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The Enron Crisis: Some Lessons for Transition Economies

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By Adolf Enthoven

The collapse of Enron Corporation, the seventh largest corporation in the United States, is the largest bankruptcy case in U.S. history. Shareholders, employees, retirees, and others lost more than $60 billion, and Enron's shares have dropped to less than 1 percent of their recent high value. If the necessary regulations and safeguards had been in place, this could have been prevented. It will undoubtedly result in stricter economic, financial, and accounting regulations, especially for the capital markets. While the issues to be dealt with have a U.S. focus, transition economies and their professional and governmental bodies can draw their own conclusions on how to deal with such issues in their respective socioeconomic environments. All the more so because they often look to the U.S. accounting and financial regulatory frameworks as models to be emulated.

The Enron case reflects the loopholes that the company–and presumably its top management (in conjunction with financial institutions, its outside auditors, and its legal counsel)—were able to exploit and the excesses they engaged in at the expense of numerous stakeholders. It is not a pretty picture. Abuses of certain generally accepted accounting principles and procedures should have been caught internally and by internal and external auditors. Internal control, a critical element of accounting, was deficient. The unethical conduct of many executives, members of the Board of Directors, outside accountants, financial analysts, and banks involved does not reflect well on certain facets of American capitalism. As Professor Paul Krugman wrote in the *New York Times*: "It takes the lid off crony capitalism."

Transition economies, which are currently developing their own financial, accounting, legal, and economic regulatory

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Contents

frameworks as an underlying element for sound capital formation and economic progress, might learn from this case, which brought several critical issues to the forefront.

Genuine Transparency Is Required

Enron's financial statements were neither clear nor open, and were misleading, or even deceptive. Both the company and its outside auditors appear to be the culprits. By creating hundreds of so-called special purpose entities (limited partnerships), Enron kept debts off the company's consolidated balance sheets and income statements. It used these special purpose entities as vehicles to raise capital for Enron without adding debt to its financial statements, which would have dragged down its credit rating. Enron's 2000 annual report lists more than 3,000 subsidiaries, including over 300 special purpose entities and 900 offshore subsidiaries and partnerships (used in part to eliminate U.S. income tax liability). The company has not paid any U.S. federal income tax for the last four years. Harvey Pitt, chairman of the Securities and Exchange Commission (SEC), characterized Enron's financial statements as "dense and impenetrable." Enron also had billions of dollars of outstanding derivative contracts that were not properly disclosed. To protect shareholders, the antidote is to keep the capital market—including the stock markets—transparent.

Stronger Government Oversight Is Necessary

As a consequence of the Enron debacle, government oversight of both the accounting profession's self-regulation and the rules for corporate disclosures are likely to be greatly strengthened, presumably mainly by means of the SEC. The SEC, established after the 1933/34 depression, has already proposed creating an accounting disciplinary body to overhaul the existing system of accounting oversight. The accounting profession, headed by the American Institute of Certified Public Accountants (AICPA), clearly does not have the power or the influence to regulate its member bodies. The Public Oversight Board, established by the profession to review and watchdog the accounting bodies, has done little so far. As expected, when reviewing other firms' audit reports (peer reviews), accounting firms have tended to give them passing marks. Thus to date, self-regulation and peer review have been ineffective.

The existing accounting model and prevailing accounting and auditing standards and principles may well be reviewed following Enron's exposure of their weaknesses. Accounting statements should give stakeholders a clear picture of a firm's operations as well as of its financial structure. Joseph Berardino, chief executive of Arthur Andersen, Enron's auditing firm, admitted that: "Our financial reporting model is broken. It is out of date and unresponsive to today's new business model, complex financial structures, and associated business risks."

Although extensive government oversight and basic regulations are undoubtedly warranted, under a proper structure that includes government oversight, the accounting profession might well be able largely to self-regulate itself. Pure government handling of these activities is neither desirable nor effective, because it would result in a political process, thereby involving people without the necessary knowledge and insight. International accounting bodies, such as the International Federation of Accountants and the International Accounting

Standards Body, could help shape the final outcome.

Sources of Conflicts of Interest Should Be Eliminated

Conflicts of interest may arise between a company and its accounting firm, because the accounting firm is often highly dependent on the company's income. In addition, the accounting firm may perform lucrative management services for the company, or also be responsible for internal auditing, as happened at Enron. Furthermore, banks and financial analysts may have an interest in painting a good picture of the company's position, because negative reports may hamper their relations with the company. (Financial analysts recommend selling for only about 1 percent of all the stocks they handle.) Thus financial analysts tend to be instrumental in pushing and inflating the value of their clients' stock. In October 2001, 16 out of 17 securities analysts listed Enron as a buy or strong buy. Finally, members of boards of directors generally have personal, financial, or consulting relationships with the corporations on whose board they sit.

Faced with strong pressure for deregulation from many members of Congress, the SEC loosened accounting standards, in particular, by allowing accounting firms to enter into consultancy relationships with the companies that they audit, which potentially decreases the auditor's independence, and could therefore compromise the overall integrity of audited financial statements. Information technology consulting generated approximately half of accounting firms' revenues. In 2000, then SEC Chairman Arthur Levitt tried to ban auditors from providing their clients with information technology and consulting services and from conducting internal audits for their clients. KPMG, Deloitte and Touche, Arthur Andersen, and the AICPA opposed that effort, threatening to go to court to block the SEC. Ultimately they got lawmakers to pressure Levitt to back off. However, as a consequence of the Enron scandal, the auditing industry appears to be dropping its once intense hostility to restrictions on its consulting business.

Cooking the Books in Hungary

In December 2002 Hungary's special police commando unit arrested fugitive auditor Agnes Kalacsi, a primary suspect of helping dozens of companies manufacture fake invoices for tax evasion purposes. Her Ukrainian bodyguards did not intervene. Together with her Ukrainian partners, she was running an auditing business, allegedly with Mafia connections.

Since the transition process started, a series of large scandals related to privatization have surfaced, especially in the evaluation of the assets of privatized enterprises. On many occasions the auditors colluded with the buyers to artificially underestimate the value of the company for sale. This suspicion was raised by the sale of the big hotel chains, HungarHotels and Taverna. The auditors were fired, but no formal charges were filed. As the police point out, catching auditors committing unlawful acts is extremely difficult and according to Hungarian law, auditors are entitled to keep information related to the finances of the audited company confidential. Auditors have to decide whether the company's accounting practices are endangering the public interest. As their responsibility is not clear, in most cases the maximum sanction is their dismissal. This was the case in 1993, when the shareholders of Hungarian Airlines voted to cut ties with PriceWaterhouseCoopers' Budapest Office. They charged the accounting company with having too cozy a relationship with the management and with a "lax attitude" in evaluating the airline's 1992 financial report.

On a larger scale Deloitte and Touche (auditors of the locally-owned Prudentia Auditing and Advisory Company), are charged with being accomplices of Postabank's former management under chief executive officer Gabor Prinz. Postabank's 1996 and 1997 annual reports were falsified, shareholders—among them the biggest one, the state—were misled. Postabank, the fourth largest commercial bank in Hungary in the 1990s, accumulated huge debt, that only came to light as a result, the newly elected government's large-scale investigation in 1998. The responsibility of Arthur Andersen auditors, who were also reviewing Postabank's reports, has been raised as well. Gabor Prinz was forced to resign and took refuge in Vienna. The government had to consolidate Postabank with a huge capital injection. In an ongoing court case the government is demanding Ft 170 billion (about $60 million) compensation from the auditors, Deloitte and Touche, Arthur Andersen, and Prudentia.

Based on Agnes Gyenis' article in the Hungarian World Economy Weekly.

Many companies retain the same auditors indefinitely, and an additional government requirement may well be that each company change its auditors every five years or so, while in the intervening years the partners are rotated.

While auditors are supposed to assure the public that a corporation's financial statements accurately reflect its condition—and as independent watchdogs should do their best to make sure investors can trust corporate financial statements—such reporting may be compromised because of external pressures and pressures exerted by the company being audited. In the case of Enron this situation applied to the special purpose entities, which created vehicles for getting access to more capital and increasing leverage without adding debt to the balance sheet.

Conflicts of interest can also arise on the part of banks and other financial entities as, for example, in Enron's case, where both Citigroup and J.P. Morgan Chase provided extensive financing for Enron's intricate and misleading financial structure. In recent years both have earned tens of millions of dollars in fees from the company for a variety of banking and investment banking services. Now each is likely to be writing off hundreds of millions of dollars in losses from loans to Enron and related entities that the company cannot pay back.

The 1933 Glass-Seagall Act legally separated the lending business from investment banking services, such as handling the issuance of securities, because the financial turmoil of 1929 was partly attributed to the fact that the two activities were intricately interwoven. However, Congress repealed this law in 1999. It could now face new pressure to reestablish some restrictions on or oversight of mixing commercial banking and investment banking.

The Enron case is not, as yet, a political scandal, but essentially an accounting, financial, and ethical scandal. However, donating sizable sums of money to political parties, as Enron did, is a means of buying influence. The legality of all this may also become more restricted. In Enron's case Kenneth Lay, the chief executive, also told the head of the U.S. Federal Energy Relations Commission to push harder for deregulation of the industry, an issue of particular interest to Enron.

