 urban credit cooperatives in Shanghai. IFC's cooperation with BOS led to an IFC equity investment in 1999 for a 5 percent stake in the bank, IFC's first investment in a Chinese bank. Since then BOS has made substantial progress in introducing international standards and best practices

to improve the bank's corporate governance, management, and processing. This new investment by IFC is part of a capital increase undertaken by BOS. Also participating in the capital increase are the Hong Kong and Shanghai Banking Corporation and the Shanghai Commercial Bank of Hong Kong for an equity stake of 8 and 3 percent, respectively. The investment of the two foreign banks is significant, because it represents the first investments by foreign commercial banks in a domestic Chinese bank.

... and Supports Vietnam's Higher Education

IFC has invested $7.25 million in the Royal Melbourne Institute of Technology International University, based in Ho Chi Minh City, contributing to the building and operations of a new campus. This is the first foreign-owned university in Vietnam. The Asian Development Bank will also provide a loan of $7.25 million in support of the project.

The university will offer undergraduate and graduate degree programs, English and other foreign language training, corporate training, and continuing education programs. It will be wholly owned by the Royal Melbourne Institute of Technology of Australia. This is the first education project under the government of Vietnam's new law to promote foreign private investment in the areas of health, education, science, and research.

No Deal Yet in World Bank Grants Versus Loan Dispute

British and U.S. officials meeting in London in early May again failed to agree on topping up the coffers of IDA, the World Bank's soft loan financing arm. The last replenishment of IDA funds three years ago runs out on June 30. The two countries have been at odds since last year over the Bank's request for $12.5 billion of extra cash for IDA, which lends on highly concessional terms to the world's poorest countries. The United States initially proposed that IDA raise the proportion of funds it gives out as grants to 50 percent.

For the World Bank this means that 50 percent of IDA funds would be converted into grants. The rationale behind this proposal is that many developing countries cannot afford any additional debt. Loans to chronically indebted and impoverished countries, even at low interest rates, mean debt build-up. In many instances, the U.S. administration argued, grants are a more appropriate way of providing assistance for long-term needs. Investments in social sector programs are crucial, but their growth effects are not realized until many years in the future, and thus generate little income to help repay loans.

The United Kingdom is opposed to the U.S. idea and is against allowing more than 10 percent of IDA funds to be given out as grants on the grounds that a large grants scheme would deplete IDA's resources over time. Backed by several other European countries, the United Kingdom argues that a switch to grants on this scale would deprive the World Bank of future income (about 40 percent of IDA's resources come from reflows from previous loans). If IDA provided grants, this gap would have to be filled by a substantial increase in donor contributions. If overall development assistance budgets continue to shrink, sustaining a substantial grant window within IDA would not be possible.

U.S. negotiators asserted that IDA's high repayment record is not an accurate reflection of its financial situation. They said that in the past decade the Group of Seven and others have agreed to forgive most or all the repayments due from earlier bilateral aid loans. IDA has become, in effect, a preferred creditor. Donor countries have been willing to forego repayments of their old bilateral loans to ensure that debts to IDA can be repaid. U.S. Treasury officials also asserted that most foreign aid is increasingly being provided on grant terms: almost 99 percent of bilateral official development assistance from richer countries now takes the form of grants, up from 78 percent in 1989. Many of the countries most resistant to IDA grants give most or all of their bilateral aid to poor countries as grants. They noted that while the United Kingdom was strongly opposing the concept of IDA grants, the U.K. chancellor of the exchequer had given a speech in New York supporting the establishment of a new multibillion dollar trust fund to address the millennium development goals by means of grants.

Several European countries have indicated they could go as high as 18 percent of IDA funds being given out as grants, but no deal has yet been struck. Delegates at the talks also discussed the possibility of using the grants in conjunction with other funding for global programs such as combating HIV/AIDS or helping countries emerging

from conflict. This could be more acceptable to the European nations.

The U.S. Treasury has also hinted that it might increase its contributions to IDA by 18 percent over the previous IDA round. If performance benchmarks were met, U.S. contributions to IDA would be stepped up from $850 million in the first year, to $950 million in the second year, and to $1.05 billion in the third year. In this case IDA income would be reduced by only 4 percent over 20 years.

The U.S. government's performance targets are, however, controversial, as they imply that a neutral methodology for assessing the impact of IDA funding in poor countries can be found. Furthermore, warn some observers, converting IDA loans to grants is only the first step on a slippery slope of implementing the recommendations of the Meltzer Commission. The commission, which reported to Congress in 2000, recommended that the World Bank Group be transformed into a grant-making institution. It proposed that the World Bank should cease making loans (except in certain circumstances), focusing instead on special purpose grants, increased aid effectiveness, and evaluation of results, proposals that some experts say seem to resemble the reform agenda of the current U.S. administration. Adam Lerrick and Alan Meltzer, coauthors of the report, stressed that grants would be linked to projects, monitored for results, and paid only for performance. Despite the similarities, U.S. Treasury officials deny that the administration's proposal was derived from the Meltzer Commission's report.

Treasury Secretary Paul O'Neill, however, has argued that "the World Bank could be more effective if it gave money to health, education and sanitation projects in the developing world, instead of lending money to governments that sometimes waste the resources." Responding to such criticisms the World Bank's recent study, "The Role and Effectiveness of Development Assistance: Lessons from World Bank Experience" by Rogers Halsey, pointed out: "Project outcomes, as measured by the World Bank's independent Operations Evaluations Department, have improved sharply over the past decade The Bank increased the share of projects rated as satisfactorily attaining key project objectives from well below 60 percent in the late 1980s to above 80 percent today."

Source: World Bank, Reuters, Vander Caceres Salazar from Bretton Woods Project.

New Books and Working Papers

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

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Working Papers
http://econ.worldbank.org

Dominique van de Walle, **The Static and Dynamic Incidence of Vietnam's Public Safety Net,** WPS 2791, March 2, 2002

Vietnam's social welfare programs do not adequately protect and promote the poor. Increased spending, with better coverage and targeting, could help poor and vulnerable households. The author's analysis shows that coverage and payments to households are low and have had a negligible impact on poverty. In principle, better targeting could improve the impact of current outlays. The analysis also shows that the system was ineffective in protecting households that were vulnerable to shocks. Finally, the results suggest that even though there is a greater concentration of poverty-related programs and greater household participation in poorer communes, the system spends more (absolutely and relatively) on the poor in richer communes.
To order: Dominique van de Walle, email: dvandewalle@worldbank.org.

Adam Wagstaff, **Inequalities in Health in Developing Countries: Swimming against the Tide?** WPS 2795, February 2002, 40 pp.

Large inequalities in health are apparently not associated with large inequalities in income or with small shares of publicly financed health spending. They are, however, associated with higher per capita incomes. Health inequalities rise with rising per capita incomes partly because

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Local Government and Public Service Reform Initiative

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The World Bank in cooperation with SITE and WDI

LGI/OSI

The spring 2002 issue of the Local Government Brief, published by the Local Government and Public Service Reform Initiative-OSI is dealing with the timely issue of international development aid, primarily from the perspective of recipient countries' governments and NGOs. A selection of the articles follows. All are available on http://lgi.osi.hu/publications/default.asp?idx=inseries&id=4.

Pitfalls of Foreign Aid: Lessons from Estonia

By Tiina Randma

Foreign aid has become a remarkably extensive field of activity in all the Central and Eastern European (CEE) countries and elsewhere in the world. Based on the author's experience of working on various foreign aid projects in Estonia (mostly in the field of public administration reform) and as a foreign consultant to other CEE countries and the Federal Republic of Yugoslavia, she summarizes some major lessons that should be instructive to both aid donors and aid recipients.

Roger Riddell, in his discussion paper "Aid in the 21st Century," published by the United Nations Development Programme in 1996, argues that foreign aid is provided for four main reasons: to further donors' strategic and political interests; to further donors' economic, including commercial, interests; to respond to humanitarian (ethical or moral) imperatives; and to respond to additional or complementary imperatives arising from historical relationships between donors and recipients. The assumption on which the principles of giving aid are based, apart from strictly humanitarian motives, is that by improving democracy and security in a region, and the investment climate and the standard of living of the recipient country in general, the donor benefits from such investments in the short and long term.

Foreign Aid to Estonia

Foreign, nonreimbursable aid has been an important part of Estonia's development process. The EU has become the most significant donor and its importance will likely continue to grow over the coming years. In 2001 the EU contributed 63 percent of Estonia's total foreign aid. To date the PHARE program has contributed a total of €253 million of aid to Estonia, most of which has gone to the education and financial sectors, social services, social integration, and governance. Since 2000 another EU program, the Instrument for Structural Policies for Pre-Accession (ISPA), has also become a significant donor to Estonia and other EU candidate countries. Annual ISPA funding for Estonia—primarily targeting the environment and infrastructure, mostly transportation—is increasing from €20.8 million in 2000 to €36.4 million in 2006. A third EU program, Special Accession Program for Agriculture and Rural Development (SAPARD), has committed to support Estonian agriculture with more than €12 million a year during 2000-06. Estonia benefits from numerous other EU programs and initiatives.

Impact Evaluation

Although the scope of various aid programs in Estonia is impressive, what counts is the actual impact of foreign aid. Donors have become increasingly interested in carrying out evaluation to enhance the development impact. The complexity of evaluating the impact of foreign aid is well explained by Frederick Nixon in his 1994 study, "Foreign Aid and External Assistance": "If humanitarian factors are not of the highest priority, it should not surprise us if we find it difficult to establish a positive causal connection between aid and development." In addition, as T. Carothers observed in his 1999 report entitled "Aiding Democracy Abroad, the Learning Curve, foreign aid evaluations tend to focus more on outputs than on effects. That is, they tend to look at what activities the project sponsored, how many people were

trained, what equipment was donated, how many consultant-days were used, and so forth, instead of assessing the real impact of aid, for example, whether civil servants performed better, decisionmaking became more transparent, local democracy developed, and so on.

Experience has shown that not all foreign aid has been used to fulfill the goals that were stated when giving the aid. For example, A. Tucker, in his similarly titled study, published in 1995, provides shocking evidence of corruption and greed in Western academic aid to Eastern Europe. Several foreign aid plans allocate substantial amounts of money for foreign consultants, which makes the total sums of aid look good, but critics have questioned the real impact of such consultancies on achieving the stated end results. As Alan Mayhew put it in the "EU's Policy toward the CEE": "The member states of the European Union tend to regard PHARE as an employment program for their own consultants."

Difficulties in evaluating the impact of foreign aid are closely linked to a number of broader problems. **The first is the lack of policy planning and strategic management in the recipient country or organization.** There is little donors can do if recipients do not have clear policies and strategic management in place. However, recipient countries or organizations should identify their own priorities and set realistic goals and action plans in order to specify the need for external aid to donors. If the objective of aid is to have a real impact on a country's development, then foreign aid should be part of existing plans. Even if strategic goals are in place, aid recipients may have problems in communicating their needs to donors. The 1998 evaluation of PHARE public administration reform programs indicated that the three PHARE projects that had addressed public administration reform in 1993-95 had failed because the Estonian government did not have a coherent concept for public administration reform at the time the projects were designed and implemented.

The second problem is a lack of information and failure to learn from previous aid programs. Some of the more experienced people and organizations are gaining considerable expertise in aid administration and in particular countries' problems; however, they rarely share their knowledge in written form, and when they do it is usually only for their own internal use. People in the business of dispensing foreign aid are much more inclined toward action than retrospective reflection. Bureaucratic imperatives reinforce this tendency, above all, the pressure to keep moving from one project to the next. Also many aid administrators are resistant to critical reflection. Foreign aid is a competitive business. Donors are not motivated to share their knowledge and best ideas with each another or to make critical reviews of their own performance public to the extent that, even if they produce reports for external consumption, such publications are usually public relations efforts and not objective overviews of lessons learned. This lack of accumulated knowledge about foreign aid has negative consequences for both donors and recipients, and the extent of cross-learning among different regions or among different sectors or programs in recipient countries is insufficient. This leads many organizations to constantly reinvent the wheel when they embark on new projects.

In some cases in Estonia donors have gone as far as to start large-scale projects in fields they have already worked on in the recent past without any systematic analysis of the results of previous projects The evaluation of PHARE public administration reform programs conducted by an independent agency in 1998 indicated that the three PHARE projects mentioned earlier were not integrated with each other. There was no sign of lessons learned from previous failed projects and there was no synergy between them. The evaluation also failed to discover any links with other programs launched with the help of foreign aid that addressed the same issues.

The third problem is donors' poor knowledge of a recipient country or organization. Often short-term foreign consultants are poorly informed about the country or organization for which they are consulting. This leads to a situation where many aid providers seem to have universal models in mind on how to promote changes in their respective field, be it the development of a market economy or democratization. The general idea behind such universal models seems to be an understanding that the use of the same template, including institutions and processes, can lead to similar positive consequences in each country. Thus consultants' recommendations can easily be biased toward their own limited experience of their home countries or gleaned from a few recipient countries in which they previously worked. Many foreign consultants are unaware of the variety of different approaches employed in countries other than their own. Aid providers promote what they know best, which is almost always their own country's approach to a specific issue. Moreover, consultants sometimes introduce idealized models that do not work in their own countries

Foreign consultants should have broad comparative knowledge about their topic and should be given enough

time to learn about the recipient country or organization. In this regard long-term consultants are more likely to succeed than short-term consultants. Aid recipients should be able to identify precisely what they want from donors and particular consultants. Only in this way they can avoid "one size fits all" solutions.

The fourth problem is the missing link to power. Often the objective of foreign aid is to reshape institutions, laws, or procedures in transition countries, but this remains a self-contained effort. For example, merely sponsoring the writing of new laws barely scratches the surface. The new drafts are often not enacted into law, or if they are, the relevant state institutions usually lack the capacity to implement or enforce them and no budgetary provisions are made to pay for the costs of implementation. Reform projects that are funded, planned, managed, and evaluated by foreigners are only occasionally backed by real commitment from those in the recipient countries. Local decisionmakers may feel a lack of ownership of foreign aid programs, because these are likely to be disconnected from the important existing institutions in a given society, namely, politicians, top administrators, or influential lobbying groups. Foreign aid initiatives that are aimed at local government reform should have a clear understanding of local power relationships.

Promoters of democracy have often acted on the assumption that a key obstacle to democratization in countries coming out of long periods of authoritarian or totalitarian rule is an overly strong central government. They have oriented their work to strengthen NGOs and local governments, and thereby counterbalance the dominant power of the central government. Thus the core of many decentralization projects is the provision of training and technical assistance for local government institutions and officials, including technical skills pertinent to local government work, such as the design and implementation of local elections, service delivery, budgeting, resource mobilization, and project planning and management.

While decentralization raises many economic, administrative, and social issues, it is above all a political issue. It is about power, about whether those holding most of it in society are willing to give significant portions of it away. Even when a country is in a democratic transition, the leading holders of power and central government officials are usually reluctant to devolve real authority to local governments. Therefore for foreign aid to have a real impact, identifying and understanding different actors' interests and actual power is imperative. Often foreign aid cannot substantially modify an unfavorable configuration of interests or counteract powerful local actors. Nevertheless, aid can sometimes affect interests and power in minor but worthwhile ways by changing particular actors' perceptions and knowledge. For example, by realizing that central government officials are likely to oppose decentralization because they fear a loss of control, aid providers can design training programs for senior central government officials and politicians rather than simply training local government officials.

To sum up, donors and their local partners should identify the key players in society—politicians or senior administrators—who are likely to be of help in implementing plans or policies developed with the assistance of foreign aid. These key people should be involved in the foreign aid project from the earliest planning phase, thereby increasing their commitment to and ownership of a particular project. Clarifying the responsibilities of donors and local leaders would also be useful, for instance, who is responsible for making changes happen, to avoid later disillusion. No simple remedies are available that donors and aid recipients can use to make the foreign aid process more efficient. Both need to bear the problems in mind to make foreign aid more useful and rewarding for both parties.

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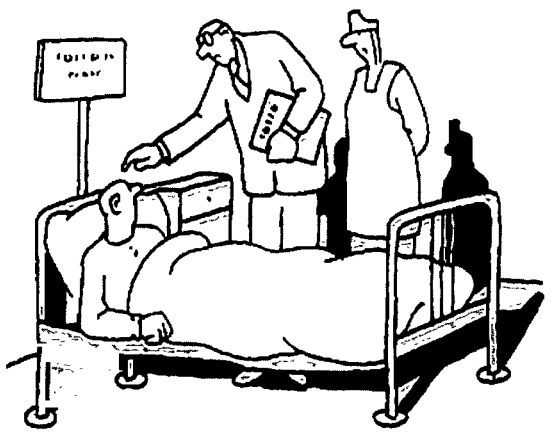
Cost Effective Health Care



"That man who's telling you to get up isn't a miracle healer but a clerk from the health insurance company."

From the Czech magazine *Slovo*

Dancing with Donors: Opportunities for NGOs

By Kenneth Davey

The World Bank in cooperation with SITE and WDI

This is not an objective analysis by an unbiased source. It is full of the prejudices of a writer who for the last 30 years has been part of the donors' mercenary army of consultants, their salaries paid from the fees earned from donors' advisory and research projects and scholarships, working for the U.K. Department for International Development (DFID) and in 18 countries for the World Bank.

Donors take themselves incredibly seriously. They have to justify themselves to their own funders, whether domestic taxpayers or charitable givers, and habitually exaggerate their own influence and usefulness. Nevertheless, they are important, individually or collectively. They deploy considerable resources, which have an impact, good or bad, on the political, economic, and social development of recipient countries. These resources are intellectual and political as well as financial. Thus NGOs concerned with social and economic development in recipient countries cannot ignore donors.

Understanding Donors

Donors claim to know what is best for the country they are seeking to aid. They base this not only on their good intentions, but also on their intellectual resources and their access to international expertise and experience. The organization of this expertise varies. Sometimes it is in-house. The World Bank has a huge apparatus of sectoral policy and research departments, while the DFID employs a growing army of advisors, backed up by external resource centers." The EU, by contrast, employs few specialists directly. All depend on consultants to a varying extent.

The quality of these intellectual resources is highly variable. The best are represented by teams who develop long-term familiarity with particular issues and regions, collaborate extensively with local specialists, and try hard to develop locally appropriate solutions as well as the capacity to sustain them. The worst are the "body shops" that parachute in expertise in prepackaged systems. In-house staff of the multilateral agencies tend to be long on academic qualifications and short on hands-on experience. A besetting sin of donor staff and consultants alike is adherence to fashion. World Bank staff, in particular, have always been overcritical of the solutions they have promoted in the past and overoptimistic about those they are proposing now. They are often prone to simplistic perceptions of national situations, with a Hollywood reference frame within which people are either good guys or bad guys, for reform or against reform. Consultants rarely give adequate weight to the political costs of their recommendations or to the need for user-friendly explanations and dissemination.

The financial resources donors deploy vary not only in volume, but also in their net addition to the recipient economy. Some programs look far less generous once expenditures on donor personnel are deducted. Another factor that is difficult to measure is the hidden costs to the recipient of the time and administrative attention expended in negotiating with donors. The World Bank, for example, lends large amounts of money, but levies a heavy cost through its demands for data and discussion. Transaction costs are even heavier in the case of EU funding, but at least it comes in grant form. Even though the process of obtaining EU funds is exasperatingly protracted, it does provide some Central and Eastern European governments with far greater investment finance than they have been able to generate from other sources.

Donors habitually apply pressure for the adoption of particular reforms and measures, whose success is also variable. Donors' ability to overcome domestic skepticism or political and bureaucratic inertia is limited except in crisis conditions (usually fiscal). Donors are probably most effective when supporting a reform agenda actively promoted by domestic factions; they come in useful as scapegoats. The incentives for complying with donor pressure are rarely only the access to their money. The prospects of accession to the EU has undoubtedly overcome political obstacles to much reform that has had strong but insufficient indigenous support.

Donor interventions are subject to various constraints and conflicts of interest. They obviously have set agendas. DFID programs are heavily influenced by U.K. Development Secretary Clare Short 's concerns about poverty and social exclusion. Cutting public expenditure and economic liberalization are hallmarks of the IMF's standard prescription. Donors also tend to have

standard tricks of the trade: the IMF always sells treasury systems; the DFID likes to set up civil service departments; and the U.S. Agency for International Development (USAID) has a worldwide crusade to promote municipal bonds, with dire consequences for some municipal budgets.

Some donors are hamstrung by the jealous eyes of their own masters. Congressional paranoia holds the USAID in thrall; accusations about nepotism in the award of contracts often bring EU programs to a standstill. Nor are donor agencies necessarily more cohesive than other large organizations. The World Bank 's macroeconomists urge governments to cut public spending, while their sectoral departments lend ministries money to increase it.

Thus donors are at their worst when trying to impose standard policies and practices taken from "home" experience. They are at their best when supporting host expertise in the analysis of options, acting as partners but not dictators in the development and application of reformed policies and practices. At the risk of cliché, this is an interactive and exploratory process, requiring a readiness to listen and defer to others, which meshes uneasily with the innate arrogance of the donor role. Generally donors are more vulnerable than they seem, more anxious about criticism and underperformance than they would admit, and more open to constructive cooperation with organizations and individuals who gain their confidence.

Roles for NGOs

In some spheres NGOs are now seen as natural partners in the design and implementation of official programs. This is mainly in the social sector, where NGOs often have special expertise in particular mental and medical conditions and can mobilize community responses to supplement government resources. In poorer countries and communities NGOs may also be seen as partners in the development of physical infrastructure, such as water supply, irrigation, or waste management

In such spheres donor programs are increasingly built around partnerships between government and NGOs. There is a far wider tendency, however, for donors to include national resources in the design and execution of their programs. Donor projects are typically executed by consultants chosen through public tender. International consultants, or consultants from the donor country under bilateral aid, are increasingly mandated by terms of reference to tender in harness with an organization in the recipient country. Occasionally, but increasingly, the roles are reversed, with tenders open only to host country organizations with international consultants playing a supporting role.

Competing for and managing donor consulting contracts is a demanding business, requiring the ability to identify opportunities, compile tenders (often at short notice), and comply with complex procedures. It is a game in which local subsidiaries of international consulting firms like PriceWaterhouseCoopers or KPMG have a strong comparative advantage. Some of the indigenous think tanks have geared themselves toward this market, supported in a number of cases by the Open Society Institute. This presents the nongovernmental sector with a growing opportunity not only to do lucrative business, but more significantly, to influence national development by working directly with donors. NGOs with strong professional networks could exploit these opportunities for themselves as organizations or for their specialist collaborators by entering the tendering game or allying themselves with firms and organizations who are already playing it.

Access to Opinion

Donors and their consultants are often isolated from public contact and opinion. They interact with sections of the bureaucracy and are informed almost entirely by its perceptions and interests. They may be uncomfortable about this, but lack the opportunity, contacts, or mandate to test their analysis or recommendations against other sources of information and opinion. Direct contact with known critics and opponents of the government may be diplomatically unacceptable.

Politically neutral NGOs can be helpful in such situations by providing an acceptable forum for debating issues and ideas with a wider audience. Roundtables, workshops, and seminars organized by universities or civil society institutions may provide opportunities for off the record discussions where participants are not inhibited by the need to take an official position.

Trying out innovations in the public sector is often difficult, because they require changes in the law or in budgetary practices. Introduced nationwide, the cost of failure may be severe. NGOs may have the capacity to experiment with fewer legal and bureaucratic impediments and very localized risk. Thus they may offer donors more flexible test beds for reformed policies and practices.

NGOs may also reach the point where dancing with donors means totally opposing the content or execution of donor programs. Being nongovernmental should enable organizations to express outright opposition to donor interventions that they believe are detrimental to national interests. The positive linkages suggested in this article should help avert the need for this, but they should not weaken NGOs' ability to voice criticism where other methods of influence have failed.

NGOs' may well feel powerless against the combined forces of donors and government, but many NGOs are part of international networks that may well take up their cause with greater effect, particularly if the experience is replicated elsewhere. Local government associations, for example, have an independent line to Brussels through member state associations and the Committee of the Regions. What is important, however, is a well-presented case. Evidence of the detrimental impacts of donor approaches needs to be well documented and accompanied by alternative solutions to the problems donors are addressing.

Conclusion

Communication between NGOs and donors does not need to be confined to the exchange of petrol bombs and tear gas on the streets of Genoa. More constructive channels are available and both parties may be increasingly ready to explore them Donor organizations are less monolithic and more self-critical than they appear to the external world. Opportunities for positive engagement with a wider range of expertise and opinion within host countries are increasing. This is a chance for NGOs to become a more constructive force in national affairs, but exploiting it requires more than passionate commitment. Professionalism in the justification and presentation of ideas and in the cultivation of contacts is also essential.

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The EU's Reform of External Aid

By Claus Schultze

The EU is one of the major actors involved in international cooperation and development assistance. The EU and its member states provide some 55 percent of total official development assistance and more than two-thirds of international grant aid. In addition to being the largest donor of humanitarian aid in the world, the European Commission manages roughly 10 percent of official development assistance worldwide, amounting to €9.6 billion in 2001. One-third of this aid goes to Africa, the Caribbean, and the Pacific islands and two-thirds goes to Central and Eastern Europe and the newly industrializing states, the Balkans, the Middle East, the Mediterranean countries, and Asia and Latin America. In total, the EU finances projects in more than 140 countries. Unlike many other EU funding programs, such as agriculture and structural funds (which are administered largely through the EU member states), the EU's external assistance is directly managed by the European Commission.

The growing importance of the EU's role in external assistance has, however, not been matched by appropriate adjustments in human resources, structures, and management capabilities. Hence its external assistance programs have acquired a reputation for slow and unresponsive delivery services, poor quality, and excessively centralized and rigid procedures. This is why the Commission, as part of its wider administrative reform efforts, is currently engaged in revamping its external assistance policies, programs, and procedures.

In its 2000 report "Communication on the Reform of the Management of External Assistance," the Commission outlined its reform program. Since then it has published two annual reports describing the progress achieved and pointing to the challenges that lie ahead.

One of the cornerstones of this reform agenda has been to unite the project cycle—from identification to evaluation—under one roof by creating the Europe Aid Cooperation Office (AidCo). Until AidCo's creation in 2000, a complex and fragmented structure of different layers and geographical units within the administration and outside external bodies devised and managed aid. Since then, large segments of the programming responsibility have been transferred to AidCo. This new organization has also absorbed the contracting responsibility, which was formerly split

between the Public Service for External Relations and a large number of technical assistance offices. It has also taken over the implementation and evaluation tasks of the now largely disbanded technical assistance offices.

The Commission's Directorate General for External Relations and Directorate General for Development Aid are now largely responsible for elaborating the strategic frameworks (country strategies) within which AidCo operates. With the exceptions of pre-accession aid and the EU 's humanitarian aid, AidCo is now responsible for the practical side of most EU external aid operations, that is, identifying and preparing projects and programs, making financing decisions, implementing activities, and monitoring and evaluation.

Another cornerstone of the EU 's external assistance reform is large-scale devolution of project management to the Commission delegations in the beneficiary countries, which will have more responsibilities for allocating and managing funds tailored to local needs. The Commission is also seeking to enhance the transparency and visibility of its activities and management practices, and to this end has improved and extended its Internet services.

Development Strategies, a London-based development consulting firm, recently pointed out that the welcome increase in aid disbursement since the creation of AidCo has often been accompanied by a further deterioration on the ground and a weakening of the prominent poverty focus of EU aid. It added that improving this situation will depend crucially on the Commission's ability to learn from past mistakes and create an atmosphere of open debate and dialogue (*European Voice*, March 21-27).

With the creation of AidCo the Commission clearly took a step in the right direction and demonstrated its determination to focus on the right issues and continue to reform its disbursement practices. Thus the institution is likely to live up to the quality standards set by other donors. It should make progress in its efforts to coordinate the EU's external relations policies and programs and those of its member states, a task that requires not only administrative reform, but the goodwill of all the ministries and governments involved.

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Bank of Finland
Institute for Economies in Transition

Current Issues in Pension Reform in the Baltic Countries

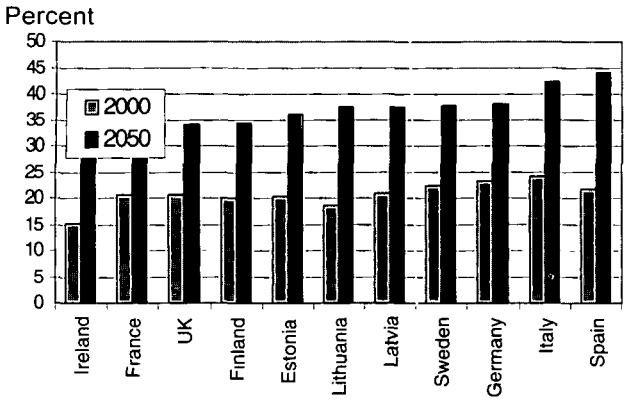
By Tuuli Koivu

The Baltic states inherited pay-as-you-go (PAYG) pension systems from the former Soviet Union. Under a PAYG system, those who work pay for current pensioners' benefits. These systems rapidly became unsustainable after independence because of demographic shifts, whereby populations are aging (see the figure) and birth rates are falling, and rising unemployment. Given the absence of a strong link between their contributions and their benefits, employees had little incentive to pay PAYG taxes. The Baltic states soon realized that their pension systems could no longer guarantee pensioners a sufficient standard of living. In the second half of 2001 the average monthly old-age pension was just €102 in Latvia, €101 in Estonia, and €89 in Lithuania.

The Baltic countries started to reform their pension schemes in the mid-1990s. The objective was to adopt a three-pillar system that would ensure long-term affordability of the welfare system while preserving an adequate social safety net for all citizens. The first pillar would be a scaled down PAYG system. The second pillar would be a fully funded system of privately managed savings accounts financed from payroll taxes. The third pillar would be based on voluntary pension fund contributions.

The first pension reforms involved downsizing PAYG systems by raising the retirement age, eliminating extra benefits, and strengthening the link between contributions and benefits. Next the voluntary pension scheme was created in 1998-99. Even though contributions are tax deductible, voluntary schemes have yet to become popular. In Latvia, which has made the most progress, as of September 2001 only 9,100 people were participating in private pension plans.

Proportion of the Population Aged 60 Years and Older, Selected European Countries, 2000 and 2050



Source: United Nations, *World Population Prospects: The 2000 Revision.*

Latvia's second pillar has been in place since July 2001. Second-pillar contributions are mandatory for employees under 30 and optional for those aged 30 to 49. Few have chosen to participate in the scheme. Contributions will rise gradually from 2 percent of income in 2001-06 to 10 percent from 2010 onward, and contributions to the first pillar will be reduced proportionally. The Treasury will initially manage second-pillar funds to reduce administrative costs. The funds will be primarily invested in state securities and bank time deposits. As of 2003 participants will have the right to choose who will manage their savings from among a group of reputable investment companies licensed by the state.