Raising Accounting Standards

The Enron case may have a significant impact on the accounting and auditing professions in the United States. The Financial Accounting Standards Board (FASB) is responsible for developing accounting standards and the AICPA is responsible for auditing standards. The FASB often takes a long time to develop extremely detailed standards, and many standards run behind events, as in the case of partnerships in off-balance sheet reporting and heavy debt.

Improving Auditors' Training

As the case of Enron showed, auditors require knowledge beyond the field of accounting and auditing. This raises the issue of whether the accounting training for certified public accountants covers such fields adequately and in sufficient depth. Training also needs to pay more attention to ethics (or codes of conduct). While the Audit Committee of Enron's Board of Directors had plenty of talent, apparently it did not adequately review the financial and accounting situation, for example, the disclosure of any financial ties to directors.

Overhauling Stock Options and Retirement Funds

To encourage employees to participate in retirement savings plans in addition to pension plans, the U.S. Congress freed retirement plans from many regulations. The use of company stock in retirement plans has benefited companies and shareholders, and about 30 percent of the assets in retirement funds are company stock. In the case of Enron, whose stock plunged from $90 to $0.80, this can be disastrous for retirees. Regulation in this regard will undoubtedly also be forthcoming, whereby no more than 10 to 15 percent of the stock held in a retirement fund can be own-company stock. In the case of Enron, employees were prevented from selling their stock, while top management were allowed to and made millions of dollars in profit selling their stock options when the stock was high.

To sum up, for transition economies, most of which have a somewhat different economic, financial, and accounting infrastructure, the lessons of the Enron case appear to be to pay close attention to installing well-functioning financial, accounting, and auditing frameworks conducive to the development of their capital and finance markets. Above all, before they embark on full deregulation and install free markets in a move toward a more market-oriented, capitalistic economy, they need to be sure that the proper financial, accounting, and legal infrastructure is in place.

The author is the director of the Center for International Accounting Development, The University of Texas at Dallas, 2601 N. Floyd Road, Richardson, Texas 75083-0688, tel.: 972-883-2320, fax.: 972-883-2192.

Accounting and Auditing Abuses and Their Remedies

On December 21 the U.S. Securities and Exchange Commission (SEC) announced that it would review the annual reports of all Fortune 500 companies for accounting irregularities.

Enron's spectacular collapse adds impetus to the calls for a reexamination of corporate accounting and transparency norms. Many U.S. companies have adopted aggressive accounting practices, at times concealing serious financial troubles, and have misled investors. Under the U.S. system for regulating accounting practices, publicly traded companies are required to prepare audited financial statements according to Generally Accepted Accounting Principles (GAAP). Since 1973 the SEC has relied on the Financial Accounting Standards Board, a private organization consisting of accountants, to establish the terms of GAAP. The SEC monitors and enforces company compliance with these standards, as well as promulgating its own accounting rules.

In recent years, many companies used accounting strategies to artificially enhance their reported earnings. Although legitimate under current accounting rules, widespread adoption of these accounting techniques has led to a pronounced deterioration in the quality of financial reporting. In addition, companies are increasingly supplying quarterly earnings news releases that resort to pro forma accounting numbers. These are computed as if some significant event (usually expenses, which if reported would decrease earnings) did not occur. Companies have been allowed to present as much pro forma information as they like provided that their annual reports, including official, audited financial statements, are prepared according to GAAP. According to one recent estimate, in recent annual reports as many as 300 Fortune 500 companies used some form of pro forma exclusion of categories of expenses from their operating earnings.

Global Crossing Crossed the Line

In another spectacular bankruptcy case, the telecommunications giant Global Crossing failed after betting too heavily on the demand for fiber optic telecommunications. To lure investors into financing a $15 billion effort that ultimately ran aground, Global Crossing relied on a mixture of new economy hype and accounting tricks that created the illusion of revenue. The firm apparently signed

Investigating Enron

The collapse of Enron has spurred several U.S. government investigations, namely:

- The **Justice Department** is investigating the possibility of fraud in the company's accounting practices and whether the company defrauded investors by concealing financial information.
- The **Securities and Exchange Commission (Treasury)** is investigating whether Enron broke securities laws by misleading investigators about its financial condition.
- The **Labor Department** is looking into allegations that Enron improperly blocked its employees from selling the company's stock in their retirement accounts.

Meanwhile, congressional bodies are undertaking the following actions:

- The **Senate Governmental Affairs Committee** will focus on a broad range of concerns, including the company's relationship to Bush administration officials and the federal agencies' oversight of the company.
- The **Senate Commerce, Science, and Transportation Committee** is focusing on the treatment of employees' retirement funds and securities analysts' recommendations, among other issues.
- The **House Energy and Commerce Committee** will focus, among others, matter on the regulation of energy and natural gas markets.
- The **House Financial Services Committee** is focusing on the impact on commodity markets, on the company's accounting practices, and on potential securities fraud, among other issues.
- The **House Education and Work Force Committee** will focus on Enron's retirement plan and its compliance with the Employee Retirement Income Security Act, which regulates employer-sponsored pension plans.

long-term contracts with customers, then booked the income stream immediately. Meanwhile it took the opposite approach to the equipment needed to deliver on these contracts, that is, in contrast to the revenue, it pushed such capital costs off into the future. Global Crossing also seems to have colluded with other telecommunications firms to inflate revenue by cross-selling to each other. If you sell me your hammer and I sell you mine, we both get to report income.

If the audit rules had been stricter, Global Crossing might have had a harder time hyping its way to stock market stardom, and the ensuing crash, in which many ordinary investors got burned, might also have been avoided. Indeed, the broader high-tech bubble, which was inflated with much help from aggressive bookkeeping, might also have been mitigated. Firms cooked their books to raise more capital than they could wisely use; the resulting bust was the prime cause of last year's recession. Even today, one of the chief threats to the recovery is the possibility that more Enron-style disasters will emerge. The nation's audit system needs a thorough overhaul, not just hasty tweaking.

Should Auditors Be Separated from Companies?

Dave Cotton, in a recent article published in the *Washington Post,* warns that last year a public opinion survey put certified public accountants (CPAs) solidly in the middle of a short list of most trusted professionals. Thanks to Enron and Arthur Andersen, CPAs might be lucky to outrank journalists, lawyers, or used car salesmen in the next survey. But trust can be restored in the CPA profession. There are two ways to do that with minimal government intervention, red tape, and regulation. One is to make accounting firms work directly for the people with the most to lose: investors. Cotton suggests to set up a system whereby the stock exchanges use a competitive process to select CPA firms to audit the financial statements of companies whose stock is traded on their exchanges. That would take auditors off the payroll of the firms they are supposed to be monitoring.

Another measure would be to beef up the strength of the accounting industry's ethics review panel. Based on his personal experiences as a member of the Ethics Committee of the American Institute of Certified Public Accountants (AICPA), Cotton saw ethical lapses that resulted in millions of dollars of losses, but the punishment was minimal, often with as little as 16 hours of continuing education. Meanwhile, only state accountancy review boards can strip accountants of their licenses, but they struggle with varying levels of standards, and problems of cronyism. Prohibiting accounting firms from collecting lucrative consulting fees from the companies they are auditing is only half the solution. Andersen got $27 million in consulting fees from Enron in a single year and $25 million for the Enron audit. Taking away consulting fees, and audit fees are still enough to undermine independence and cloud auditors' judgment. Better to simply sever the links between companies and their auditors than to establish new mechanisms to monitor a relationship that naturally lends itself to abuse.

Relieved of the fear that corporations might dismiss them for being too tough, auditors could focus on telling investors what they need to know—and alerting accounting and auditing standard-setters about emerging techniques of dubious propriety. These measures should still be accompanied by moves to prohibit accounting firms from performing consulting services for their audit clients. This should have been done long ago, except that the bigger accounting firms control the AICPA, which writes the Code of Professional Conduct, the profession's ethics rules—concludes Dave Cotton who is a partner with Cotton & Company LLP, an auditing firm in Alexandria, Virginia.

Partly based on reports from Oxford Analytica, the U.K.-based international consulting group.

Changing Math Teaching in the United States

***1950**: A logger sells a truckload of lumber for $100. His cost of production is 4/5 of the price. What is his profit?*

***1980**: A logger sells a truckload of lumber for $100. His cost of production is $80 and his profit is $20. Your assignment: Underline the number 20.*

***1990**: By cutting down beautiful forest trees, the logger makes $20. How do you feel about a person who makes a living this way? How did the forest birds and squirrels feel as the logger cut down the trees and watched their homes being destroyed? There are no wrong answers.*

***2002**: A logger sells a truckload of lumber for $100. His cost of production is $120. How does Arthur Andersen determine that his profit margin is $60?*

Joke downloaded from the Internet

Hopes of EU Accession Countries in 2002 and Beyond

By Claus Schultze

"Wonderful experiment arguing about milk quotas instead of shooting at each other" (recent quote from a senior EU official).

As envisaged in the 2001 enlargement report by the European Commission, which is coordinating accession negotiations, up to 10 countries could join the EU simultaneously as early as 2004. The report finally brought EU accession within clear reach for most candidate countries of Central and Eastern Europe. At their 2001 year-end meeting in Brussels, the EU heads of state named the countries that would be part of this "big bang" enlargement. The Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovenia, and Slovakia, as well as Cyprus and Malta, could finalize their accession negotiations by the end of this year or early 2003 at the latest, leaving about one year for the necessary ratification process. Bulgaria and Romania were told that they needed some more time to attain the economic and political "maturity" required for EU membership. Estimates suggest that the two countries will not be ready before 2008.