In Estonia, workers born during or after 1983 will start making mandatory pension fund contributions in July 2002. They will pay 2 percent of their income and the Tax Board will contribute 4 percent or a fifth of the 20 percent social tax that employees currently pay under the first pillar of the social security system. The state will cover payments transferred from the Tax Board.

Lithuania has yet to pass legislation on its second pillar. Under a Cabinet proposal the second pillar would take effect in 2004. The system would require workers up to 30 years old to contribute 5 percent of their income to the second pillar.

Three-pillar pension systems should provide a higher rate of return on savings than PAYG systems, and thus allow the state to provide the present level of benefits without raising the contribution rate, even when the number of pensioners increases and the number of employees declines. By providing a clearer connection between lifetime contributions and pension benefits, the new system may also improve the efficiency of labor markets. The model is expected to stimulate savings, which could increase investment in projects that improve productivity However, empirical data offer little to support this optimistic view. Proponents of three-pillar systems even claim that they will accelerate the development of financial markets, but regulations constraining investment are likely to limit the impact of such systems on capital markets.

Critics have pointed to the increased risks to pensioners and the system's high administrative costs, but the most difficult problem in pension reform by far is financing the transition costs. The more workers who participate and the larger the contributions to the second pillar, the higher the transition costs. The Baltic countries estimate that the transition will cost 0.5 to 1 percent of GDP annually for 5 to 10 years. They will likely finance part of the costs from privatization funds and borrow the rest. Lithuania has considered borrowing from the World Bank. Thanks to their relatively modest external debt levels, borrowing should not cause any problems in the Baltic countries.

The author is an economist at BOFIT. This article was published in the January issue of the Baltic Economies—Bimonthly Review and is available on http://www.bof.fi/bofi./.

Research Scholarships

The Bank of Finland's Institute for Economies in Transition (BOFIT) is looking for visiting researchers for 2003. BOFIT conducts high-level research on transition economics and monitors economic developments in Russia and the Baltic states. The research focuses on (but is not limited to) issues related to macroeconomic performance, the public sector, and financial markets in transition economies. The institute publishes two research-oriented discussion paper series and regular economic reviews. Scholarships for two to six months are available for 2003 for high-level research projects in areas pertinent to the institute's research objectives.

Those interested in applying are invited to send a brief research proposal, a *curriculum vitae* detailing their academic and research background, the names of two or three references, and a copy of an earlier paper selected by the applicant to: Bank of Finland, Institute for Economies in Transition, P.O. Box 160, Helsinki, Finland; fax: +358-9-183-2294, email: bofit@bof.fi. The deadline for applications for the 2003 program is June 14, 2002.

For further information contact Iikka Korhonen, Research Supervisor, tel.: +358-9-183-2986, email: iikka.korhonen@bof.fi, or Jouko Rautava, Acting Head of Institute, tel.: +358-9-183-2297, email: jouko.rautava@bof.fi.

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The Great Divide and Beyond: Financial Architecture in Transition

By Erik Berglöf and Patrick Bolton

A growing and deepening divide has opened up between countries where economic development has taken off and those caught in a vicious cycle of institutional backwardness and macroeconomic instability. This "great divide" is apparent in almost every measure of economic performance, such as GDP growth, investment, government finances, growth in inequality, general institutional infrastructure, and increasingly in measures of financial development.

Countries that have made it to the "right" side of the divide (Hungary, Poland, Slovenia, the Baltic states) have pursued a remarkable diversity of policies aimed at financial development. Yet strikingly, the basic financial architecture of these front-runners today is remarkably similar: strongly dominated by commercial banks, increasingly foreign owned, that lend primarily to government. Stock markets are highly volatile and illiquid, and their sustainability is in question as the numbers of listed firms are stagnating, or even falling. Enterprises rely most on internally generated funds, and essentially all external long-term finance comes from foreign direct investment.

The great divide in economic and financial development and the convergence in financial architecture among the successful countries raise fundamental questions of how institutional reforms and financial development have interacted with economic growth. Does financial development lead to economic growth, or do financial institutions and markets develop in response to pressures from the real sector? Or are both financial development and economic growth driven by some underlying variable? Is skipping stages of financial development possible, or must all countries go through a phase of bank-oriented financial architecture? Financial transition represents a unique opportunity to shed new light on these important issues.

Needed: Strong Government with a Sound Fiscal Base

We conclude that financial development does not explain why a small group of countries developed and grew while most transition economies remained mired in recession and economic decline. Some countries experienced financial development, at least as traditionally measured, without economic growth. Indeed, in several cases financial development undermined real sector development. Other countries grew without much financial development. In general, the financial sector has played a small role in restructuring the manufacturing sector in the transition countries.

We find that the great divide opened up in the wake of price liberalization and the ensuing banking crises and bailouts. It was governments' ability to achieve macroeconomic stability and fiscal responsibility, together with a commitment to refrain from excessively bailing out failing banks or loss-making enterprises, that determined whether economic *and* financial development took off. In other words, strong government with a sound fiscal base is the main predictor of positive future economic performance in transition economies.

Fiscal responsibility promotes both financial development and economic growth through two important channels: first, it limits the extent of crowding out of private investment by government borrowing; and second, it lends credibility to the government's undertaking to maintain macroeconomic stability, an essential condition for private investment. No doubt specific initial conditions and underlying country characteristics facilitate the emergence of strong and fiscally sound governments capable of enforcing the rule of law.

The convergence in financial architecture among the front-runner countries is consistent with a view in the literature

that suggests a link between the level of economic development and the design of financial systems. Countries that have attempted to jump-start the development of financial markets have all reverted to more bank-oriented financial systems. In a weak institutional environment, depositors must be convinced that banks will not abscond with their money or become involved in excessively risky projects. This may also help explain why banks lend to governments rather than to enterprises.

Lessons Learned

Ten years later, we can point to a number of lessons learned, namely:

- One of the most striking observations of the past decade of financial transition is the importance of fiscal discipline at the initial juncture. This is the critical point when the great divide opens up.
- Countries on the wrong side of this divide become caught in a vicious circle of macroeconomic instability and repeated relapses in financial development. At best financial development in these countries has little effect on economic growth, and may even be counterproductive by softening firms' budget constraints.
- By contrast, in countries on the right side of the great divide financial development seems to have been positively correlated with economic growth.
- Despite a great variety of financial transition policies pursued in these countries, their financial architecture appears to have converged to a bank-based system with substantial foreign ownership.
- On the positive side, the financial sector has contributed to hardening budget constraints, but on the negative side, banks have not yet begun extending significant long-term finance, nor have they actively promoted restructuring in the industrial sector.
- Even though the transition process is, in essence, a problem of institutional reform and build-up, the early economic literature on transition mainly took a macroeconomic perspective, emphasizing price liberalization and policies toward stability. Ironically, even though this perspective has been criticized for ignoring underlying institutions and the role of the financial sector in development, the financial transition pattern of the past decade suggests that the focus on macroeconomic stability and fiscal responsibility turns out to have been well placed.
- Sound government finances create favorable conditions not only for financial development, but also for proper enforcement of the law. Writing new laws or transferring them more or less wholesale from abroad is relatively easy. Ensuring proper enforcement is much more difficult. In our view lack of enforcement emanates from the same weakness of government and fiscal irresponsibility that undermine financial development.
- Western Europe can play an important role in providing outside anchors for the financial and economic development of transition countries. The process of accession to the EU has made a critical contribution to relieving domestic political constraints in the transition countries of Central and Eastern Europe. The pressure to meet the criteria for EU membership was essential for the adoption and enforcement of laws and regulations and for building basic institutions. Perhaps even more important, the widely shared aspiration to rejoin Europe has given strong direction to, and strengthened the commitment of, the governments of these countries. Providing such anchors for the countries on the wrong side of the great divide is a major challenge for the future.

Erik Berglöf is the director of SITE. Patrick Bolton is a professor of economics at Princeton University. For the full version of this paper see the Journal of Economic Perspectives, vol. 16, no. 1, Winter 2002, pp. 77-100.

Enlargement and Beyond: Baltic Rim Heads of State Address Stockholm Conference on Baltic Sea Region Security and Cooperation

SITE joined the U.S. Embassy in Stockholm, the Swedish Institute for International Affairs, and the Stockholm International Peace Research Institute in hosting the Sixth Stockholm Conference on Baltic Sea Region Security and Cooperation, held at the Stockholm School of Economics on April 24, 2002.

This series of highly regarded annual events gives political and economic leaders from Russia, the Baltic states, EU member countries, and the United States an opportunity to explore ways to create a safer and stronger Euro-Atlantic community. This year the meeting featured keynote speeches and two panel sessions that addressed the relationship between Russia and an enlarged EU, the Common European Economic Space, and an expanded NATO.

Featured speakers included Polish President Aleksandr Kwasniewski, Lithuanian President Valdas Adamkus, Swedish Prime Minister Göran Persson, German Deputy Defense Minister Walther Stützle, and U.S. Deputy Assistant Secretary of State Heather Conley. Reginald Dale of the *International Herald Tribune* moderated the two panel sessions.

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The Latvian Labor Market: Signs of Normalization?

By Morten Hansen and Romans Pancs

How does one define the emergence of a normal market economy? Preliminary results on the behavior of the Latvian labor market suggest that the 1998 Russian ruble crisis marked a turning point in normalization, according to a report by the Baltic International Centre for Economic Policy Studies (BICEPS), which studied this issue in collaboration with the Centre for European and Transition Studies at the University of Latvia.

Anyone who has worked with transition economies will be familiar with the difficulty of finding stable macroeconomic relationships, and often of obtaining data to estimate such relationships. Besides being annoying for researchers, this poses a serious impediment to policymakers. Thus an important question is the extent to which a transition economy has "normalized," that is, to what extent have certain standard macroeconomic relationships emerged and become stable. Here we do not offer any general definition of normalization or of how to test it, but in a tentative search for normalization we look at one specific case related to the Latvian labor market

We managed to obtain data on job vacancies in Latvia and used these, together with information about unemployment and inflation, to investigate two market economy relationships: the Beveridge curve, which posits a negative relationship between unemployment and vacancies, and the Phillips curve, which posits a similar relationship between inflation and unemployment. While it may be too early to identify a stable Phillips curve relationship, the Beveridge curve provides easily interpretable and useful information about the Latvian labor market and how it responded to the Russian crisis shock of 1998.

Impact of the Russian Crisis

On August 17, 1998, Russia devalued the ruble and defaulted on Treasury bills and on interest payments to several Paris Club creditors. Within a year the ruble price of Latvian lats had more than quadrupled, a massive devaluation by any standards. Latvian exports to Russia reacted predictably: whereas Latvian exports to Russia had accounted for 21 percent of total exports in 1997, this figure had declined to only 7 percent in 1999 and 4.2 percent in 2001. GDP growth and unemployment reacted similarly.

Throughout 1997 and into 1998 Latvia had enjoyed high growth rates of 6 to10 percent per year, but growth dropped sharply in the third and fourth quarters of 1998, and was negative during the first two quarters of 1999. Then the economy rebounded, and since 2000 growth rates have again been sizable, suggesting that the effects of the Russian crisis are essentially over.

The unemployment rate, having hovered around 6 or 7 percent from 1995 through mid-1998, increased for 10 successive months starting in July 1998 and ending in April 1999. Thereafter, through December 2000, unemployment rates slowly decreased, or at least did not increase.

The GDP and unemployment effects seem to suggest the following:

- The Latvian economy was enjoying strong economic growth prior to the Russian crisis.
- The Russian crisis, although seemingly dire from an exchange rate and exports point of view, was relatively easily overcome.
- The unemployment rate responded to the Russian crisis as one would have expected.
- The increase in unemployment was severe, reflecting the severe drop in exports, but did not last for long.
- The Latvian economy is clearly enjoying strong productivity gains. Even given the increasing unemployment in early 1999, the economy is growing quite fast again.

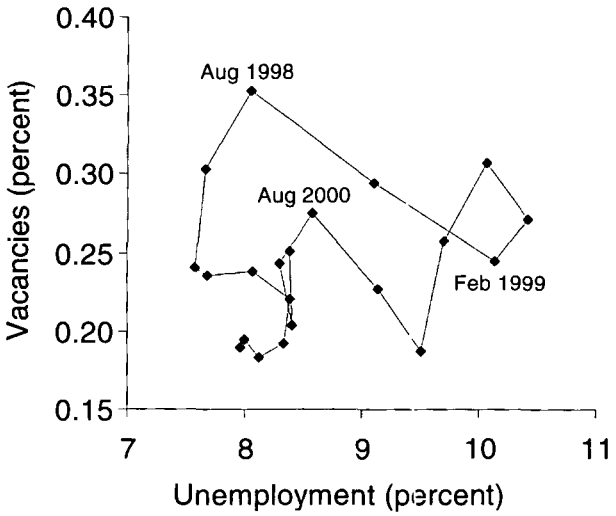
Beveridge and Phillips Curves

GDP and unemployment trends responded to the negative economic shock of the Russian crisis in textbook fashion, which is not surprising given the aggregate nature of these indicators. Of interest, however, is whether other key relationships responded similarly.

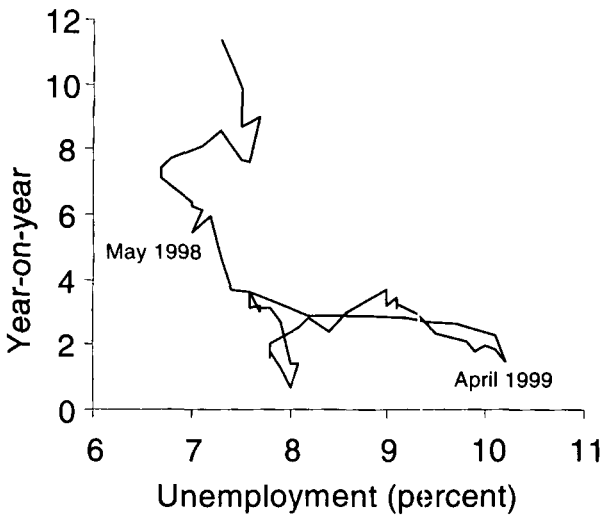
We looked at the Phillips and Beveridge curves, with the latter being of particular interest to us (see the figures). The Phillips curve should be viewed with caution. The high inflation-low unemployment points represent early years, when inflation was higher but was adjusting downwards. The Russian crisis increased unemployment, but seemingly had little impact on inflation.

The Beveridge curve, however, seems readily interpretable. It represents the relationship between job vacancies and unemployment, reflecting the segmentation of the labor market. Because of skills differences, excess demand for one type of labor may coexist with excess supply of another type of labor. In Latvia the lack of geographical mobility results in another mismatch between the demand for and the supply of labor. Usually labor markets are characterized by large gross flows into or out of employment. The Beveridge curve, which shows the joint movement of job vacancies and the unemployment rate, can reveal interesting information about the matching process, that is, how the supply of labor may or may not match the demand for labor.

Beveridge Curve, May 1996-May 2002



Phillips Curve, January 1997-December 2001



Two types of shocks affected the relationship:

- Negative shocks to economic activity—the rate of job destruction increases at the same time as the rate of job creation decreases
- Reallocation shocks—changes in the intensity of reallocation of labor from one sector to another.

The Russian crisis is an example of the former category, and the conclusions to be drawn from the relationship are relatively simple. With GDP growth increasing during 1997, the vacancy rate increased because of a higher demand for labor, but the unemployment rate barely fell, an interesting observation and one worthy of further study. The vacancy rate peaked in August 1998, just before the Russian crisis. Then, as the crisis hit, the unemployment rate increased sharply while the rate of vacancies fell, a response fully consistent with what one would expect from a negative economic shock. As unemployment peaked in April 1999, vacancies were apparently filled more easily. When the unemployment rate subsequently dropped again, reflecting the rather quick reversion to high economic growth, the demand for labor was again high, as reflected in a higher vacancy rate. Currently, the Beveridge relationship seems to have reverted to where it stood before the Russian crisis.

To sum up, the Beveridge curve indicates that the Latvian labor market behaved more or less as expected in a market economy. This is in contrast to the rather shapeless and erratic behavior observed before 1998 Our conclusions should offer encouragement to policymakers as well as suggest directions for future research.

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THE WILLIAM DAVIDSON INSTITUTE
AT THE UNIVERSITY OF MICHIGAN BUSINESS SCHOOL

Starting with the this issue of the Transition Newsletter, we will regularly summarize the William Davidson Institute's (WDI's) working papers dealing with EU enlargement. To see the full set of working papers on this topic visit WDI's web site at www.wdi.bus.umich.edu.

Variety, Jobs, and EU Enlargement

By Tito Boeri and Joaquim Oliveira Martins

Two key factors that have allowed the rapidly growing economies of Central and Eastern Europe (CEE) to cope with their external constraints have been their relatively low unit labor costs and the initial undervaluation of their exchange rates. Their accession to the EU will inevitably reduce both sources of competitiveness of Eastern European exports, as real wages are likely to catch up to Western European levels and current EU members are pushing the countries to enforce labor market and social regulations that will increase their labor costs. Our analysis suggests that the ongoing success of transition, notably of those countries that upon accession will likely face increasing pressures for real wage convergence with the EU, will depend significantly on the speed with which they reallocate labor from homogenized to diversified goods producers.

Small, open economies can grow faster than their neighbors without running into a balance of payment crisis if they succeed in increasing the number of differentiated goods produced domestically. Increased variety in these countries after trade liberalization is an unambiguous sign that consumers coming from the empty shelves of the pretransition era have a strong taste for variety, and hence that new varieties can create their own demand. However, increasing variety will involve intensifying the worker reallocation process, because production is still largely concentrated in homogeneous goods and scale-intensive industries and enterprise density is significantly lower than in Western Europe.

Output Collapsed, Not Trade

After 1989 all the transition countries experienced one of the most marked depressions ever observed in recent economic history. Between 1989 and 1991 GDP declined by as much as 30 percent in Eastern European countries such as Bulgaria and Romania. While this depression is well documented in the literature, the fact that trade volumes did not collapse in line with output has received much less attention. While these countries were experiencing a deep economic depression, imports were relatively buoyant throughout the region with the exception of Bulgaria.

By 1989 approximately a quarter of CEE countries' trade was with the former Soviet Union. Intraregional trade in Eastern Europe accounted for roughly 15 to 16 percent of total trade turnover, while countries of the Organisation for Economic Co-operation and Development (OECD) accounted for more than 40 percent of trade flows and the rest of the world for another 16 percent. Six years later, in 1995, the picture had changed substantially. Exports to the Russian Federation represented only some 10 percent of CEE trade, imports from Russia were less than 15 percent of total imports, and the share of intraregional trade was well below 10 percent of total trade. The share of trade turnover with the rest of the world also decreased somewhat compared with the pretransition era, while the industrial market economies, mainly the EU, accounted for almost 70 percent of both the exports and imports of Central and Eastern Europe.

Another feature of the transition economies' trade patterns has been their persistent specialization in heavy, energy-intensive industries and low-skilled segments of the manufacturing sector, despite having a relatively well-educated labor force and cheaper labor relative to their Western counterparts. Only Hungary and Slovenia have a comparative advantage in light industries and are also significant net exporters in industries such as electrical machinery, plastics, and pharmaceutical products. This is a clear sign of a more advanced stage of transition.

Product Variety and Transition

Surprisingly, the literature on transition economies has overlooked a crucial dimension of structural change, namely, the shift from homogenized goods to differentiated goods

and, in particular, to many different product varieties. Why were varieties lacking before the start of transition? Under central planning resources were systematically diverted away from final consumption goods, and countries maintained limited trade relations with Western countries that were confined to exports of raw materials and intermediate goods. Moreover, increasing the number of varieties of goods available to consumers generally requires growth in the number of firms, but enterprise creation in these countries faced practically insurmountable entry barriers. Socialist firms were also characterized by a high degree of vertical integration, which even under a market system does not favor the development of product varieties.

One of the first steps of the transition toward a market economy was opening up to trade, and hence lifting restrictions against domestic consumers' purchase of differentiated goods. Put another way, demand started to matter in the determination of equilibrium. Accordingly, the countries imported a large number of product varieties. Domestic production of varieties has also begun, but gradually. The build-up of a network of variety producers is, after all, a time consuming and costly process. Insofar as this process requires new business start-ups, this implies large sunk entry costs and high failure rates. Entry barriers were particularly high in Eastern Europe because of a lack of market institutions, entrepreneurship, and financial intermediaries channeling resources to new enterprise creation. The stronger the entry barriers, the fewer the business start-ups, and the slower the development of new varieties.

At the outset of transition, trade was liberalized. This involved a sudden increase in the number of varieties available and consumers can now finally spread their consumption over the large number of varieties produced in the West. However, Eastern European countries must initially be net exporters of their homogenized goods in order to finance imports of varieties. Insofar as they start producing varieties domestically, then they can also export varieties as trade becomes increasingly of the intra-industry (horizontal) type. However, entry of variety is a long process. Meanwhile, coping with external constraints forces transition countries to sell cheap, homogeneous goods abroad. Trade in varieties is balanced only when enterprise density in the East converges to the levels prevailing in the West. Thus to summarize, transition economies initially experience a large trade deficit in differentiated goods financed by large exports of homogenized goods and, in the long-run, intra-industry trade will dominate.

Support of Start-Up Activities

According to our analysis, the depression in the transition countries was related to shifts in the structure of consumption rewarding differentiated products and inertia by the previous supply structure in adapting to this shock. Two facts support this explanation of a supply-driven depression. First, aggregate investment fell less than output. Second, while GDP and industrial production were collapsing, imports did not fall, and actually grew rapidly after the early phase of transition. An important feature of our model is that the demand shift occurs without exogenous changes in preferences.

Our results are also consistent with the increase in enterprise density registered in all the transition economies since 1990. The positive relationship between enterprise density and levels of real income per capita holds reasonably well in both the transition and the Western European countries. The countries more advanced in the transition, such as the Czech Republic, Hungary, and Slovenia, are also the countries with the highest GDP per capita and enterprise density. Moreover, the countries where enterprise density was higher from the start displayed lower and less protracted declines in output, for example, output fell more in Poland than in Hungary.

The soaring trade deficits that appeared in the early stages of transition and reappeared in 1996 and 1997 are also in line with our analysis. Insofar as the number of domestic variety producers is far from its long-run equilibrium, increases in real wages (associated with catch-up effects, for instance) translate into increased demand for varieties that are largely imported. Overall, the only way to sustain real wage growth over the long-run is by an increase in varieties, a growth that creates its own demand.

In many transition countries the bottoming out of the recession has been associated with demand in the OECD countries for homogeneous goods produced in the East. However, sustainable growth can only come from the development of many small, specialized units in the manufacturing sector, that is, growth in the long-run can only come from an increase in enterprise density.

Although entry is the driving force behind long-term economic growth, in the short run it diverts resources away from production, thereby inducing output losses. These

initial losses are larger the wider the gap between the inherited enterprise density and that prevailing in the long run. The recovery from the transitional recession is slower the higher the barriers to the entry of new firms. Steps to reduce such barriers are likely to speed up the transition significantly and reduce its costs in terms of forgone output.

After the initial explosion of new business start-ups, the pace of new firm creation is slowing down considerably, yet the transition countries are still far from reaching enterprise densities comparable to those of OECD countries. Most of the development of a new private sector has occurred in "gap-filling" service activities rather than in manufacturing. The environment is still unfavorable to the development of small firms in manufacturing because of the high real interest rates, the lack of venture capital, the interlocking structure of banks and large corporations, and an absence of infrastructure for the development of small firms.

Trade liberalization has been a major shock for these countries and has been associated with dramatic output falls and a rise in unemployment. Some scholars argue that trade should have been liberalized only gradually; however, opening up to trade has played a crucial role in paving the way for the entry of new firms. Trade also promoted subcontracting in some sectors, such as machinery and apparel, and the hope is that this will be followed by the transfer of know-how and learning and the creation of a critical mass of dynamic and innovative small and medium enterprises. Nevertheless, much remains to be done to reduce barriers to the entry and survival of new firms in transition economies.

Conclusion

The success of transition, notably of those countries that, upon entering the EU will likely face increasing pressures for real wage convergence with the EU, will depend on the speed with which they reallocate labor from homogenized to diversified goods producers. From a historical perspective, high costs of entry have to be accompanied by generous unemployment benefits to start the reallocation process on a sufficiently large scale. Unemployment benefits, however, ended up increasing the social security burden on the active population. A better way to start the process would have been to reduce the obstacles to starting up new activities and, conditional on that, have lower unemployment benefits in place. Although being wise after the event is easy, some lessons are still useful for those countries lagging behind in the transition process.

Tito Boeri is a professor of economics at Bocconi University, Milan and IGIER and a WDI research fellow. Joaquim Oliveira Martins is an economist at the OECD. This summary is based on their WDI Working Paper no. 301.

Costs and Benefits of "Euroization" in Central and Eastern Europe

By D. Mario Nuti

The current simultaneous EU enlargement and monetary unification are about to create unprecedented economic segmentation in Europe. Previous enlargement and deepening processes treated old and new members equally. Countries were either part of or outside the European Community. Any other diversification existed already and was not generated by the progress and pattern of European integration.

Membership of the European Monetary Union (EMU) is an integral part of the *acquis communautaire*, which new and old members alike are committed to implement. It is subject to three qualifications:

- Requesting possible derogations (exceptions from the rule), such as those negotiated by Denmark and the United Kingdom. No new member is expected to request derogations.
- Participating successfully in the exchange rate mechanism for at least two years before joining the EMU (Sweden has failed to implement the mechanism to date).
- Meeting other Maastricht Treaty standards for monetary and financial convergence in relation to public debt and deficits, inflation, and interest rates. (Failure to achieve these standards delayed Greek membership in the EMU until the June 2000 Lisbon summit).

Therefore even if all the new members opted to join the EMU at the earliest possible date, Europe would be segmented into at least the following four groups:

- Members of both the EU and the EMU. This group currently consists of 12 countries, including Greece.

• Members of the EU that are self-excluded from the EMU (Denmark, Sweden, and the United Kingdom), soon to be joined by the next batch of new members.
• Ten Central European applicant countries—Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic, and Slovenia—plus Cyprus, Malta, and Turkey, followed, or perhaps overtaken by in the case of Croatia, countries in southeastern Europe. All these countries' admission to the EU is subject to economic and political conditions and will be staggered over time, beginning no earlier than 2003-04.
• The rest of Europe and other countries of the former Soviet Union, which are excluded from the EMU for the foreseeable future.

Those countries that wish to secure a closer monetary integration with the EMU either before or instead of EMU membership, have two possible and, most important, unilateral ways to do so. First, they could adopt a currency board to manage a domestic currency linked to the euro. One unit of the currency could be made equivalent to €1 at no extra cost. Second, and a more drastic alternative, would be to officially adopt the euro as the national currency.

Advantages of Euroization

The prevailing view, both in the economic literature and in policy circles, is that euroization has immediate positive net advantages, especially in transition countries where government institutions lack the credibility and track record needed to successfully adopt alternative exchange rate regimes and the monetary policies necessary to back them.

An argument for euroization (or dollarization) is national governments' consequent ability to overcome their difficulties in borrowing internationally in their domestic currency. Euroization also avoids both the volatility and inflationary bias of floating rates and the vulnerability to speculative crises resulting from fixed rates that are not irrevocably fixed. Even successful fixed exchange rate regimes can become vulnerable as a result of their own success, because they attract capital inflows that lead to real revaluation, thereby undermining competitiveness. At some point those flows can be easily, suddenly, and massively reversed. Unlike pegs subject to intermittent adjustments, irrevocably fixed rates do not encourage speculation, as demonstrated by the experience of EMU members since May 1998 in contrast to the September 1992 exchange rate mechanism crisis and its abandonment by Italy and the United Kingdom.

Additional benefits of euroization include the following:
• Lower transaction costs, just like for EMU members.
• Greater economic integration, both through increased trade and more foreign direct investment, especially if euroization is accompanied by mutual trade liberalization, or possibly a free trade area without the considerable restrictions still impeding trade with current candidates for EU accession.
• Probably lower basic interest rates in the presence of a currency board than would otherwise be the case (though interest rates are invariably higher than in the reference country, because they are subject to risk premiums for any individual country or borrower). Interest rates might be even lower if the domestic currency was replaced by the euro.

Whether a country chose the option of a currency board or currency replacement, euroization would involve automatic, self-regulating adjustments in the money supply. These would be determined by trends in domestically held foreign assets, which would expand given a balance of payments surplus and contract during times of deficits, as is supposed to happen under a gold standard.

Unlike partial, unofficial euroization, total and official currency replacement would not complicate the choice of intermediate targets of monetary policy by introducing a dual currency component in the money supply, and would not pass on the shocks of exchange rate adjustments to producers and financial institutions. Initially, euroization might be accompanied by a degree of undervaluation of the old currency with respect to the euro, a weakness that might be compounded by an initial weakness of the euro with respect to other hard currencies (as in 1999–2000). Undervaluation might be a blessing in disguise from the viewpoint of competitiveness and employment (though not of inflation).

Disadvantages of Early Euroization

While different approaches to euroization could yield the expected net advantages, this is not a foregone conclusion. The issue is not just one of a possible rejection of euroization on grounds of national pride, with countries hanging on to a domestic currency as a symbol of national sovereignty and thereby causing temporary or permanent exclusion from the EMU. Whether approaches to euroization can succeed is an empirical issue that depends on the relative strength of the associated disadvantages, bearing in mind that local

adoption of the euro as the domestic currency—whether as a banknote or as backing for domestic banknotes—is not the same as being a member of the EMU.

A number of distinct disadvantages are associated with the operation of a currency board with respect to EMU membership, namely:

- Initial endowment of a currency board regime with sufficient foreign exchange reserves to back the entire currency in circulation (whether new or unchanged) at the permanently fixed exchange rate preselected by the government Estonia benefited from the return of 11 tons of gold that it had sent to the West before 1940. Lithuania also benefited from the return of 6 tons of gold as well as purchases of gold from the IMF. Other countries might be less fortunate. Poland (with $26 billion in reserves, that is, twice the amount needed to back or replace its domestic currency), the Czech Republic, and Slovenia are likely to be able to afford euroization, while Hungary and Slovakia may not be able to.
- Loss of seigniorage, that is, loss of the revenues obtained by issuing domestic currency. Under the currency board option this loss could be offset, at least in part, by interest earned on reserves. Also, countries could agree on an arrangement to share seigniorage with the European Currency Board (ECB). The International Monetary Stability Act of 2000, introduced in the U.S. Senate by the chair of the Joint Economic Committee, Senator Connie Mack, contemplated such an arrangement for dollarized countries. According to Larry Summers, then U.S. Treasury secretary: "In the long term, finding ways of bribing people to dollarize, or at least give back the extra currency that is earned when dollarization takes place, ought to be an international priority" (part of his statement made before the U.S. Senate Joint Economic Committee, 1999). The same argument would apply to euroization.
- Lack of a lender of last resort, which would involve a considerable degree of financial fragility. This is particularly serious in the early stages of transition. The International Monetary Stability Act (Section 2.b) specifically states that: "The Federal Reserve System has no obligation to act as a lender of last resort to the financial systems of dollarized countries." The mythical advantage of a currency board is that the domestic currency is fully backed by foreign exchange, and thus the board could lend as a last resort only using any excess reserves it might have over and above what it required to back the domestic currency. Such reserves would be substantial in Poland, but not anywhere else in the area.
- Impossibility of entirely eliminating the risk of a parity change. By linking its domestic currency to a more credible currency, contrary to what is widely believed, a government cannot acquire the other currency's credibility.