With the necessary economic, administrative, and institutional reforms well on track and the finishing line in sight for most candidates, what can these countries hope for in 2002? As usual, the devil is in the details, and plenty of pitfalls can still thwart any hope for a speedy conclusion of the negotiations. Regional policy and agriculture and their expensive budgetary implications might still turn out to be stumbling blocks. (Farm spending and aid for the poor together account for some 80 percent of the EU's $87 billion budget for this year.) The hope is that Spain and Denmark, countries that will successively hold the EU presidency in 2002, will be able to push forward the negotiations according to schedule and broker the necessary compromises between the current 15 member states.

Milestones: Seville and Copenhagen

Spain initially expected delays because of the unsolved issues left over from Belgium's EU presidency, notably, chapters such as competition and taxation and justice and home affairs have only been closed with a small number of countries. Recently, however, Madrid has committed itself firmly to the enlargement roadmap, which foresees adherence to a strict schedule and deadlines for advancing the negotiations. Following a Commission proposal to negotiate entry on the basis of the present legal framework and budgetary ceilings, agreed at the Berlin Summit in 1999, Spain has practically detached the remaining enlargement negotiations about regional policy and agriculture from internal EU reform issues. However, Spain has a strong interest in securing the continuous flow of regional aid from Brussels to its backward regions. Backed by Greece, Italy, and Portugal, the other main beneficiaries of the current regional aid regime, Spain seems prepared to defend the southern European share of the cake to the detriment of the incoming new members from Central and Eastern Europe.

Denmark aspires to be able to announce the ultimate success of the whole process, thereby celebrating the 10-year cycle that stretches from the Copenhagen European Council meeting in 1993—which opened the door to EU enlargement—to the forthcoming Copenhagen summit in December 2002. However, its new center-right government is somewhat inexperienced on EU issues, and carries the burden of Denmark being labeled as a notoriously "eurosceptic" country that has opted out of several arrangements, including the introduction of the euro.

The Case for Limited Absorption Capacities

The candidate countries were told not to expect more than the equivalent of 4 percent of their GDP as financial aid to their most backward regions. This means that they would receive only half of the financial assistance in per capita terms than current members. The official argument is that the accession countries' "absorption capacities" for EU-funded structural programs are limited. According to the current EU funding regime, a country receiving structural aid from specially earmarked funds needs to cofinance these measures

from its own budget, typically by 20 to 50 percent.

The following funds are the main financial instruments for the EU's structural policies:

- ***The European Regional Development Fund*** *helps disadvantaged regions build competitive infrastructure for transport, energy, telecommunications, the environment, education and health, investment in production, services for small businesses, and local development.*
- ***The European Social Fund*** *promotes employment by providing assistance with training and recruitment.*
- ***The European Agricultural Guidance and Guarantee Fund*** *supports national aid schemes for agriculture and rural development.*
- ***The Financial Instrument for Fisheries Guidance*** *supports modernization of the fisheries sector.*

Whereas these funds therefore impose an additional and possibly critical budgetary challenge to the incoming new member states, agricultural aid comes for free. However, the Commission has proposed transition periods in agriculture of up to 10 years, during which direct aid to farmers would only be phased in gradually, starting with 25 percent of the subsidies EU farmers currently enjoy. The new members would start receiving full farm subsidies within a reformed EU agricultural policy only in 2013 (see box on page 9).

The Winding Road to Accession

The Commission signaled that before it proposes a common EU position to the Council of Ministers' Working Group on Enlargement, it would continue informal discussions with the candidate countries that would focus on the future allocation of the structural funds, the direct aid to farmers, and the allotment of production quotas, as well as on the necessary transition regimes. In any case, given the many vested interests involved and the candidates' expectations of being treated the same way as current EU members, the candidates are likely to be disappointed by the outcome of these negotiations.

With each member state having veto power, political developments can complicate, and possibly delay, the necessary compromise on the EU's negotiating position. The outcomes of two upcoming elections, one in France in May and June and the other in Germany in September, could complicate matters. A strengthened position of France's mighty agricultural lobby could influence discussions about the agricultural chapter, and a conservative and more eurosceptic government in Germany could further complicate the negotiations, adding to the troubles recently experienced with the new right-wing populist government in Italy. While threatening to complicate the process, domestic politics are unlikely to stop EU enlargement. On several occasions during the past year EU heads of state have clearly stated that the enlargement process is irreversible.

How strongly the EU will stick to its declared impartial management of the accession process is still questionable, because negotiations will have to be wrapped up at the end of 2002. The EU has always maintained that each country will join on its own merits, if it is ready for membership, and if it has fulfilled all the strict accession criteria, particularly those related to EU legislation. The new members will be entitled to participate directly in the EU's decisionmaking process. The enlargement modifies the very basis of the Union, the setup of its institutions, and the nature of its policies. To let in countries that are not fully prepared—even if this affects only a minor number of policy areas—would seriously undermine the functioning of the EU and of its cornerstone, the internal market.

However, the indications are that not every country will be measured by the same standard. Poland, for instance, even though it is lagging behind frontrunner countries such as the Czech Republic, Estonia, and Slovenia, is not too worried, knowing that Germany is on its side. If politics gets the upper hand, the credibility of the enlargement process and of the EU might suffer, although the political and financial costs of a phased EU enlargement—with countries joining at different times—might weigh more than any such concerns.

The upcoming (second) Irish referendum on the Nice Treaty and the country's general elections to be held no later than June 2002 could also cause delays in the accession process. The Nice Treaty foresees complex new voting procedures for the EU Council, as well as other crucial institutional arrangements. Its ratification is a precondition for EU enlargement. (Every multilaterally negotiated change to the original European treaties, as well as all accession agreements, have to be ratified in all the member states in accordance with their specific constitutional requirements.) In June 2001 Irish voters rejected the Nice Treaty and thereby indirectly voted against EU enlargement, which many said had not been their intention. If the forthcoming second Irish referendum has the same outcome, the EU would face serious political difficulties, with possible repercussions for speedy enlargement. Finding creative solutions to permit the accession of the candidate countries without Nice Treaty considerations would certainly delay the enlargement schedule.

Chores Ahead

Above all, the adoption and implementation of the approximately 80,000-page body of EU legislation continues to remain the prime challenge facing the accession countries in 2002. The legislative adoption of EU law is now progressing rapidly. However, implementation is encountering considerable difficulties, partly because of the countries' still limited public administration and judicial capacity, and partly, but to a lesser degree, because of political factors. According to the Commission, nearly all the countries are facing difficulties in implementing competition policy and rules on state aid. Furthermore, as the Commission's report points out: "Securing the independence of courts, greater transparency of public administration and more consistent efforts to fight corruption and

The EU Commission Proposes—and Got Hit from all Sides

On January 30 the European Commission published two papers about how to extend the EU's regional aid and agricultural policy to the new member states. The money allocated to the new member states keeps within the overall ceiling on enlargement costs, which the EU agreed on in Berlin in 1999 for the current budget, which runs until the end of 2006. The recommendations include the following:

- When they join—as currently expected—in 2004, new member states will be entitled to 25 percent of the direct payments given to farmers in the existing member states. Each year thereafter their entitlement will increase until it reaches 100 percent in 2013. (This 10-year transitional period will also affect the 2007-13 budget.) The payments will be based on farm acreage, not on production levels. In the meantime, farmers in the applicant Central and East European states will receive market support and rural development funds from the EU as well.
- The overall budget for agricultural support to the new member states will be just over €40 billion ($34.8 billion), a figure that includes their annual contributions of about €5.5 billion.
- Between 2004 and 2006 the new members will also receive regional aid for infrastructure and environmental improvement. By 2006 they will be receiving structural funds at a rate of €137 per capita, which is just over half the amount that the four poorest existing member states will receive per head in that year. Some candidate countries will also receive additional funds for administrative reform and nuclear safety.

Following their mid-February meeting in Budapest, the prime ministers of four Visegrád countries—the Czech Republic, Hungary, Poland, and Slovakia—rejected the proposal, urging the EU that "structural and agricultural funding should be applied in full to the candidate countries from the moment of accession, and the per capita subsidies to candidate countries should be identical to those given to EU members with the same level of economic development." Prime Minister Victor Orbán of Hungary departed somewhat from this position and raised the possibility of a compromise: "Hungary will do its best to see that the subsidies are increased and that the transition period is cut to three years following accession in 2004. By 2007, when the EU will have to pass a new budget, a reform of common agricultural policy could be reached with new member states, making provisional discrimination against them unnecessary."

While the candidates are disappointed, as the proposals raise the prospect of a 10-year wait until they are treated equally with the existing member states, current members find the proposals too generous:

- At the EU foreign ministers' meeting on February 8, France and Germany criticized the plan and are seeking a 25 percent cut in the proposed spending of $35 billion in 2004-06 for farmers and poor regions in the 10 candidate countries. The Netherlands, Sweden, and the United Kingdom also said the spending plan of the EU Executive Commission was too generous at a time when Europe must restrain farm spending. They suggested that direct income support for EU farmers be ended and that no such payments be made at all to East European farmers. They argued that such subsidies would discourage East European governments from restructuring their farm sectors, which are more fragmented and inefficient than in the EU. Statistics point to significant problems. In Poland, for instance, 27 percent of the work force is employed in agriculture, whereas the EU average is 5.4 percent.
- A two-tier system for agricultural subsidies would seriously distort the EU's internal market. Farmers of current member states would be receiving four times the level of subsidies of their counterparts in candidate countries, but selling on the same markets. No other sector of the EU economy is so distorted or receives such support from the EU's budget.