Peg to the Euro?

In addition to the disadvantages caused by euroization falling short of full EMU membership, the euro may be unsustainable as a pegging currency in any form for three main reasons.

First, the euro may not be the preferred currency in the country's invoicing practices in foreign trade. A large part of the external debt of a number of countries is in U.S. dollars. In 1997 the share of dollar-denominated external debt was 77.9 percent in the Czech Republic, 75.1 percent in Bulgaria, 61 6 percent in Lithuania, and 46 percent in Poland, compared with deutschmark-denominated debt shares of 4.7, 4.7, 6.2, and 9.9 percent, respectively. For such countries any devaluation of the euro with respect to the dollar, as occurred during the first 18 months of the euro's existence in 1999–2000, would raise the domestic burden of foreign debt service, and a significant re-denomination of external debt would have to accompany inaction in relation to the euro.

Second, the ECB's monetary policy would be unsuitable for the fundamentals of the countries undertaking euroization. Apart from providing liquidity to euroized countries against foreign exchange, the ECB would have no obligation to consider their particular needs, just as the International Monetary Stability Act quoted earlier states that "the Federal Reserve System has no obligation to consider the economic conditions of dollarized countries when formulating or implementing monetary policy" (Section 2.b).

Third, the stabilization needs of transition economies may not leave much margin for an independent monetary policy, which is totally lost when using any fixed exchange rate regime. However, the instant abatement of inflation may not necessarily be the best policy, as confirmed by the dominant success of the Polish economy, which for all the talk of shock therapy has been disinflated at an excruciatingly gradual rate. Moreover, all Central and Eastern European transition economies are facing challenging issues of social welfare reform on a greater scale than the rest of Europe. Before worrying about convergence, many transition regions such as Kosovo or Serbia have to worry about reconstruction.

All the arguments in this section make a case not against unilateral euroization as such, but against early membership of the EMU. However, seeing that the main, indeed the only, point of unilateral euroization is to replicate the effects of joining the EMU earlier than would otherwise be possible, these are also arguments against unilateral euroization.

Speed of Convergence

A great deal of attention has been given to both financial and monetary convergence as represented by the Maastricht criteria and to the progress of systemic transition. On both counts the picture is encouraging, at least for the front-runners lined up for accession, but it is also misleading. Their government deficits and debt as shares of GDP are below or near Maastricht parameters; inflation and interest rates are much higher, but still within striking distance in most cases; and the progress of transition as recorded by the European Bank for Reconstruction and Development, especially in privatization and foreign trade, is impressive. However, the Maastricht criteria ignore essential and worrying features of transition economies, such as quasi-fiscal deficits and debt resulting from public contingent commitments, extrabudgetary funds, and hidden subsidies. They also ignore nonperforming loans on the balance sheets of state banks, the low share of credit for the private sector, the low capitalization and/or low liquidity of financial markets throughout transition economies, and the extraordinary volatility of their rates of return.

Once quasi-fiscal items are taken into account, even seemingly virtuous candidates lose much of their attraction. The share of credit going to the private sector appears to be inversely related to the share of bad loans. Transition economies seem to have either low market capitalization or a low ratio of value traded to market capitalization of their stock markets.

These considerations suggest that greater caution is needed in assessing the progress of new members' convergence to a single EU standard, and therefore in evaluating the net advantages of both their membership in the EMU and of possible EMU membership surrogates.

Cautious Approach Recommended

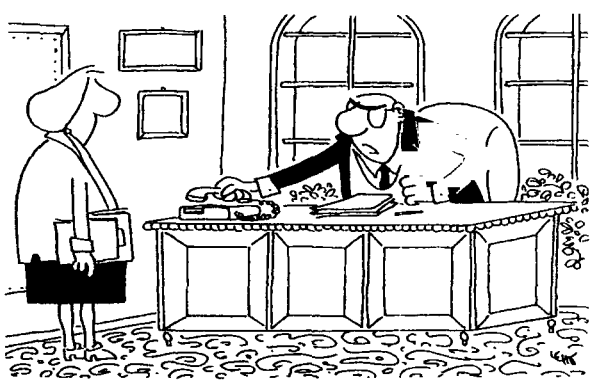
To the uninformed the arrangements of the current EMU area and those of the wider euro area enlarged to include strict euroization and/or euro-backed local currency would be absolutely indistinguishable. However, the different role of the ECB would be an immensely important difference, because in a strictly euroized country it would not act as a central bank. That is, the ECB would not be a lender of last resort. It would act as an institute of issue, but would not have any responsibility toward a euroized, non-EMU member country in deciding its monetary or exchange rate policy.

Ultimately the net balance of costs and benefits, both for the euroized country and for the EU and its members, is an empirical question that depends on the degree of monetary, real, and institutional convergence already achieved before euroization and its subsequent progress; the initial endowment of currency reserves; the initial currency of choice for invoicing and payment practices in foreign trade; the size and denomination of foreign debt; the already existing degree of use of foreign exchange in the domestic economy; the international credibility of domestic monetary institutions; and the degree of cooperation between domestic and European institutions, both political and monetary.

Observers and officials are probably being overoptimistic in their evaluations of current trends in financial and monetary convergence, and especially in institutional and real convergence. Euroization may well result in positive net advantages, but these should not be taken for granted. Meanwhile, the unexploited potential for greater economic integration through greater trade access to EU markets should not be neglected.

D. Mario Nuti is a professor of economics at the University of Rome "La Sapienza" and the London Business School and a WDI research fellow. This summary is based on his WDI Working Paper no. 340.

Ruthless Fight Against Corruption



"These people don't get it! They are so arrogant. They think I can be corrupted with a mere 30 million."

From the Hungarian magazine *Hócipõ*

The World Bank in cooperation with SITE and WDI

Why Do Governments Privatize?

By Loren Brandt, Hongbin Li, and Joanne Roberts

Since the early 1980s, privatization has become a widely used strategy for addressing problems in state-owned enterprises. Its use has not been limited to firms in the former socialist countries, but extends to state-owned firms that were established in predominantly market economies after World War II. In both cases governments want to increase enterprise efficiency by improving corporate governance, need to reduce government subsidies and raise fiscal revenues, and aim to limit government interference in the economy.

While the literature has paid considerable attention to differences in how firms have been privatized—primarily because of the implications for firms' postprivatization governance and performance—no work has been done to explain differences in the use of privatization across countries.

China has generally avoided privatization as a policy tool for dealing with the ailing state enterprise sector and has limited state sector privatization to smaller state-owned firms, and then only in the last few years. In contrast, since the mid-1990s China has undertaken massive privatization of firms owned and managed by lower levels of government, namely, township and village enterprises. A growing number of local governments have also shut down their firms. Ironically, these same firms are credited with having been the most dynamic segment of the Chinese economy since reform, and have been a major source of economic growth. Perhaps the most striking thing about this process is that it has not occurred uniformly, and considerable heterogeneity is apparent across China.

Our objective is to explain the observed differences in privatization behavior. Our basic premise is that governments and politicians derive a variety of economic, social, and political benefits from the control over enterprises that comes with ownership. The size of these benefits, however, is not determined in isolation, but depends on the rest of the economic environment, including, for example, the choices of enterprise managers and the nature of local financial institutions. We argue that differences in these institutions across localities affect the private and public returns to government ownership, and thus the incentives of governments and politicians to privatize firms.

We develop a simple model to analyze how the interactions of three key players—the government, a bank, and a firm manager/owner—affect the privatization decision. Our model links the government's privatization decision to its ability to extract benefits from ownership, the hardness of the firm's budget constraints, the human capital of the enterprise managers, the cost of monitoring the firm, and the bank's incentives and constraints. These factors ultimately determine how the value of the firm varies with its ownership. While privatization can benefit a government because it eliminates the agency cost inherent in government ownership, it also implies a loss of political capital by the leader. In essence, the decision to privatize involves weighing these costs and benefits.

Theoretically, we find that privatization is more likely when benefits to the government from owning firms are smaller, when leaders have low human capital, and when managers have high human capital. We also find that some factors have an ambiguous effect on privatization, including the hardness of the firm's budget constraints, the bank's concern about profits, the bank manager's human capital, and the costs associated with bank illiquidity. However, when the budget constraint is much harder for privately-owned than for government-owned firms, these factors have unambiguously positive effects on privatization.

In the empirical part of the paper, drawing on a unique dataset of township governments, firms, and local financial institutions we collected in 1998 and 2000, we test hypotheses generated from the theoretical model and explain the heterogeneity of privatization and shutdown patterns across townships. The results of the empirical work support our theoretical predictions: privatization is more likely when leaders have low human capital, when leaders find extracting benefits from government-owned firms difficult, when bank managers have high human capital, and when bank managers have good incentives and are more constrained by liquidity. Furthermore, we find that when the government-owned firm's budget constraint is hard, some of the foregoing effects on privatization become weaker.

Given the important role of financial institutions in the privatization process, in future work we plan to examine how these same institutions are influencing the returns

to privatization. In addition to being a potential source of selection effects, banks also influence firm performance through their willingness to lend and their monitoring role. Discrimination against private firms has been a prominent feature of Chinese policy, and how important this may be in shaping the benefits and returns to government divestiture remains to be seen.

Loren Brandt is a professor of economics at the University of Toronto and a WDI research fellow. Hongbin Li is an assistant professor of economics at the Chinese University of Hong Kong. Joanne Roberts is an assistant professor of economics at the University of Toronto. This article is a summary of the authors' study published as WDI Working Paper no. 429.

The World Bank in cooperation with SITE and WDI

Mass Privatization and Partial State Ownership of Firms in Transition Economies

By John Bennet, Saul Estrin, and James Maw

Since the fall of the Berlin Wall the transition economies have privatized tens of thousands of firms. Most countries have employed some form of mass privatization, distributing state assets at a zero price (or at a nominal price to cover administrative costs), and the state has frequently retained some shares. In this paper the authors show that such policies may be entirely rational for a government that seeks to maximize its own expected net revenue.

The initial focus of our analysis is the privatization of firms to insiders (their managers and workers) as has occurred widely in Romania and Russia, for example. The model is extended to the case of privatization to outsiders, as has predominated in countries such as the Czech Republic and Hungary. We model a game played by the government and potential buyers that determines the price to be paid for each share, the proportion of shares to be sold, and the firm's output and employment after privatization. In the basic framework all the gains generated by privatization arise because the new owners restructure the enterprise by cutting surplus labor. However, we also explore the possibility that privatization directly improves company performance because of such factors as increased managerial incentives.

The possibility of mass privatization arises from a constraint on the range of bargains that the government can strike. We argue that in the sensitive political and institutional environment of transition economies governments could not have sold firms at a negative price. This has two main implications: first, that the government may gain from selling enterprises at a zero price, even when sale at a positive price is possible; and second, that when privatization takes place at a zero price, for the state to retain some shares may well be advantageous.

The impact of the non-negative price constraint is not simply to raise an equilibrium price to zero when it would otherwise have been negative. There is also a more subtle effect by which, even if it can sell a firm's entire assets at a positive price, the government may gain from retaining state ownership of a portion of the shares and selling the remainder for a zero price. This result is more likely if the government's bargaining power is low, in which case it is less able to appropriate the net surplus generated by a corporate restructuring process.

These general conclusions hold for both insider and outsider privatization, though details differ between the two cases. If private ownership does not affect labor efficiency, then with insider privatization the optimal approach may be for the government to retain some ownership and sell the remainder for a zero price. With outsider privatization, however, these policies are necessarily optimal for the government. Insider and outsider privatization also lead, in general, to different amounts of restructuring. Assuming that the relationship is the same under each type of privatization, then if firms are sold at positive prices, employment is greater, and therefore restructuring is less, with insider privatization than with outsider privatization. If, however, the non-negative price constraint binds, then the possibility arises that insiders will restructure more than outsiders.

This analysis is consistent with the cross-country pattern of privatization methods. The few countries, such as Estonia and Hungary, where governments held strong bargaining positions relative to insiders or other

potential purchasers of state-owned enterprises eschewed mass privatization. They sold firms at positive prices and retained few or no shareholdings. In most of the former Soviet Union and in the Balkans, however, governments were much weaker in relation to insiders. In these countries mass privatizations and retained state shareholdings were widespread

John Bennet is a professor of economics and finance at Brunel University, United Kingdom. Saul Estrin is a professor of economics at the London Business School and a WDI research fellow. James Maw is a professor of economics at the University of Wales Swansea. This article is a summary of the authors' study published as WDI Working Paper no. 435.

Partial Privatization and Firm Performance: Evidence from India

By Nandini Gupta

The economic transition of socialist economies and the trend toward privatization within both developing and industrial market economies have generated a large empirical literature on the effects of ownership on firm performance. Most of these studies find that privatization has a positive impact on firms' profitability and efficiency. Most of the assets of the firms in these studies have been privatized and control rights have been transferred from the government to private owners. Surprisingly, little is known about the effects of partial privatization, in which control rights are not transferred, even though most privatization transactions of a significant size are partial sales of equity, often through the stock market. This paper uses information on the fraction of equity sold through partial privatizations in India to investigate whether the sale of minority stakes affects the performance of government-owned firms.

India's privatization program has proceeded slowly, with an average of 16 percent of equity in 44 of 258 government-owned firms sold in the 10 years following the adoption of a privatization policy in 1991. The pace has picked up slightly in recent years, with five firms being sold to strategic partners in the last two years, but the sale of noncontrolling shares remains the primary method of privatization.

The theoretical literature on privatization considers two types of problems associated with government ownership: the political problem whereby political interference distorts managers' objectives and constraints, and the managerial problem whereby poor monitoring leads to low incentives among managers. In firms that have been fully privatized it is difficult to identify whether the observed improvements in firm performance occur because the new owners pursue profit maximization rather than other objectives, or because the new owners are better able to monitor managers. Partial privatization without transfer of control allows us to concentrate on the second possibility. The firm remains under government control and subject to political interference, but the trading of shares on public stock markets provides current information about the firm's performance as judged by market participants. The state can use this information to monitor the managers more effectively, and managers can use it in the executive job market as a public signal of their performance.

India's adoption of a disinvestment policy was accompanied by two other policies that allow us to investigate the relative effects of privatization and competition. So-called dereservation eliminated restrictions on private entry into all but 4 of 17 sectors that used to be reserved for the public sector. At the same time the government liberalized restrictions on foreign equity investments in all but a few sectors of the economy. While some have argued that competition is more effective at shaping managers' incentives, others argue that so long as political interference and poor governance characterize public sector firms, inefficiencies cannot be fully addressed by increased competition. By controlling for changes in competitive conditions we are also able to ensure that changes in firm behavior are not incorrectly attributed to privatization.