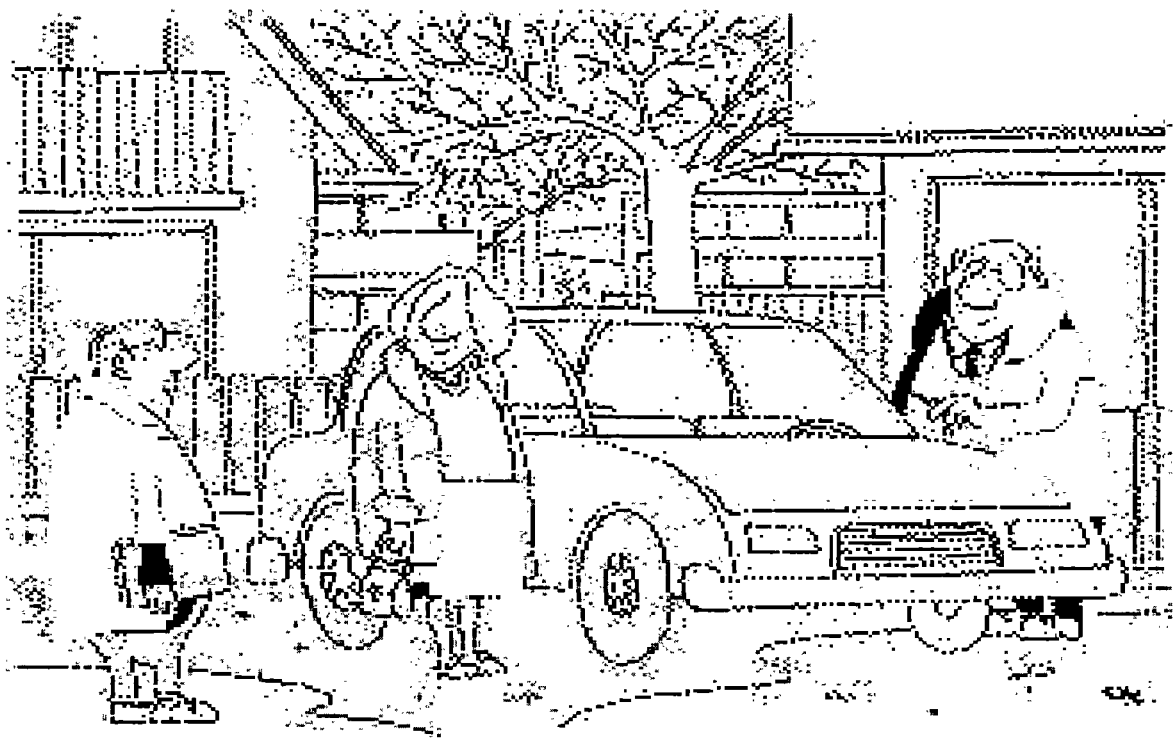
crime will require additional efforts in all candidate countries despite the overall stable democratic conditions."

A distinction should be drawn between issues that have to be resolved before a country can join the Union, such as conformity of public procurement and state subsidies with EU rules, and issues that require more sustained and long-term efforts, such as improving the situation of the Roma population and rooting out corruption. Another important area is to continue improving the candidate countries' administrative capacity from the central government down to the local level so that they can actually enforce the legislation that is in place. The EU Commission, in particular, has made it clear that it will monitor progress on this front, and has offered assistance. The forthcoming 2002 progress report, due in October, will be instrumental in assessing the state of affairs with respect to these and other issues. On the basis of this report the Commission will identify those countries that can finalize negotiations by the end of the year. The final decision will be taken in December at the EU summit meeting in Copenhagen.

Reforming the highly bureaucratic EU system and making it more efficient so that it can more easily digest the intake of up to 13 candidate countries without making the system ungovernable is certainly a difficult task for the years to come. For the first time in the history of European integration, during their December 2001 meeting in Brussels the heads of state nominated a constitutional convention, which includes delegates of the accession countries, to deliberate about EU reform and a future constitution. As the convention can only make recommendations, it will be the EU heads of state who will have to underwrite any constitutional changes at a forthcoming intergovernmental conference in 2004, at which up to 10 additional member countries could already participate as full members and participate in decisions on the future shape of the Union. After all, EU reform and EU enlargement are interrelated processes.

The author researches EU governance at the Free University of Brussels.

Profitable Nonprofits



What a nice car neighbor! Financed from which nonprofit foundation?

From the Hungarian Daily *Népszabadság*

What Can Transition Economies Learn from the First 10 Years?

A New World Bank Report

Creating a policy environment that disciplines low-productivity, old enterprises into releasing resources and encourages high-productivity, new enterprises to absorb those resources and to undertake new investment—without tilting the playing field in favor of any particular type of enterprise while strengthening the social safety net—is central to economic growth in transition economies. This is the main lesson to be learned from the successful reformers in Central Europe and the Baltics concludes a new, 128-page World Bank study entitled *The First Ten Years—Analysis and Lessons for Eastern Europe and the Former Soviet Union* (available on http://wbln0018.worldbank.org/eca/eca.nsf).

Without actually ranking the transition countries, the new World Bank report clearly divides them into leading reformers, primarily the Central European countries and the Baltics, and the rest, mainly the Southeast European and CIS countries. In the first group, by 2000 only the Czech Republic had not reached its 1990 GDP level. Hungary, Latvia, Poland, Slovenia, and to some extent Estonia and Lithuania have enjoyed several years of uninterrupted growth. By contrast, growth in Bulgaria and Romania was sharply interrupted by serious macroeconomic crises brought on by insufficient structural reform in the mid-1990s, and in 2000 GDP stood at four-fifths of its 1990 level. In 12 countries of the former Soviet Union average real GDP had only reached 62.7 percent of its 1990 level.

Continued growth is important for the leading reformers in Central Europe and the Baltics: per capita incomes were still only 68 percent of the EU average for Slovenia, 59 percent for the Czech Republic, and 49 percent for Hungary. And these are the wealthiest countries aspiring to EU accession. However, an exclusive focus on growth while providing basic public goods and protecting the most vulnerable is not enough. Accession countries need to consolidate the gains of the first decade of transition and address second generation reform issues, namely, they need to:

- Secure control over quasi-fiscal and contingent liabilities
- Undertake labor and financial market reforms to allow wider sharing of the benefits of growth
- Restructure social expenditures to make them fiscally more affordable without impairing the effectiveness of the social safety net.

Disciplining the Old, Encouraging the New

The common heritage of socialism implied that all countries in the region began their transition with a production system adapted not to a competitive environment, but to the exigencies of a command economy. For example, energy intensity, measured as the amount of energy used per unit of GDP, was 0.95 tons of oil equivalent per $1,000 of GDP in the Soviet Union in 1985, compared with 0.50 tons of oil equivalent per $1,000 of GDP in countries of the Organisation for Economic Co-operation and Development. Thus many sectors and enterprises were not viable after price liberalization.

The countries had to confront two challenges. First, they had to impose market discipline on inherited enterprises so that these enterprises had an incentive to restructure and, in so doing, they would become more productive and able to compete at the new prices. Market discipline also meant that those enterprises that failed to restructure should be closed. Second, they had to encourage the creation of new enterprises willing and able to compete in the marketplace without seeking special favors from the state.

Barriers to the creation of new firms are a critical obstacle to sustained growth in the transition countries of Eastern Europe and the former Soviet Union. New firms, mostly employing 50 or fewer workers, have rapidly become the major source of employment in the rapidly growing countries of Central Europe and the Baltics. In Poland, for example, where output in 2000 was nearly one-and-a-half times that in 1990, more than half of all workers are employed in such firms, compared with a quarter a decade ago. Small enterprises' share of employment in 1998 was also about 50 percent for other leading reformers, such as the Czech Republic, Hungary, Latvia, and Lithuania, roughly the same as in the

EU. In contrast, in the large countries of the former Soviet Union, where output in 2000 stood at roughly two-thirds that in 1990, fewer than one in five workers were employed in such firms, with that share remaining almost stagnant up to 1998.

Thus should policymakers focus on encouraging the creation of new firms and the resulting employment opportunities while postponing the pain of liquidating and restructuring old and inefficient firms inherited from the past until such a cushion is in place? Not so as long as the old firms enjoy soft budget constraints, for example, receiving credit and foreign exchange on preferential terms and not being required to pay taxes, social security contributions, utility bills, and bank debt, as new entrants will not face a level playing field. For example, in Bulgaria and Romania the protection of state enterprises and farm collectives through the banking sector led to a sharp increase in bad debts. These bad debts prevented the expansion of bank credit to new, small, and politically less connected enterprises. Eventually the situation triggered banking and macroeconomic crises in both countries. Similarly, the old industrial sector in Belarus and Uzbekistan paid much less for its foreign exchange and

The Transition Recession and the Great Depression, Selected Countries

Country	*Consecutive years of output decline*	*Cumulative output decline (percent)*	*Real GDP, 2000 (1990 = 100)*
Transition countries			
Central Southern Europe and the Baltics	4	23	107
Albania	3	33	110
Bulgaria	4	16	81
Croatia	4	36	87
Czech Republic	3	12	99
Estonia	5	35	85
Hungary	4	15	109
Latvia	6	51	61
Lithuania	5	44	67
Poland	2	6	144
Romania	3	21	82
Slovak Republic	4	23	105
Slovenia	3	14	120
CIS[a]	7	51	63
Armenia	4	63	67
Azerbaijan	6	60	55
Belarus	6	35	88
Georgia	5	78	29
Kazakhstan	6	41	90
Kyrgyz Republic	6	50	66
Moldova	7	63	35
Russian Federation	7	40	64
Tajikistan	7	50	48
Ukraine	10	59	43
Uzbekistan	6	18	95
Great Depression, 1930-34			
France	3	11	n.a.
Germany	3	16	n.a.
United Kingdom	2	6	n.a.
United States	4	27	n.a.

n.a. Not applicable.
a. Simple average, except for the index of 1990 GDP, which shows population-weighted averages.
Source: World Bank

credit needs than new, small enterprises, while in Georgia, the Kyrgyz Republic, Moldova, Russia, and Ukraine the old, large, and less energy-efficient enterprises have been allowed to run up significant arrears to the utility companies, while new and more energy-efficient enterprises have received less favorable treatment.

Reducing barriers to entry—a strategy of encouragement—must therefore be accompanied by a hardening of budget constraints on both old and new firms—a strategy of discipline—without tilting the playing field toward either kind of enterprise. If economic reforms in support of discipline and encouragement are so critical for growth, why have all countries not adopted them? Because the winners from early stages of liberalization and privatization—typically those who enjoyed control over state assets and close ties with the political elite—may oppose reforms that will erode their initial gains. Such reforms would include further trade liberalization, measures to facilitate the entry of new domestic and foreign competitors, and legislation to protect minority shareholders and creditors. In Russia, for example, during the 1990s, powerful industrialists frequently hampered the work and enforcement efforts of the Securities and Exchange Commission to strengthen the rights of small shareholders.

Hungary and Poland saw a sharp and early decline in employment and a rapid demise of the old sector, which initially made resources available to the new sector cheaply. The evidence suggests that new enterprises must reach a threshold of around 40 percent in their contribution to employment before they can become an engine of growth. In Russia and Ukraine, where the contribution of the new sector to employment is well below this threshold, a large proportion of the labor force remains mired in old, unrestructured enterprises that are not generating increases in productivity. In these countries the new sector has not emerged as a source of growth.

Learning from China?

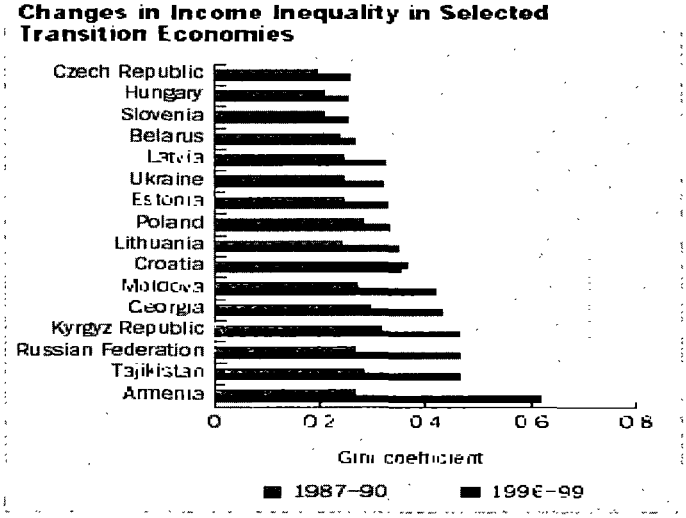
China's success in encouraging the entry of new enterprises (China's GDP per capita grew 8 percent per year from 1978 to 1995, lifting 200 million people out of absolute poverty) without imposing significant discipline on state enterprises raises a question about the applicability of China's reform to the transition economies of Eastern Europe and the former Soviet Union. China reaped spectacular gains from liberalizing repressed sectors such as agriculture, which had surplus labor, and rural industries and from a massive inflow of foreign direct investment. However, loss-making state enterprises were far less important in China than in most countries in Eastern Europe and the former Soviet Union. For example, only 19 percent of the Chinese labor force worked in the state sector and were thus entitled to a range of social benefits, compared with 90 percent in Russia. In addition, tight political control over asset stripping, together with some state capacity for managing public assets, allowed China to move its loss-making state enterprises more slowly to market conditions at the same time the explosive growth of new enterprises took place.

These conditions were largely absent in most transition economies covered by the report. The transition economies of Eastern Europe and the former Soviet Union did not have the resources for a phased transition for state enterprises, but they would be well advised to draw from China's experience in relation to the importance of encouraging new enterprises as a basis for wealth creation and economic growth.

Increased Inequality

The report admits that income inequality increased throughout the region during the last decade. The Gini coefficient (the standard measure of inequality) increased the least in Hungary, the Czech Republic, and Slovenia, compared with other transition countries (see the figure). The countries of Europe and Central Asia started the transition with some of the lowest levels of inequality in the

Changes in Income Inequality in Selected Transition Economies



Source: World Bank

world. In 1988 fewer than 1 in 25 people lived in absolute poverty (as measured by an income of less than $2.15 a day). Ten years later, in 1998, one in five people in the region could be regarded as "absolutely poor." Absolute poverty is as high as 68 percent in Tajikistan, 50 percent in the Kyrgyz Republic, and 40 percent in Armenia. Together with Moldova and Russia, they now rival the world's most unequal countries.

In Central Europe and the Baltics rising returns to education, decompressing wages, and emerging returns to risk taking and entrepreneurship, basically positive developments, signal that the market is now rewarding skills and effort, and partly explain the growing inequality. At the same time, however, strong social transfers and redistribution mechanisms have dampened the rise in education premiums and wage dispersion, in line with the demands these societies have placed on their governments for such measures.

The experience of the CIS is different. Rising education premiums and wage dispersion explain little of the rise in inequality. In Armenia, Georgia, the Kyrgyz Republic, Moldova, and Russia income differences linked to educational achievement explain less than 5 percent of inequality, compared with 20 percent in Slovenia and 15 percent in Hungary and Poland. The huge rise in inequality is due to the prevalence of widespread corruption and rent–seeking; the capture of the state by narrow vested interests, which have modified policy to their advantage, often at a high social cost; and the resulting collapse of formal wage and income opportunities.

Conclusions

Analysis of the first 10 years of transition in Eastern Europe and the former Soviet Union highlights the following lessons, which could be applied in the future to economies that have made limited progress with reform.

- While the initial conditions that prevailed at the beginning of the transition were critical for explaining the output decline that occurred in all the countries, market-oriented policy reforms have played a significant role in promoting subsequent economic growth.
- Policymakers cannot postpone the pain of liquidating and restructuring the old sector until the cushion provided by new enterprises is in place
- Legal and regulatory institutions have to be developed to oversee enterprise management. In the meantime, where direct sales of state assets to strategic investors—a preferred method of privatization—is not feasible, policymakers face a difficult choice between

—Privatization by sale to ineffective owners in a context of weak corporate governance, with the risk of the assets and income of minority shareholders being expropriated by those who gained control over the enterprise, and

—Continued state ownership in the face of inadequate political commitment to transparent privatization outcomes and limited institutional capacity to prevent asset stripping by incumbent enterprise managers.

- Resistance by the immediate beneficiaries of liberalization and privatization (oligarchs, former apparatchiks) to competition that could reduce their special privileges should be broken. The government needs to support new small and medium enterprises that would suffer as a result of an uneven playing field and stand to gain from further reform. Fiscal policy has an important role to play in this respect.

Main Recipients of Foreign Direct Investment, Selected Transition Countries, 1992-99

	1992-95		*1996-99*	
County	***US$ millions***	***Percentage of GDP***	***US$ millions***	***Percentage of GDP***
Central Southern Europe and the Baltics	21,091	0.5	50,558	3.3
Czech Republic	4,821	2.9	10,104	4.6
Estonia	647	3.9	1,050	5.2
Hungary	9,399	5.7	6,979	3.8
Poland	2,540	0.6	17,096	2.9
CIS	8,272	1.0	22,001	2.5
Azerbaijan	237	4.2	3,222	20.9
Kazakhstan	2,357	2.7	4,971	6.4
Russia	3,965	0.3	8,412	0.7
Turkmenistan	427	3.5	334	3.0

Note: Shares of GDP are period averages of medians for the group.
Source: World Bank; country statistical office data.

Transitions' Early Winners Can Prevent Further Reform—Interview with Pradeep Mitra

By Richard Hirschler

Pradeep Mitra and Marcelo Selowsky headed the team of experts that produced the World Bank's report entitled *The First Ten Years—Analysis and Lessons for Eastern Europe and the Former Soviet Union*. How long will initial conditions haunt these economies? Why is the struggle between the old and new sectors so decisive? What does "low-level equilibrium trap" mean? Pradeep Mitra, recently appointed to the position of chief economist for the Bank's ECA Region to succeed Marcelo Selowsky, who was offered a leading position in the IMF, answers these questions in the following interview with Transition editor Richard Hirschler.