Comparing the mean performance of firms in the years prior to the first stage of partial privatization to average performance in the years following the first stage, we find significant differences in revenues, labor productivity, and the share of government loans in firms' total borrowing. Compared with average performance in the prior years, sales and profits increase by 59 percentage

points and 22.6 percentage points, respectively, and the fraction of loans financed by the government declines by 5.8 percentage points. By contrast, employment does not appear to change significantly after partial privatization. To control for firm-specific and macroeconomic factors that could account for performance change, we also estimate firm fixed effects specifications to investigate the average impact of partial privatization on firm performance using firms that remain wholly government owned as the control group. We find that a 10 percentage point decrease in the share of government equity would increase sales by 27 percentage points, profits by 15 percentage points, average product of labor (sales over labor) by 6 percentage points, and returns to labor (operating income over employment) by 8 percentage points; however, no accompanying decline in employment occurs.

The results also indicate that partial privatization continues to have a significant impact on firm performance when we control for competitive conditions. Firms in sectors that were previously reserved for the government react favorably to dereservation, as evidenced by significantly higher sales revenues and profits. However, liberalizing restrictions on foreign participation has an adverse impact on sales. Unlike privatization, changes in competitive conditions do not appear to affect productive efficiency as measured by the average product of labor and returns to labor, but competitive pressures do affect allocative efficiency, because they appear to reduce employment. These results suggest that a combination of privatization and policies to enhance competition can improve firm performance.

We also find evidence that the share of government loans in total borrowing has a statistically significant negative impact on both sales and profits, which is consistent with the view that the government may use loans to pursue objectives other than profit maximization. However, soft budget constraints do not appear to affect the level of employment in these firms.

Nandini Gupta is a visiting assistant professor of corporate strategy and international business at the University of Michigan Business School and a WDI research fellow. This article is a summary of the author's study published as WDI Working Paper no. 426.

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WDI Conferences

Labor Markets in Emerging Economies Conference
April 1-6, 2002, San Jose, Costa Rica

The conference focuses on two main topics, namely, labor markets and public policy in a comparative perspective: Latin America and Eastern Europe, and job flows in transition economies. This is the second international conference on this subject sponsored jointly by the German-based Institute for the Study of Labor (IZA) and WDI. The organizers are Hartmut Lehmann, IZA, and Katherine Terrell, WDI.

Information: Erica Bush, email: ebush@umich.edu, or http://www.wdi.bus.umich.edu/events/.

Annual International Conference on Transition Economics
June 21-23, 2002, Riga, Latvia

This conference, organized by the Center for Economic Policy Research and WDI, will be hosted this year by the Stockholm Institute of Transition Economics and the Baltic Institute Center for Economic Policy Studies. The conference will take place at the facilities of the Stockholm School of Economics. The Scientific Organizing Committee consists of Erik Berglof, Gerard Roland, and Jan Svejnar.

The conference will provide a forum for leading economists and other social scientists working on transition and development issues to meet, present new research, develop collaborative relationships, and complete ongoing research. The conference will also bring together key policymakers in the region and researchers, facilitating discussion and the exchange of ideas. A special feature of this year's conference will be a panel exploring the similarities and differences between issues and methods for dealing with them in transition and development economics.

Information: Jessica Mason, email: jmason@cepr.org, or http://www.wdi.bus.umich.edu/events/.

Fourth Annual Conference on Financial Market Development in Emerging and Transition Economies
December 16-17, 2002, Santiago, Chile

This conference is organized by WDI with the School of Business of the Pontificia Universidad Catolica de Chile,

the Amsterdam Center for International Finance Research at the University of Amsterdam, and *International Review of Finance.*

Call for papers: Like our previous international workshops in Amsterdam, at the London Business School, and at the Hong Kong Institute of Science and Technology, this annual conference is a small gathering of researchers focusing on the evolution of financial markets and corporate finance practices in emerging and transition economies. We are interested in theoretical and empirical papers on topics that include market development, banking, the effects of the legal and contractual environment, privatization, international corporate governance and financing, corporate groups, international financial integration, political risk, and the impact of reform policy on financial markets. Many papers presented at our previous conferences have recently appeared in top journals. The conference committee consists of Prof. Enrico Perotti, University of Amsterdam; Dr. Anna Meyendorff, WDI; Prof. Eduardo Walker, Pontificia Universidad Catolica de Chile; and Prof. Sheridan Titman, University of Texas, Austin. The sponsors will provide travel grants for invited speakers. Papers should be sent by July 1 in electronic form to Erica Bush at ebush@umich.edu.

For information on the previous conferences on this theme go to http://www.fee.uva.nl/fm/cifra/cifra.htm.

If you would also like your paper to be considered for publication in the International Review of Finance, please send three copies along with a $50 submission fee to Sheridan Titman, Department of Finance, College of Business Administration, University of Texas, Austin, Texas 78712-1179, U.S A.; email· titman@mail.utexas.edu.

Conference Diary

For the Record

International Agribusiness Conference: Moving up the Food Chain and Adding Value
April 7-9, 2002, Kyiv, Ukraine

The Ninth Annual Agribusiness Alliance Conference took place in April at Congress Hall. The CNFA Agribusiness Alliance—a group of 200 U.S., European, and multinational organizations representing agribusiness functions varying from production to financing, marketing, and development assistance—hosted the conference, which considered strategies for expanding agriculture, trade, and investment opportunities in the rapidly developing business environment of the CIS. It was sponsored this year by Tetra Pak, Chumak, and Rise. The conference featured Ukrainian Prime Minister Anatoly Kinach and Vice Prime Minister Leonid Kozachenko.

The meeting provided a forum for more than 250 leaders of private enterprises, national governments, and multilateral organizations from the United States, Europe, and the CIS to engage in open, public dialogue, forge new market strategies, and share case studies of business ventures. According to Fredrik Svinhufvud, the managing director of Tetra Pak Ukraine "To satisfy consumer needs with high-quality products, companies must consider the whole value chain starting with raw material production. This conference gave a rare opportunity for experienced CIS business leaders to exchange innovative ideas and market insights that add value to each link of the chain."

The agenda included sessions on the emergence of food processing and retail food marketing sectors, corporate governance, input distribution, privatization, and land reform.

CNFA is a nonpartisan NGO dedicated to stimulating economic growth and development in the world's transitional and emerging economies. It was founded in the belief that opportunity and the incentive to earn a profit, inherent to private enterprise, are among the most potent, sustainable engines of development.

Information: Michael Kunz, tel : 1-202-296-3920, email : mkunz@cnfa.org.

Modernizing Government—Integrating Structural and Budget Reforms for a Better-Performing Public Sector
April 17-19, 2002, Melia White House Hotel, London

Information: Charlotte Ford, Marketing Executive, Adam Smith Institute, Westminster Tower, 3 Albert Embankment, London SE1 7SP, United Kingdom, tel.: 44-20-7735-6660, fax: 44-20-7793-0090, URL: www.adamsmithinstitute.com.

Forthcoming

Priority Environmental Projects for Accession (PEPA) Progress Meeting
June 10-11, 2002, Szentendre, Hungary

Topics: Long-term planning and financing strategies for meeting targets and obligations, anticipating and addressing problems with project implementation, the future role of the European Community in general and the PEPA program in particular, and others. The meeting will present successful case studies on topics such as project prioritization, state aid legislation, and investment by smaller municipalities. The meeting will include a number of break-out sessions and opportunities for delegates to talk together informally, both on general subjects and in relation to specific issues, such as PEPA's future role.

Information: Miroslav Chodak, Project Manager, Regional Environmental Center for Central and Eastern Europe, Ady Endre ut 9-11, 2000 Szentendre, Hungary; tel.: 36-26-504-000, fax: 36-26-311-294, URL: http://www.rec.org/

International Conference on Transition Economics
June 20-24, 2002, Riga, Latvia

Organizers: The Centre for Economic Policy Research, the Stockholm Institute for Transition Economics, and the Baltic International Centre for Economic Policy Studies (BICEPS) with The William Davidson Institute, University of Michigan.

Leading economists and other social scientists working on transition and development issues will meet to discuss new research and to interact with key policymakers in the region. A special feature of the event will be a panel exploring the similarities and differences between issues and approaches in transition and developing economics.

BICEPS is located in the historic art nouveau district of Riga in a complex of buildings that also houses the Stockholm School of Economics in Riga and the Riga Graduate School of Law. Riga, Latvia's capital, is a port city of just under 1 million inhabitants.

Information: Go to http://www. biceps.org.

Fourth Annual Bank Conference on Development Economics in Europe (ABCDE-Europe)
June 24-26, 2002, Oslo, Norway

Organized by the World Bank and hosted by the Norwegian government, the conference will discuss possibilities for boosting the fight against global poverty. The 300 participants include some of the world's leading development experts, as well as policymakers and NGO representatives. The speakers will include Jagdish N. Bhagwati of Columbia University; Ernesto Zedillo, former president of Mexico; Kwesi Botchwey, Harvard University; and Murasoli Maran, India's minister of industry and commerce. Major topics include trade policy, development aid and the millennium development goals, failed states, migration, and political economy of crisis and reform. Eighteen workshops will be organized by NGOs, research institutes, and academics. The full program is available at the conference's web site: http://www.worldbank.org/abcde-europe.

Information: World Bank Washington, D.C., Boris Pleskovic, tel.: 202-473-1062, email: bpleskovic@worldbank.org, World Bank Paris: Jean-Christophe Bas, tel · 331-40693000, email: bas@worldbank.org.

11th Conference of the International Association for the Economics of Participation: Participation Worldwide
July 4–6, 2002, Catholic University of Brussels, Belgium

Conference themes: The biannual International Association for the Economics of Participation conferences provide an international forum for presenting and debating current research and scholarship on the economics of participation. The major themes of the 2002 conference will be the following:

- Development and combination of forms of workers' participation around the world
- Theoretical and empirical studies on the economic and social effects of participation
- Workers' participation across borders in a transnational and global context
- Employee participation and EU enlargement
- Employee ownership in transition economies
- Workers' participation and social economy in developing countries
- Workers' participation, social dialogue, and civil society.

Information: Daniel Vaughan-Whitehead, Avenue du Pesage, 127, B-1050 Bruxelles, Belgium, email: Daniel.Vaughan-Whitehead@cec.eu.int.

Seventh North–Western Banking Conference
July 17-20, 2002, St. Petersburg, Russia

Topics: Clients and banks—from cooperation to partnership, which will include interaction between the banking

and industrial sectors; banks' participation in the restructuring of enterprises and the realization of regional projects; assisting industrial growth through trade and project finance instruments; attracting foreign capital; banks and the organization of companies' bonded debt; and other issues. Parallel sessions include legal regulation of banking activities (currency regulation and currency control, Federal Law on Counteraction to Legalization of Income Obtained through Criminal Means, loan security), leasing, and bank-to-bank relationships within Russia and the CIS.

The participation fee is $970, which includes accommodation at the St. Petersburg Hotel, meals, information materials, and an entertainment program (welcoming party, boat trip around the rivers and canals of St. Petersburg, a reception in one of the palaces). Confirm participation by June 15, 2002.

Language: Russian.

Information: Organization Committee, tel.: 812-1185344, 118-5342, fax: 812-1185341, e-mail: conference@psbank.spb.ru.

Unofficial Activities in Transition Countries: 10 Years of Experience
October 18-19, 2002, Zagreb, Croatia

This international conference will analyze the size, scope, causes, consequences, and policy implications of unofficial (illegal, unrecorded, unreported, informal, underground, hidden, shadow, parallel) activities in transition countries during the past decade. The conference aims to answer such questions as.

- Why have unofficial activities been so widespread in some transition countries and less important in others?
- How did this develop? What have the consequences been?
- Is some pattern or sequencing apparent in the development of unofficial activities connected with transition and reforms?
- If so, can we derive any policy recommendations from the experience of more advanced transition countries that could usefully be offered to those that have not gone as far along this road?

Prospective contributors are invited to submit an application, abstract, and *curriculum vitae* before May 31 and a final paper before September 30. Travel and accommodation expenses will be paid for the authors of papers selected for presentation depending on available funds.

Papers and abstracts should include keywords, full name and affiliation, address, email, and fax and phone numbers of the author. We strongly support email submissions. All papers must conform to standard journal style formats Please follow instructions provided on http://www.aeaweb.org/aer/styleguide.html.

Selected papers will be published in a special issue of the journal *Financijska teorija i praksa* and possibly in a conference volume.

Information: Katarina Ott, Institute of Public Finance, Katanciceva 5, 10000 Zagreb, Croatia; tel.: 385-1-4819363, fax: 385-1-4819365, email: kott@ijf.hr, URL: http://www.ijf.hr.

Marketing and Business Strategies for Central and Eastern Europe
December 5-7, 2002, Arcotel Hotel Wimberger, Vienna, Austria

This is the 10th annual conference of the Kellstadt Center for Marketing Analysis and Planning, DePaul University, Chicago, and the Department of International Business, University of Economics and Business Administration, Vienna.

Empirical research, case studies, or discussion sessions are sought that address such topics as comparative analysis of conditions of market entry in Central and Eastern European (CEE) countries, market entry through exports versus market entry via capital investment, acquisitions as opposed to joint ventures in CEE, marketing strategies to reach CEE consumers, marketing mix decisions for markets in CEE, financial strategies for opening CEE markets, and case studies of CEE experiences by Western firms.

Abstracts of the papers, in English, should be received by September 15, 2002. The final papers must be ready by November 1, 2002. For more information or to send abstracts contact either of the conference sponsors.

Information: Prof. Dr. Reiner Springer, Wirtschaftsuniversität Wien, Althanstr. 51, 1090 Vienna, Austria; tel.: + 43-1-313 36/4371, fax: + 43-1-313 36/751, email: Reiner.Springer@wu-wien.ac.at, or Prof. Dr. Petr Chadraba, Kellstadt Center for Marketing Analysis and Planning, DePaul University, 1 East Jackson Boulevard, Chicago, Illinois 60604; tel.: 312-362-6889, fax: 312-362-5647, email: pchadrab@depaul.edu.

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The World Bank in cooperation with SITE and WDI

Problems with Russia's Compulsory Screening for HIV/AIDS

By Kimberly Cartwright

Russian policymakers and health officials have become increasingly alarmed about the growing incidence of HIV infection. At the end of 2000, 51,952 new cases of HIV had been reported, a 258 percent increase over the previous year and a 1,183 percent increase over 1998. The chief of the Russian AIDS Center estimates that Russia will have 1 million cases by 2005; however, compulsory screening of the population does not seem to be a useful policy.

In 1995, in response to the growing number of HIV infections, the Russian government passed a law to prevent the spread of AIDS. The law serves as the basis for the Federal Anti-AIDS Program. However, a host of factors thwart these and other federally mandated laws and programs from working effectively, massive indifference persists among public and private health practitioners, and Russia has inadequate numbers of appropriately trained medical staff. In addition, at both the federal and regional levels, officials and practitioners adhere to earlier orders and policies that tended to reinforce common prejudices about people who contract HIV.

Thus it is no surprise that the architects of the federal law and federal programs have failed to allay the HIV epidemic. They attribute their failure to insufficient financing. This is certainly a factor. For three years the Russian government conducted stop-and-go negotiations with the World Bank to secure financing for its anti-AIDS programs. Several weeks prior to the scheduled date for a new round of negotiations, which ultimately did not take place at the request of the Ministry of Health, we conducted an institutional assessment of health care providers in Moscow and Nizhniy Novgorod for the World Bank.

Site visits and interviews revealed that the struggle to reduce the prevalence of HIV in Russia faces more fundamental problems than a lack of funds or of legal enforcement. Both federal and local government programs are doing a poor job of reaching high-risk groups. Instead, federal authorities—despite the 1995 law—still carry out compulsory mass screenings, including employer-based screenings for HIV and other sexually transmitted diseases. A significant proportion of the population—14 to 17 percent or 20 to 25 million people—was annually tested for HIV in the years following the 1995 repeal of mass screening anywhere from one to four times.

Why do the authorities continue to screen on what appears to be an ad hoc basis? Screening for sexually transmitted diseases has a long tradition in Russia, dating back to the late 1900s. Officials believe that by counting and identifying all HIV-infected individuals, even if this means violating their civil liberties, they will slow down the pace of new infections and eventually control the epidemic. They also believe that it demonstrates to the public that they are aggressively taking concrete measures to fight HIV/AIDS.

Compulsory screening of major population groups in Russia, however, should be discontinued for a number of reasons as follows:

- *Russia does not allocate enough resources for treating individuals with HIV/AIDS.* The long-term goal of screening programs is to detect diseases early on with the aim of reducing morbidity and mortality. For countries to achieve this goal they must have sufficient resources not only to detect, but also to treat infected individuals. Since the start of the HIV epidemic in the mid-1990s, the Russian government has been unable to provide sustained treatment to those already infected. In 2000 just 600 people were prescribed AZT cocktails at some point during their treatment.
- *HIV prevalence is still relatively low and universal screening is not a sensitive tool for detecting new HIV infections.* Of the 22 million people screened in 1999, just 18,707 (0.083 percent) were diagnosed as

HIV-positive. There is also the risk of a high number of false positive tests.

• *Compulsory screening may not be targeting high-risk populations.* Since the reporting categories are different from the mandatory screening groups, officials have no way of evaluating whether screening is targeting the right groups. Summarizing the achievements of the 1993-95 federal program, Ministry of Health authorities wrote: "Russia is the only country in the world where costly and ineffective population screening is practiced. Mandatory HIV screening is carried out on one-sixth of the total population on people who are not associated with a risk category. These people are being screened for HIV several times a year, while high-risk groups are not being screened. In reality, most of those infected with HIV who belong to a high-risk group voluntarily undergo anonymous testing."

• *Compulsory screening is expensive for the government.* According to Vadim Pokrovskiy, head of the Russian AIDS Center, the federal government spent approximately Rub 20 million ($714,000) for HIV testing programs in 2000, or 56 percent of the amount spent on all HIV/AIDS activities financed by the federal program.

• *Compulsory screening is expensive for citizens.* While the law guarantees free medical examinations in state health care institutions, most state health clinics charge patients and employers for HIV testing. The employers often pass such costs on to their employees. Based on the overall prevalence rate of 57 HIV cases per 100,000 population and the retail cost of testing of $2, identifying one HIV-positive case through employment-based screening could cost taxpayers $3,508. Private expenditure on HIV testing in 2000 amounted to about $93.5 million.

While $2 for an HIV test does not seem high for an individual, he or she is also required to pay to have blood drawn for syphilis testing, for bacterial testing of a minimum set of sexually transmitted diseases, and for a skin evaluation. As in most cases the HIV test is administered along with these other tests and a physician's examination, the HIV test ends up costing significantly more than the $2 test fee, with the total cost of testing ranging from $14 to $25 in Nizhniy Novgorod (prices based on four clinics) and $71 to $100 in Moscow (prices based on three clinics). Considering that the average monthly salary was $30 in Nizhniy Novgorod and $150 in Moscow at the time this study was conducted (April 2000), testing is a considerable expense for citizens to bear several times a year.

Kimberly Cartwright is a research associate with the Urban Institute. *Research for this article was supported by a grant to the World Bank from the U.K. Department for International Development and by the Urban Institute.* *For a complete listing of citations and methods used in the calculations contact the author at Kcartwri@ui.urban.org.*

Inertia Leads Nowhere: Moldova's Economy Needs Decisive Action

By Valeriu Prohnitchi

The first decade of transition from a planned economy to a market economy is nearly over in Moldova. This provides a good opportunity for analyzing economic developments in the country. While Moldova has accomplished much in relation to political and human rights, freedom, and democracy, an extensive review of the current economic situation presents a bleak picture.

Moldova's economic deficiencies are partly explained by the initial conditions inherited from the former totalitarian regime and by Moldova's deep integration into the hyper-centralized Soviet economic system. While the Soviet economy was relatively developed, its politico-ideological fundaments were erroneous and fragile. All the components of economic activity—production, distribution and redistribution, and even consumption—were strictly controlled and guided by Moscow. Moldova had no economic and trade relations with other countries except through the Soviet Union. This is why during the initial stages of transition Moldova found that it lacked stable export markets, established trade partners, and external marketing skills.

While the Soviet economic legacy was indeed burdensome, one cannot invoke the inherited structural distortions as the main cause of Moldova's economic failures. This is confirmed by the economic performance of the

Baltic states. Even though these countries were even more integrated into the Soviet economy and more dependent on Eastern markets, unlike Moldova, they have succeeded in capitalizing on their political independence to create the conditions necessary for economic prosperity.

In Moldova, the political and social instability and the extensive corruption, both associated with an unattractive business climate, undermined various attempts at reform, and the hesitant leadership's lack of management skills became apparent. The fact that the government changed 8 times in 11 years made matters worse.

Moldova Needs Foreign Support

After one year in office, the Communist Party of Moldova (CPM) is facing a number of potentially difficult challenges. One such challenge is the deteriorating fiscal situation. In January government revenues were 15 percent below target, and on February 1 Prime Minister Vasile Tarlev told union leaders that there was no money to pay wage arrears to public sector employees, in particular, to teachers and doctors. There are also some positive developments. The GDP growth rate accelerated to 6 percent last year, and the CPM has grudgingly accepted the idea that poverty reduction and economic improvement need continued market-oriented reforms.

Foreign investment would help, but Moldova's last major privatization was two years ago. During the CPMs first year in office it demonstrated its reluctance to privatize, though the government will soon choose an adviser to sell wineries and has passed a law governing the sale of tobacco facilities. Selling fixed-line monopoly Mold-telecom and two energy distributors would help to restore international confidence, although the most serious interest is likely to come from Russian and Ukrainian investors rather than from Western investors. In February the government published a list of 24 companies earmarked for renationalization, including the U.K./U.S./Romanian pharmaceuticals joint venture Farmaco. The government claims most of these companies did not meet the conditions laid out in the privatization contracts.

On April 30 Tarlev announced that international lending agencies may resume aid to Moldova in June, disbursing up to $130 million by the end of the year. The World Bank and IMF froze lending to Moldova last year because of concerns about the slow pace of reform. Tarlev, who met with senior World Bank and IMF officials during a visit to Washington, disclosed that the World Bank Board plans to debate the $30 million third Structural Adjustment Credit to Moldova on June 18. Moldova could receive the first tranche of the loan in late June or early July. The World Bank previously made it clear that it will not release the $30 million credit until the government pushes on with privatization, market liberalization, poverty alleviation, and so on. This means selling energy, telecommunications, and winery companies; maintaining an independent energy regulator; and liberalizing access to the Internet. Until that happens, the IMF, for its part, will not resume its $142 million Poverty Reduction and Growth Facility Program.

The IMF suspended cooperation with Moldova last year, after disbursing $25 million of its $142 million lending program. An IMF mission visited Chisinau in March in an effort to revive cooperation. Even though inflation fell from 18.4 percent in 2000 to 6.3 percent last year, the IMF is concerned about fiscal stability, and in particular, the sustainability of the 2002 budget. Other concerns include Moldova's new Civil Code, intended to replace the Soviet code and create a legal environment more conducive to business. An IMF mission is due to arrive for an economic review in May.

Foreign funds are vital to prevent economic collapse and help the country avoid defaulting on its foreign debt. The government must pay $200 million to service foreign debts this year, including the principal on $75 million of Eurobonds in June. This amounts to about 70 percent of Moldova's budget. Before 2000 Moldova's debt repayments amounted to around 10 percent of its budget, rising to 42 percent last year. Moldova's debt currently amounts to $1.5 billion, or 105 percent of GDP, mostly owed to the IMF, the World Bank, the Paris Club of sovereign creditors, and Russia (to which Moldova owes some $300 million for energy).

If no debt restructuring or external assistance is forthcoming, the government is likely to rely in the first instance on central bank financing to meet its debt obligations. Once it has exhausted this option, a default seems likely later in the year.

Excerpted from reports of the international research group Oxford Analytica, Oxford, U.K. (see http://www.oxan.com/index.html) and Reuters and World Bank sources.

The Giurgiulesti oil terminal was supposed to have been built by 1999 on the Moldovan portion of the Danube River. It was not, and its fate is still uncertain. Senior public officials have been involved in scandalous corruption affairs. The Air Force lost 30 military aircraft, not in war, but because they were sold illegally. In addition, Moldova has failed to diversify its energy suppliers. In 1994 and 2000 the government refused repeatedly to contribute anything to the construction of a second reactor at Romania's Cernavoda nuclear power plant.

Although some positive developments in monetary and commercial policy took place, by and large Moldova's social and economic transition has failed. In 2000 GDP was about one-third of its 1989 level. Based on official statistics that indicated a 6.1 percent real GDP increase (in constant prices) last year, Moldova would require 17 to 18 years of similar average annual growth just to return to its 1989-90 output level. Plunged into huge internal and external debts, the economy needs to perform extremely well if Moldova wishes to honor its obligations. While official unemployment is no more than 2 percent, estimates suggest that the real figure is around 15 to 17 percent, an assessment indirectly confirmed by the massive exodus of citizens looking for better jobs abroad.

The economy is negatively affected by structural distortions. Only a few other European countries are as highly dependent on agriculture (30 to 35 percent of GDP), which in turn implies an overwhelming dependence on climatic factors. At the same time, the share of the population employed in agriculture is considerably higher than the agrarian sector's contribution to GDP. Hence labor productivity is low in this sector, which is not yet market oriented, and remains mainly a source of subsistence for the rural population. Industry is inefficient, mainly because of obsolete technology and worn out equipment, as well as archaic or nonexistent marketing systems.

The lack of physical infrastructure, underdeveloped institutions, and highly asymmetric market information impede normal, transparent market flows. The state still retains a large monopoly in acquiring agricultural produce and farmers are compelled to accept excessively low prices. The local market is limited, but access to external markets is difficult because Eastern markets are unstable, while European ones are closed to merchandise that does not reach Western quality standards. The well organized, sometimes transnational, criminal gangs and racketeers whose networks give them underground control of the national economy represent another critical factor in relation to production and distribution.

During these years of profound transformation marked by enormous social costs, Moldova has missed many of its initial opportunities—such as integrating into the EU, diversifying its external markets and energy suppliers, and capitalizing on the commercial opportunities from gaining "Danube country" status—and moved forward only through inertia. European integration is no more than a rhetorical exercise used during election campaigns and is not a real concern of political elites and of civil society, as was signaled again by the communists' victory during the last general elections in February 2001. The current leaders are more preoccupied by Moldova's integration into the Eurasian Economic Community than into the EU. The impressive political ascension of the communists, riding high on a wave of nostalgia, followed widespread disappointment with the previous leadership, which was protecting its own interests without capitalizing on the population's initial enthusiasm for reform.

The blame for Moldova's economic failures should not be laid only on its weak, inefficient, and meagerly financed public institutions. Much of the responsibility lies with civil society, which is indifferent and lacks initiative. Moldova has only a few think-tanks, concentrated in the capital, that focus on economic issues, and there are no discussions between public agencies and civil society organizations about national economical strategies, while classical economic theory has demonstrated that private initiative is the main engine of any prosperous society. The country's future success will depend on well thought out, decisive actions and personal courage, a success that could propel Moldova into becoming an equal member of the family of European nations.

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New Books and Working Papers

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

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technological change goes hand-in-hand with economic growth, coupled with a tendency for the better-off to assimilate new technology ahead of the poor.
To order: Hedy Sladovich, room MC3-311, tel.: 202-473-7698, fax.: 202-522-1154, email: hsladovich@worldbank.org.

Jocelyn A. Songco, **Do Rural Infrastructure Investments Benefit the Poor? Evaluating Linkages: A Global View, A Focus on Vietnam,** WPS 2796, February 2002, 59 pp.
To order: Herawaty Sutrisna, room MC9-242, tel.: 202-458-8032, fax.: 202-522-1556, email: hsutrisna@worldbank.org. The author may be contacted at jas494@columbia.edu.

Dimitri Vittas, **Policies to Promote Saving for Retirement: A Synthetic Overview,** WPS 2801, March 2002, 35 pp.

Vittas argues that public and private pillars are essential for a well-functioning pension system. Public pillars, funded or unfunded, offer basic benefits that are independent of the performance of financial markets. As financial markets suffer from prolonged, persistent, and large deviations from long-term trends, they cannot be relied on as the sole provider of pension benefits. Funded pillars provide benefits that are based on long-term capital accumulation and financial market performance, but they need to be privately managed to minimize dependence on public sector institutions and avoid government dominance of the economy and financial markets.

The creation of a dual regulatory structure would allow greater individual choice. One part would involve heavy regulation with constrained choice of investment funds, limits on operating fees and on account switching, and strong government safeguards and guarantees. This would cater to those workers with low risk tolerance. The other part would be more liberal, but would be based on strong conduct rules. It would offer a greater choice of investment funds, allowing multiple accounts and liberal account switching, imposing no limits on operating fees, and providing no or fewer state guarantees. This would cater to workers seeking a higher return who are willing to tolerate a higher level of risk.
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Benoît Bosquet, **The Role of Natural Resources in Fundamental Tax Reform in the Russian Federation,** WPS 2807, March 2002

The Russian Federation has one of the richest natural resource endowments in the world. Despite their importance in the Russian economy, natural resources do not contribute as much as they could to public revenues. Large resource rents (excess payments or above normal profits generated by natural resources in scarce supply) are dissipated through subsidies and wastage or are appropriated by private interests. Failure to tax this rent means levying taxes elsewhere (on capital and labor) to sustain revenues, thereby depressing investment and employment, or foregoing potential revenues. Failure to reinvest rent means that Russia perpetuates the tradition of exporting low value added raw materials and excessive capital outflows and retards its transition to sustainable economic development. The total appropriated rent on oil and gas was estimated at $9 billion in 1999 (in excess of $15 billion in 2000), or about 18 percent of consolidated tax revenues.

A more appropriate natural resource taxation system would enhance the fiscal role of natural resources and improve incentives for resource conservation and environmental protection. The state still owns most natural resources, which theoretically facilitates changing resource pricing and taxation. The cost of adjusting the tax system is relatively low at this time, because Russian tax policy is undergoing thorough reform. A seemingly desirable instrument—true differentiation of rental payments—does not exist in Russia despite legislative provisions that it should. Several natural resource taxes are specific taxes (set per volume), regardless of the market price or production cost. Such taxes favor profitable deposits and penalize marginal ones.
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Andrew Powell, **A Capital Accord for Emerging Economies?** WPS 2808, March 2002, 39 pp.
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Robert D. Ebel and Serdar Yilmaz, **On the Measurement and Impact of Fiscal Decentralization,** WPS

2809, March 2002, 26 pp.
To order: Michelle Morris, mail stop J4-403, tel.: 202-473-7285, fax.: 202-676-9810, email: fiscal_decentralization@worldbank.org.