Q: The report claims that initial conditions in the transition countries played a significant role at the beginning, but gradually became less important, and what really had a major impact was the market-oriented reforms. However, the report also recognizes that even if some countries chose the right policies, prior "memory" of a market economy also seems to matter.

A. Indeed, initial conditions in the transition economies explain much of the wide variety in output drops between the individual countries during the period of the transition recession, 1990-94. These initial conditions include distortions in those countries, such as repressed inflation, the black market exchange rates, and pretransition trade patterns. However, the subsequent recovery is better explained by the policy reforms implemented in these countries. Based on earlier research by Alan Gelb, Martha de Melo, and Cevdet Denizer we have aggregated indicators of initial conditions into three categories. In addition to distortions, we distinguish "structure," including initial income level, natural resources, share of industry, and degree of urbanization, as well as "institutions," which include market memory, geographic location, and prior experience of nationhood. We found that countries with sufficient market memory and long experience of nationhood prior to the socialist period, in other words, countries with strong initial institutions, will perform better than countries that did not have the same memory and experience, other things being equal. However, if policy reforms are strong enough, they can, to some extent, offset the disadvantages conveyed by initial conditions.

Q: Indeed, the further east we travel from Central Europe, the more economic difficulties we witness, especially in the countries of the former Soviet Union.

A. The adverse impact of initial conditions is very strong in those countries. The break-up of the Soviet Union meant the break-up of vertically integrated production chains and of long-established trade and capital patterns, which caused severe dislocation. Industrialization in the Soviet Union was based on subsidized energy and transport. Once the economies of the former Soviet Union were opened up, the resulting terms of trade shock was huge. It is not that policy reform has not worked, but it is true that the outcome of a given level of policy reform effort—as measured, for example, by the World Bank liberalization index or the transition indicators of the European Bank for Reconstruction and Development—is certainly less favorable than in the Central European countries.

Q: The report distinguishes between the old enterprises inherited from the socialist era and the newly created dynamic businesses. It claims that the latter's struggle for resources and political influence largely determines the outcome of reform efforts. As a consequence, you warn that policymakers cannot hope to postpone the pain of liquidating and restructuring the old sector. So encouraging the new and disciplining the old should go hand-in-hand.

A. That's right. Encouraging the new firms—ultimately the basis for wealth creation and economic growth—cannot be pursued effectively without at the same time imposing discipline on the old sector. The report actually distinguishes three categories of firms: old firms; restructured firms (those that have spun off assets from the old enterprises and have become viable); and new, greenfield investment. In some countries, however, new enterprises are run by people who have strong connections with the political elite and receive all kind of subsidies, whether through the budget, through the banking sector, or through the tolerance of arrears to the utility companies. In these cases discipline should apply to both old and new enterprises.

Q: The report warns that after the first wave of privatization, those who become owners will resist further liberalization and reform because they want to preserve their privileged positions.

A. In the report we refer to this as a low-level partial reform equilibrium trap. In Russia, for example, the insiders who came out well from the initial wave of liberalization and privatization fiercely opposed the Securities and Exchange Commission's efforts to strengthen the rights of minority shareholders or creditors. They felt that such measures would have limited what they could do with their newly acquired assets. A number of the CIS countries have passed good legislation on improving corporate governance, and now face the challenge of implementing it fairly and consistently.

Q: Belarus is an interesting case, because if you believe the official statistics, it was doing quite well, and together with Uzbekistan was the closest to reaching its pre-1990s GDP. Maybe this indicates that the old style structure can be economically more effective than a quasi-free market economy?

A. Belarus had recovered about 88 percent of its pretransition GDP by 2000, which is indeed high compared with other CIS countries. What we say in the report is that Belarus is a country that has not really substantially embarked on market reforms. Many of the institutions of the command economy are still in place, so the state has the capacity to provide some basic public goods. Furthermore, large transfers from Russia, mainly in the form of barter deals, are providing energy and other essential products. The case of Belarus is not inconsistent with the basic framework in the report. If you have some state capacity in place, and if you have functioning institutions, the adverse impact can be cushioned. The key challenge for Belarus, once it starts reforming, will ultimately be the same as for all other transition economies: to establish good governance and strong market-supporting institutions.

Q: What were the real surprises you came across when working on this report, that is, what findings proved to be contrary to your earlier expectations?

A. With the experience of being involved with developments in countries of the region it's difficult to say. I can say that it was surprising to find that creating a good investment climate and encouraging the creation of new enterprises will not be very effective in itself without imposing strong discipline on the old enterprises and forcing them to restructure. Furthermore, we didn't fully expect that a country could be stuck in a low-level equilibrium trap as the early winners from partial reform become effective forces against any further reform.

Q: How can the trapped countries free themselves and attain further development?

A. Countries trapped in a partial reform equilibrium should take action on three fronts:

- Reformist governments should engage much more actively in public education, for example, by telling the public that a clear link exists between tax exemptions and nonpayment of utility bills and bank debts on the one hand, and a build-up of wage and pension arrears and an inability to maintain standards in schools and hospitals on the other hand. The public needs a better grasp of these links so that people can understand and eventually support what the reformers are trying to do.

- Some sort of collective action is needed by people who are now losers, but who would stand to gain if countries moved from partial to comprehensive reform. This group includes the owners of small and medium businesses, the managers of second-tier enterprises, and business associations. These are already well organized in Central Europe and the Baltics, but less so in the CIS countries.

- The budget can be used much more actively to tax the rents that accrue to early winners from reform. They can use this additional tax revenue to fund worker retraining, severance payments, social asset divestiture, and public education and health. It would facilitate enterprise restructuring and enhance people's ability to participate in the small and medium enterprises that form the basis for wealth and employment creation.

The World Bank, Privatization, and Enterprise Reform in Transition Economies

A Retrospective Analysis

By John Nellis

Privatization in transition economies could have and should have been better managed; opportunities were missed. However, holding privatization accountable for all the problems of transition is inaccurate and unfair. Change of ownership was by itself insufficient to cut political-financial links between firms and the state, but that was not clear at the outset, and still appears to be a necessary, if not a sufficient, condition for successful reform. It is now also clear that approaching privatization less hastily and in a more deliberate manner might have been possible, in which case the results might have been less insider ownership and domination, less resistance to external investors, and more protection for minority shareholders. However, those countries in the former Soviet Union that tried to make the transition by means of this approach without much change in ownership have not met with a great deal of success.

In Poland, the marriage of a holding company idea with a give-away scheme took root in 1991, as evidence mounted about the meager results of privatization through either trade sales or share offerings (this slow pace of sales of large firms continued to be the case for a number of years). In 1991-92 the authorities, with the Bank's approval and assistance, responded in two ways: first, by dividing state-owned enterprises (SOEs) into nine sectors and seeking advice on how to deal with each group of firms on a sectoral basis; and second, by implementing a mass privatization program (MPP), which combined the asset management concept with a give-away scheme. However, political squabbles and workers' resistance delayed the implementation of the MPP for years, and many large, loss-making firms escaped privatization by this or any other method.

Poland: The Bang Was Big, Privatization Was Small

Official figures suggest that after six years of transition, only 22 percent of the starting stock of 8,400 SOEs was privatized. Clearly, despite official statements and hopes, and despite considerable prodding and assistance from the World Bank, Poland turned out to be a slow privatizer. The question is, does it matter? The reality is that Poland enjoyed, for a time, just about the best overall growth record of all European and Central Asian transition countries. It returned to growth more rapidly and with more vigor than most other transition economies, and in the mid-1990s had the highest GDP growth rate in Europe. By late 1999 Poland's GDP was estimated at 125 percent of its GDP at the end of 1989, an excellent record of positive economic achievement. Did the Poles manage this accomplishment despite the slow pace of privatization, or because of it?

With hindsight one can discern a Polish model of transition that succeeded without mass or rapid privatization. One can see that in the Polish context the introduction of free trade and of free entry for new start-up businesses, combined with a tightened budget constraint on most remaining SOEs and the introduction of a mechanism for spinning off productive assets from SOEs without formally privatizing them, presented a viable alternative to mass and rapid divestiture. Two reasons account for this. The first reason is that in conjunction with rapid and extensive small-scale privatization, these policies encouraged the explosive growth of new private firms that turned out to be the principal engine of recovery and growth in transition economies. In terms of restructuring, they have consistently outperformed privatized firms, much less SOEs.

The second reason is that the workers' councils, so worrisome to both Bank staff and external advisors in 1990, ultimately proved to be a positive force in Polish SOEs. In other transition economies, Bulgaria and Ukraine, for example, where the old centralized state structures and sectoral ministries crumbled; where firm managers took over the control of assets; where privatization was accepted in principle, but was not extensively carried out in practice; and where workers' councils were weak or nonexistent, the result was asset stripping and large-scale deterioration of firm quality. Poland avoided this outcome not only by means of good macroeconomic and financial policies, but also because workers' councils were keeping an eye on managers and hindering

them, if not totally preventing them, from asset stripping and "spontaneous" privatization. The combination of good policy, vigorously applied; infirm watchdogs; and small-scale privatization limited both the fall in output and criminal behavior in Polish SOEs.

However, while good macroeconomic policy and slow privatization worked well for a time, it is a strategy that has its limits, as evidenced by Poland's recent slowing of growth and the continuing social and financial drain caused by numerous large, loss-making state firms in coal, steel, and utilities. Ownership matters, at least eventually.

Czech Republic: The Rise of Tunneling Experts

Czechoslovakia—before the split—launched its privatization program in 1991. From the outset it was a homegrown product. By 1995, some 1,800 medium and large firms in the Czech Republic, had been privatized through two waves of a voucher process. Another 350 enterprises had been sold on a trade sale basis to strategic investors, and substantial assets had been transferred to local authorities or restored to their former owners, namely, those whose firms had been expropriated by the communist regime.

Public interest in vouchers was originally quite weak, but picked up dramatically after dozens of private investment funds came into being, claiming that they had access to specialized information, promising to diversify risk, and in several cases guaranteeing positive returns on any investment. Citizens responded by buying vouchers, with 70 percent putting their vouchers into investment funds in the first round and slightly less in the second. Thus at the end of the voucher exchange most citizens held shares in an investment fund, and not in specific firms, and the investment funds became the major holders of all privatized equity.

The initial results were tremendously encouraging. Privatization contributed to the rapid growth of the private sector share of Czech GDP, which reached 74 percent by 1996, the highest in the region. Exports shifted from Eastern to Western markets. Growth resumed, having spent but a brief time in low negative territory, and topped 6 percent in 1995. This transformation and growth were accompanied by single-digit inflation and, most surprisingly, extremely low unemployment rates. Compared with Hungary and Poland, with their initially high rates of unemployment and difficult to contain inflation, the Czech Republic looked good. Compared with Russia and many points east, it looked miraculous. By 1996 Prime Minister Klaus could state that the transition was more or less complete, and that henceforth the Czech Republic should be viewed as an ordinary European country undergoing ordinary political and economic problems. He characterized the voucher privatization program as "rapid and efficient."

Most observers and World Bank staff agreed. The early and apparently resounding success story influenced Bank staff in their recommendations on privatization in general and on voucher use in particular in a number of other transition countries. In 9 out of 26 countries reviewed vouchers were the primary divestiture method, and in 10 they were the secondary method. In many countries the Bank pushed for the use of this method. Czech representatives featured prominently in seminars and conferences sponsored and supported by the Bank during this period, disseminating what they increasingly assumed to be *the* correct privatization method.

However, while Poland and Hungary continued to enjoy growth rates of 4 and 5 percent, respectively, in the last half of the 1990s, the Czech GDP growth rate fell by 40 percent in 1996, sank to 0.3 percent in 1997, turned negative in 1998, and did not recover markedly until 2000. Several factors accounted for the prolonged slide, including two aspects of privatization. First, the privatization investment funds were insufficiently regulated, which opened the door to a variety of highly dubious and some overtly illegal actions that enriched fund managers at the expense of minority shareholders and harmed the health of the firm. Second, some of the largest funds were owned by local banks, which themselves were only partially or not at all privatized. Investment funds owned by banks tended not to treat poor performance by firms aggressively, as pulling the plug would have forced the banks to write down the resources lent to these firms. Thus the banks persisted in lending or rolling over loans to poorly performing firms privatized by vouchers.

The results were twofold. The expropriation (referred to as tunneling) of firm assets by investment fund and firm managers defrauded many minority shareholders and led to widespread public dissatisfaction with privatization. In addition, the tunneling, along with deficiencies in the capital and financial markets, retarded needed restructuring in the privatized firms, leaving them overstaffed, undercapitalized, unable to raise investment funds, and poorly managed. The low unemployment rate, formerly seen as a sign of success, began to be interpreted as an indicator of lack of change in firms.

Had the Czechs applied the case-by-case sale approach more widely (as Estonia and Hungary did, for example), then the restructuring might have been faster, the recession might have been less severe, and the problem of banks' bad debts might have been smaller and less costly. From the point of view of the World Bank, the general infatuation with the Czech voucher approach reveals a number of interesting points. To begin with, here, and even more so in Russia, most Bank staff tended to agree with those reformers who thought that ownership change was not just a necessary condition of capitalism, but a sufficient one. This led to the belief that the required legal and institutional framework would arise from demand by the new private property owners. Many reformers and their Bank supporters did see the urgent need for legal, regulatory, and administrative mechanisms to channel and guide the acquisitive behavior of property owners, but they hoped and believed that this increasingly large and powerful group would itself pressure the government for, and support the creation of, the required institutional framework. In addition, Bank staff were strongly biased toward concrete, substantial, and near-term actions, as opposed to necessarily less dramatic actions. The use of vouchers made meeting quantitative conditionality targets on numbers of firms or percentage of assets privatized relatively easy, while other methods were slower, more complicated, and more prone to delay.

Scope of Privatization and Method Used, Selected Transition Countries, 1999

Country	*Score*[a]	*Primary method*	*Secondary method*
Czech Republic	4.0	Voucher	Direct
Hungary	4.0	Direct	MEBO
Slovakia	4.0	Direct	Voucher
Estonia	4.0	Direct	Voucher
Poland	3.3	Direct	MEBO
Russia	3.3	Voucher	Direct
Kyrgyz Republic	3.0	Voucher	MEBO
Lithuania	3.0	Voucher	Direct
Georgia	3.3	Voucher	Direct
Slovenia	3.3	MEBO	Voucher
Bulgaria	3.0	Direct	Voucher
Croatia	3.0	MEBO	Voucher
Kazakhstan	3.0	Voucher	Direct
Latvia	3.0	Direct	Voucher
Macedonia	3.0	MEBO	Direct
Moldova	3.0	Voucher	Direct
Armenia	3.0	Voucher	MEBO
Romania	2.7	MEBO	Voucher
Uzbekistan	2.7	MEBO	Direct
Ukraine	2.3	MEBO	Direct
Azerbaijan	2.0	MEBO	Voucher
Albania	2.0	MEBO	Voucher
Tajikistan	2.0	Direct	Voucher
Turkmenistan	1.7	MEBO	Direct
Belarus	1.0	MEBO	Voucher
Bosnia	—	Voucher	Direct

MEBO Management-employee buyout.

a. The score is the numerical ranking of the European Bank for Reconstruction and Development. Its classification system for assessing progress in large-scale privatization is as follows: 1 = minimal progress; 2 = scheme ready for implementation, some firms divested; 3 = more than 25 percent of assets are privatized; 4 = more than 50 percent of assets are privatized and substantial progress on corporate governance has been made.

Source: European Bank for Reconstruction and Development, "Transition Report," Washington, D.C., 1999.

Bank operations and Bank staff have a predilection for immediate and substantial action, as opposed to longer-term, foundation-laying measures. Thus the reformers' arguments for the need for speedy and massive transfers fell on receptive ears.

In the last two years the Czech Republic has returned to vigorous growth, received large amounts of direct foreign investment, and privatized its problem-ridden banks. One can thus interpret the troublesome aspects of the voucher privatization program as a relatively minor and transient issue that paved the way for the country's present success, or as a set of missed opportunities to divest correctly, the full costs of which have yet to be determined.

Russia: Mass Privatization, Mass Discontent

Between early 1992 and mid-1994 Russian authorities, with the aid of the World Bank, the European Bank for Reconstruction and Development, the U.S. Agency for International Development, and other donor agencies, organized and implemented the largest and fastest privatization program ever seen, then or since. In just two years the Russian government was able to

- Corporatize and register more than 24,000 medium and large SOEs as joint stock companies.
- Distribute vouchers to virtually the entire population in some 89 *oblasts*, territories, and autonomous republics.
- Privatize more than 16,500 enterprises, most of which were in the tradable sector. Over 41 million Russian citizens became shareholders, either through direct ownership of shares in the newly privatized companies or through share ownership in voucher investment funds.

These accomplishments came at a price, that is, the need to reward the key stakeholders had led to firm managers and workers, or "insiders," ending up with a dominant 66 percent of the shares in about two-thirds of all firms divested. Here and elsewhere, insider owners generally failed to restructure the firms. In 1995 production failed to recover; few external, and even fewer foreign investors became involved in secondary trading in the privatized firms; and, most important, signs indicated that the second "cash" phase of privatization was not proceeding rapidly or transparently. Though many medium firms were privatized for cash in the next few years, the methods used were murky, and most of the remaining large firms and valuable assets were not brought to market, at least not in anything resembling an open and competitive manner. Potential external investors, especially if foreign, complained of being blocked from participating in bids. Those few external investors who had obtained shares in the MPP often complained that their stake was being illegally diluted or eliminated. Citizens began to grumble that the shares they had acquired with their vouchers were worth little, if anything.

In late 1995 to early 1996 concern changed to serious alarm over the "loans-for-shares" transfers (ostensibly auctions), in which significant stakes in 13 high-potential, natural resource-based firms were handed over to Russian commercial banks, all apparently owned by a group of financial oligarchs connected to the presidency, in a manner that was neither competitive nor transparent nor lucrative to the state. No Russian banks other than those in a self-designated inner circle were allowed to bid (foreign banks were completely excluded), and the bids were totally rigged. The government did not repay the loans received from the banks, and the shares and ownership of some of the best remaining Russian assets passed to the oligarchs. To give some idea of the results, for a loan of $170 million, Uneximbank obtained 38 percent of the shares of Norilsk Nickel, a firm that is reportedly making annual profits of $2 billion.

Russia's privatization led to a small number of individuals, who mostly achieved initial wealth through favorable deals with or outright theft from the government, in control of most of Russia's major firms. In response to internal concern and external criticism, over the next three years the World Bank scaled back on privatization efforts and shifted its focus to building an acceptance of, and a capacity to execute, case by case transactions within Russia. At the end of the day, however, very few firms were ever sold according to this method.