Scott Wallsten, **Does Sequencing Matter? Regulation and Privatization in Telecommunications Reforms,** WPS 2817, April 2002, 21 pp.

In the early 1990s many Western advisers encouraged Eastern European countries and the former Soviet Union to privatize firms quickly under the assumption that market institutions would develop once firms were privately owned. The thinking since then has emphasized the importance of establishing an institutional framework conducive to promoting competition *before* privatizing firms. To date, little empirical work has clarified the debate. Consistent with current thinking, Wallsten finds that countries that established separate regulatory authorities prior to privatization saw increased telecommunications investment, fixed telecommunications penetration, and cellular penetration compared with countries that did not. Moreover, he finds that investors are willing to pay more for telecommunications firms in countries that established a regulatory authority before privatization. This increased willingness to pay is consistent with the hypothesis that investors require a risk premium to invest where regulatory rules remain unclear.
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Leora F. Klapper and Inessa Love, **Corporate Governance, Investor Protection, and Performance in Emerging Markets,** WPS 2818, April 2002, 32 pp.
To order: Agnes Yaptenco, room MC3-446, tel.: 202-473-1823, fax.: 202-522-1155, email: ayaptenco@worldbank.org. The authors may be contacted at lklapper@worldbank.org or ilove@worldbank.org.

Shantayanan Devarajan, Margaret J. Miller, and Eric V. Swanson, **Goals for Development: History, Prospects, and Costs,** WPS 2819, April 2002, 38 pp.

The millennium development goals set quantitative targets for poverty reduction and improvements in health, education, gender equality, the environment, and other aspects of human welfare. At existing rates of progress many countries will fall short of these goals. However, if developing countries take steps to improve their policies and increased financial resources are made available, significant additional progress toward the goals is possible. According to the authors, $40 billion to $70 billion in additional assistance per year is necessary, which would roughly represent a doubling of official aid flows over their 2000 levels.
To order: Susan Brickland, room G8-015, tel.: 202-473-0944, fax.: 202-522-3235, email: sbrickland@worldbank.org. The authors may be contacted at sdevarajan@worldbank.org, mmiller5@worldbank.org, or eswanson@worldbank.org.

Igor Artemiev and Michael Haney, **The Privatization of the Russian Coal Industry: Policies and Processes in the Transformation of a Major Industry,** WPS 2820, April 2002, 28 pp.

In the early 1990s the Russian Federation implemented mass privatization with swift ownership changes in many industries. A notable exception was the coal sector, once the world's largest, which was in deep crisis and unable to function without massive subsidies. The government undertook a far-reaching program of sectoral restructuring, closing heavily loss-making mines and cutting subsidies. The positive impact of the restructuring program led to a slow but sustained improvement in the coal industry's attractiveness to private investors. By the end of 2001 private operators accounted for some 77 percent of coal output.
To order: Victoria Joseph, room I9-031, tel.: 202-473-2155, fax.: 202-522-2029, email: vjoseph@worldbank.org. The authors may be contacted at iartemiev@worldbank.org or mhaney@worldbank.org.

Nicholas Minot and Bob Baulch, **The Spatial Distribution of Poverty in Vietnam and the Potential for Targeting,** WPS 2829, April 2002, 43 pp.
To order: Rina Bonfield, room MC3-354, tel.: 202-473-1248, fax.: 202-522-3518, email: abonfield@worldbank.org. The authors may be contacted at n.minot@cgiar.org or b.baulch@ids.ac.uk.

Lodovico Pizzati, **Labor Market Implications of Switching the Currency Peg in a General Equilibrium Model for Lithuania,** WPS 2830, April 2002, 24 pp.

On February 2, 2002, Lithuania switched its currency anchor from the dollar to the euro. While pegging to the dollar (since April 1994) has proven successful throughout the transition years, the recent decision to peg to the euro was motivated by the increasing trade relations with European economies. Pizzati does not argue which peg is more appropriate, but analyzes the implications of changing the exchange rate regime for different sectors and labor groups.

While pegging to the euro entails more stability for the export sector, Lithuania is still more dependent on dollar-based imports of primary goods from the CIS than on imports from other Baltic countries or from the Central European economies. Simulation results suggest that while a euro peg will provide more stability to GDP and employment, it will also imply more volatility in prices, suggesting that under the new peg macroeconomic policy should be more concerned about inflationary pressures than before. From a sector-specific perspective, pegging to the euro will provide a more stable demand for unskilled-intensive manufacturing and commercial services, but other sectors, such as agriculture, will still face the same vulnerability to exchange rate movements. This suggests that additional policy measures may be needed to compensate for sector-specific divergences.
To order: Lodovico Pizzati, room H4-214, tel.: 202-473-2259, fax.: 202-614-0683, email: lpizzati@worldbank.org.

Adam Wagstaff and Nga Nguyet Nguyen, **Poverty and Survival Prospects of Vietnamese Children under Doi Moi,** WPS 2832, April 2002, 35 pp.

By international standards, and given its relatively low per capita income, Vietnam has achieved substantial reductions in, and low levels of, infant and under-five mortality. New evidence shows that under the economic liberalization program known as Doi Moi, this reduction in child mortality has been sustained, but the gains have been concentrated among the better-off. As a result, socioeconomic inequalities in child survival are evident in Vietnam—a change from the early 1990s when none were apparent. The lack of progress among the poor will jeopardize Vietnam's chances of achieving the international development goals for child mortality. The authors examine various policy scenarios, including expanding the coverage of health services, water, and sanitation, and find that such measures, while useful, will have only a limited effect on the mortality of poor children. They find that programs aimed at narrowing the gap between the poor and better-off may have large beneficial effects on the various determinants of child survival.
To order: Hedy Sladovich, mail stop MC3-311 , tel.: 202-473-7698, fax.: 202-522-1154, email: hsladovich @worldbank.org. The authors may be contacted at awagstaff@worldbank.org or nnga@worldbank.org.

Asad Alam and Mark Sundberg, **A Decade of Fiscal Transition,** WPS 2835, May 2002, 27 pp.

Transition literature has emphasized stabilization and enterprise restructuring. Both cross-country analyses and country-specific studies have tended to focus on fiscal stabilization and its indicators, highlighting the importance of quantitative fiscal adjustment to stabilization outcomes. Less attention has been paid to the qualitative dimensions of fiscal adjustment in transition.

The authors conclude that while the quantitative magnitude of the fiscal adjustment was dramatic, the quality of this adjustment has compromised the social and economic objectives of transition, particularly in the CIS. They draw four main conclusions, namely:

- Investments in public services fell in both absolute and relative terms.
- Reduced spending on government transfers contributed to a sharp increase in income inequality in the CIS.
- Fiscal risks increased during the transition
- Initial conditions allowed the Central European and Baltic countries to maintain higher expenditures, which may have contributed to their faster economic recovery and political support for reforms.

The authors argue that the challenge today for fiscal policy in these countries is to facilitate the transition, particularly in reallocating resources from large state-owned enterprises to new small and medium firms and providing priority public services and targeted transfers to assist those adversely affected by transition and reverse the deterioration in social outcomes
To order: Alison Panton, room H4-156, tel.: 202-458-5433, fax.: 202-522-2751, email: apanton@worldbank.org. The authors may be contacted at aalam@worldbank.org or msundberg@worldbank.org.

Bob Baulch, Truong Thi Kim Chuyen, Dominique Haughton, and Jonathan Haughton, **Ethnic Minority Development in Vietnam: A Socioeconomic Perspective,** WPS 2836, May 2002, 25 pp.
To order: Emily Khine, room MC3-301, tel.: 202-473-7471, fax.: 202-522-3518, email: kkhine@worldbank.org. Jonathan Haughton may be contacted at jhaughto@beaconhill.org.

David Dollar, **Reform, Growth, and Poverty in Vietnam,** WPS 2837, May 2002, 33 pp.

Vietnam grew rapidly in the 1990s, and yet by many measures its economic institutions are poor. Between the 1980s and 1990s Vietnam carried out significant economic reforms, notably, stabilization, the introduction of positive real interest rates, trade liberalization, and initial property rights reform in agriculture, but unless it undertakes further reforms the country's high growth rate will decelerate. Vietnam's policies have

improved a good deal, but are still rather poor in comparative perspective. A comparison of governance indicators, financial sector issues, and the infrastructure of international integration reveals serious institutional weaknesses in Vietnam that need to be addressed if a high growth rate is to be sustained.
To order: Emily Khine, room MC3-301, tel.: 202-473-7471, fax.: 202-522-3518, email: kkhine@worldbank.org. The author may be contacted at ddollar@worldbank.org.

Paul Glewwe and Phong Nguyen, **Economic Mobility in Vietnam in the 1990s,** WPS 2838, May 2002, 26 pp.

Vietnam's high economic growth in the 1990s led to sharp reductions in poverty, yet during the same period inequality increased. This increased inequality may be less worrisome if Vietnamese households experience a high degree of income mobility over time. This is because high mobility implies that the long-run distribution of income is more equally distributed than the short-run distribution, as some individuals or households are poor in some years, while others are poor in other years. Authors examine economic mobility in Vietnam using recent household survey panel data.
To order: Emily Khine, room MC3-347, tel.. 202-473-7471, fax.: 202-522-3518, email: kkhine@worldbank.org. Paul Glewwe may be contacted at pglewwe@dept.agecon.umn.edu.

Other World Bank Publications

Roger Halsey, **The Role and Effectiveness of Development Assistance: Lessons from World Bank Experience,** World Bank Research Paper, March 2002.

Foreign aid is increasingly a catalyst for change, making it possible for poor people to increase their incomes and to live longer, healthier, and more productive lives. Better allocation of aid since the end of the Cold War means that it is more effective today at reducing poverty than ever before. Nevertheless, while human development has proceeded on an unforeseen scale, progress has not been uniform across the globe, nor has development assistance always been fully effective. AIDS reduced life expectancy in Sub-Saharan Africa by three years in the 1990s, and average incomes in the region have been stagnant since 1965. Many of the transition economies of Eastern Europe and Central Asia also suffered through sharp rises in poverty in the 1990s. Some of the earlier structural adjustment programs of the 1980s paid insufficient attention to countries' commitment to reform, to address governance issues, to institution building, and to mitigate social impacts. According to the study, the development experience of the last 50 years suggests that neither the central planning approaches of the 1950s and 1960s nor the minimal government, free market approach of the 1980s and early 1990s will achieve broad poverty gains. Instead, effective approaches to development must be country-owned. While the private sector is the engine of growth, governments must provide a sound governance framework, help to create a functioning physical infrastructure, and enable investments in people. These elements are key to growth and poverty reduction, and can be greatly enhanced by external assistance. *(For the full text see: http://econ.worldbank.org/view.php?type=5&id=13080.)*

World Development Indicators 2002 (print edition and CD-ROM)

Now in its sixth edition, *World Development Indicators,* the World Bank's respected statistical publication, presents the most current and accurate information on global development on both a national level and aggregated globally. This information allows readers to monitor the progress made toward meeting the goals endorsed by the United Nations and its member countries, the World Bank, and a host of partner organizations in September 2001 in their millennium development goals.

The 400-page print edition of *World Development Indicators* 2002 allows readers to consult more than 80 tables and 600 indicators for 152 economies and 14 country groups, as well as basic indicators for a further 55 economies. Key indicators for the latest year available, important regional data, and income group analysis are also provided. In addition, six thematic presentations of analytical commentary cover World View, People, Environment, Economy, States and Markets, and Global Links.

The CD-ROM version contains 40 years of time series data for more than 200 countries from 1960-2000, single-year observations, and spreadsheets on many topics. It contains more than 1,000 country tables and the text from the *World Development Indicators* 2002 print edition and the *World Bank Atlas 2002.* The Windows®–based format permits users to search for and retrieve data in spreadsheet form, create maps and charts, and fully download them into other popular software programs for study or presentation purposes.

Stoyan Tenev and Chunlin Zhang, **Corporate Governance and Enterprise Reform in China: Building**

the Institutions of Modern Markets, International Finance Corporation, 2002, 190 pp.

As China continues in its evolution from a planned economy to a market economy and from an agricultural to a manufacturing and service-oriented economy, issues arising from owner diversification, corporate governance, and labor resource allocation have come to the forefront. In particular, the focus is on corporate governance as the state continues its withdrawal from direct ownership.

Harry G. Broadman, ed., **Unleashing Russia's Business Potential: Lessons Learned from the Region for Building Market Institutions,** World Bank Discussion Paper 434, 2002, 116 pp.

Currently many new businesses are being established in the larger urban areas. It is critical that similar new businesses develop at the regional level. This book, based on in-depth case studies of more than 70 companies across 13 regions in Russia, addresses four areas key to institutional development. These include interenterprise competition and policy at the local level, the regulatory regime governing local infrastructure services, access to corporate finance in regional markets, and the legal system for resolving commercial disputes. The publication outlines policy recommendations for each of the areas analyzed.

Gérard Rousselot-Pailley, **Guide to the European Union, 2001-2002**, Roupater, Brussels, Belgium, February 2002, 300 pp.

This guide is a survey of current EU affairs. It takes stock of the previous year's events (2000-2001) and considers the main themes of European activities likely to figure large on the agendas of EU institutions in the coming year (2002)
To order: Roupater, Rue de la Mutualité, 41, B-1190 Brussels; tel.: 322–3477671, fax: 322-3477674, email: gerard.rousselot@chello.be

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Axel Brüggemann and Thomas Linne, **Are the Central and Eastern European Transition Countries Still Vulnerable to a Financial Crisis? Results from the Signals Approach,** No 5/2002 24 pp.

The aim of paper is to analyze the vulnerability of the Central and Eastern European accession countries, as well as of Russia, to a financial crisis. Crises in Central and Eastern Europe are caused by much the same "suspects" as in others emerging markets, in particular, an overvalued exchange rate. Weak exports and dwindling currency reserves have good predictive power for assessing crisis vulnerabilities.

Marketta Järvinen, **Exchange Rate Regimes and Nominal Convergence In The CEE Countries,** No 4/2002, 40 pp.

In the context of future European Monetary Union membership of the Central and Eastern European countries. This paper examines the interaction between fiscal policy and the price level in different exchange rate regimes. The theoretical framework is based on the fiscal theory of the price level. The results show that a credibly fixed exchange rate is inconsistent with fiscal irresponsibility. Adopting the common currency enables the conduct of irresponsible policies with the result that a rise in the level of debt by one member country raises the common price level of the whole union. Furthermore, no exchange rate regime in itself is sufficient to impose responsible fiscal policy, and commitment by the authorities to conduct such policies is also needed.

Jouko Rautava, **The Role Of Oil Prices And The Real Exchange Rate In Russia's Economy,** No 3/2002

Most people seem to think that Russia's economy and fiscal situation are still crucially tied up with international oil prices and the exchange rate of the ruble, although this view has recently been challenged by some analysts. Analyzing the impact of international oil prices and the real exchange rate on Russia's economy and fiscal policy for the period 1995–2001, the author concludes that in the long run a 10 percent permanent increase (decrease) in international oil prices is associated with a 2.2 percent growth (fall) in the level of Russian GDP. Respectively, a 10 percent real appreciation (depreciation) of the ruble is associated with a 2.4 percent decline (increase) in the level of output. It confirms the dependence of Russia's fiscal revenues on output and oil price fluctuations.

Other Publication

Diane Piazolo, **The Integration Process between Eastern and Western Europe,** Kiel Studies 310, Springer Publication, Berlin 2001

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