Critiques of the Russian approach to transition, of its privatization program, and of World Bank (and other donors) support of the program have burgeoned in recent years. Nobel Laureate Joseph Stiglitz argued that privatizing in the absence of a sufficient, market-supporting institutional infrastructure was a serious mistake that led more to asset stripping than to wealth creation. He argued that this should have been foreseen, if not by the first generation of transition reformers, than at least by their Western economic advisors, and presumably by the World Bank staff involved. The implication was that the headlong rush to privatization was a basic mistake; that much of the decline and pain associated with transition in general and with privatization in particular was avoidable; and that much more attention should have been paid to building the institutional, legal, and

administrative foundation on which properly functioning capitalism is based.

But Stiglitz assumes that the Russian government was free to select an optimal policy (in terms of enhancing efficiency or welfare), and also had the capacity to implement its chosen policy. However, whether Russia possessed either the will or the ability is not clear. Russians might have moved more slowly on privatization along the lines of the Polish approach, but until very recently there was no indication of either freer entry or hard budgets, the factors that made Poland a (temporary) success. The likely alternative to mass and rapid privatization to insiders in Russia was rather what one sees in Ukraine: slow privatization of larger firms; rampant and rapacious bureaucratic interference in firms (this exists in Russia as well, though perhaps not quite so acutely); and, in the absence of a powerful set of insider owners, political stagnation as the various factions fight over the initial division of spoils. Yet despite all the faults of privatization, Russia is better off having most firms in private hands. Ukraine has not privatized nearly as much as Russia has, and is in much worse shape.

Concluding Remarks

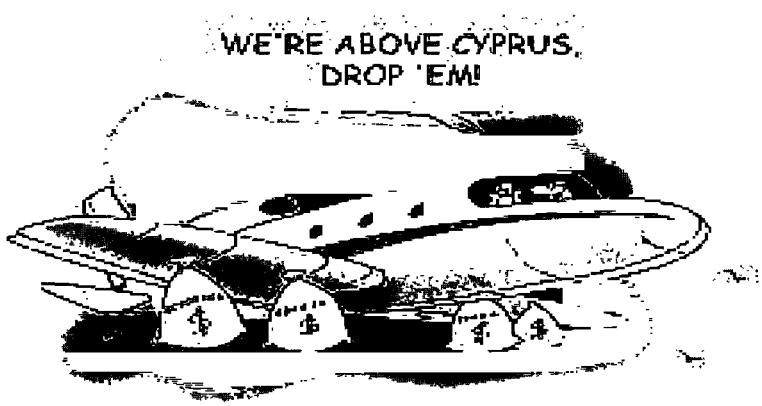
Did the World Bank's efforts in support of Russian privatization best fulfill its mission? On the basis of their experience, their technical expertise, and their perceptions as the process unfolded, should staff have advocated a different approach or a different set of techniques and tactics? Specifically, should the Bank have pushed harder for the break-up of large firms prior to their sale? Should it have resisted the exclusion of the natural resource-based firms from the voucher program, advocated a track parallel to the MPP for case by case sales of some high-potential companies earlier, and denounced the loans-for-shares scheme more forcefully? More generally, and perhaps most important, should it have perceived sooner that the transfer of ownership to insiders and the general public would—in the absence of enforceable contracts and capital and financial market regulation and the government's unwillingness and lack of capacity to impose hard budgets—result in weak corporate governance in the privatized firms and produce suboptimal results in terms of both efficiency and equity? In sum, should the Bank have pushed harder for SOE control and reform and less for privatization? While yes to the questions posed seems reasonably evident in 2002, the answer was not at all clear in 1991, or indeed much before 1996, by which time the Bank's approach to privatization in Russia and other transition countries was changing, and was becoming more cautious and longer term.

A unifying thread in all three cases shows the importance of establishing control over managers, the group that emerged from the wreckage of central planning best placed to further their own interests. Methods and policies that established rules and surveillance, that opened the doors to foreign investors that pushed for competition and freer entry and exit alongside the change of ownership, proved better, both in terms of promoting restructuring in the firms and in gaining public acceptance of the process. The faith in the voucher approach was misplaced, or at least heavily overemphasized.

The Bank might have done better to advocate the approach used by the Estonians more widely, that is, limiting the exchange of vouchers to minority stakes in firms in which a controlling majority share had already been sold to a core investor. This increases the chances of turning a firm over to a good owner that has the incentives to look after and develop the health of the firm's assets, and it also increases the chances that voucher holders will obtain shares that will maintain or increase their value. Indeed, the Estonians applied this procedure to a small number of the higher-potential firms, further increasing the prospects for the new minority shareholders.

The author is a Senior Fellow at the Center for Global Development, Washington, D.C., and a former staff member of the World Bank.

Capital Flight—A la Russe



From the Moscow daily *Moscow Times*.

September 11 Had Little Effect on the Transition Economies

The Economist Intelligence Unit's Impact Assessment

Central and Eastern Europe stands out as a region that has experienced little, if any, direct economic impact from the September 11 events and the subsequent war in Afghanistan. Strong investment growth led by foreign direct investment and structural change have put the region's economies in a relatively good position to withstand the slump in export demand. Growth in Russia has slowed because of a combination of inadequate structural reforms, continuing appreciation of the ruble, and lower oil prices, although the London-based Economist Intelligence Unit (EIU) still expects growth of 3.5 percent in 2002. Its new report, *"The Impact of September 11th—An Update"* (available on http://www.eiu.com/), contains other interesting predictions.

The events of September 11, 2001, jolted the world economy, but did not cause a recession: the slump had started months earlier as the air leaked out of the U.S. asset bubble. The attacks on New York and Washington, D.C. made the recession real, however, and the reactions of companies and consumers made a further worsening of the economy inevitable. The consensus forecast compiled before September 11 for U.S. growth was 1.6 percent for 2001 and 2.7 percent for 2002. By November these forecasts had dropped to 1.1 and 0.7 percent, respectively. The real reason that economic forecasts have been cut by so much is that September 11 forced the government, firms, consumers, and forecasters to confront the reality that the U.S. economy had been deteriorating for some time, and that hopes that it was about to turn the corner were sadly misplaced.

Improving Global Prospects

Prospects for the United States—and hence for much of the world—are now improving, but the risks of a relapse cannot be ignored. The acceleration the EIU expects to see toward the end of 2002 will be maintained into 2003, and global growth in that year will average 4.1 percent. The economies of the Organisation for Economic Co-operation and Development (OECD) are expected to perform strongly, with growth accelerating to 2.9 percent both next year and in 2004 (see table 1). This will help to boost performance in much of the emerging world. OECD growth will moderate slightly in the second half of the forecast period, but continued strong growth in the emerging world will help to keep global growth above 4 percent for the remainder of the forecast period (2002-06).

The U.S. economy is close to bottoming out. After stagnating in the final months of 2001, weak growth is expected in early 2002, albeit driven by a turnaround in the inventory cycle rather than by any improvement in final demand. The rest of the global economy is also weak, partly because

Table 1. World Economy, 1997-2006
(percent)

Region	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*
Real GDP growth										
OECD[a]	3.5	2.7	3.1	3.8	1.0	1.1	2.9	2.9	2.8	2.7
Non-OECD[a]	5.4	2.7	4.5	6.0	4.3	4.6	5.7	5.8	6.0	6.1
World[a]	4.2	2.7	3.6	4.7	2.2	2.5	4.1	4.1	4.2	4.2
World (market exchange rates)	3.5	2.2	3.1	3.9	1.3	1.4	3.3	3.3	3.3	3.3
Inflation (average)										
OECD	2.1	1.4	1.3	2.2	2.2	0.9	1.7	2.0	2.5	2.2
World	4.5	3.6	3.4	3.1	3.0	2.1	2.9	3.0	3.3	3.2

a. At purchasing power parity exchange rates.
Source: Economist Intelligence Unit.

of the depressing influence of the United States on global demand, and partly because of home-grown economic problems in other parts of the world. Here too, however, there are signs that a gradual recovery is in prospect. The euro zone appears to be stagnating, but business surveys suggest that sentiment is starting to improve and the indications are that weak growth will resume by the second quarter. In Japan, where the economy is still contracting sharply, the situation is worse. However, a pick-up in the United States and West European economies will inevitably boost Japanese exports, and the Japanese economy is expected to bottom out in the second quarter of 2002.

The slowdown in the developing world was driven primarily by developments in the OECD: falling imports in major economies, high risk aversion cutting capital flows into emerging markets, and weak demand depressing commodity prices. In 2002 many of these factors will be reversed. International capital market liquidity has improved, and many countries have been able to borrow at reasonable rates since October 2001. Even the debt default in Argentina does not seem to have upset sentiment toward emerging market borrowers The biggest risks to the global forecast are related to the outlook for the United States, which accounts for about 30 percent of world output.

One risk that cannot be ruled out is another major terrorist attack in the United States. However, how significant the economic impact of such an attack would be is unclear. The experience of September 11 suggests that the direct economic impact would be small. Rather than terrorist attacks, the most likely cause of a substantial downward revision to the EIU U.S. forecast is that continued sharp rises in unemployment will lead to renewed falls in consumer confidence, prompting a greater consumer retrenchment than the EIU currently assumes. If the global economy were to be hit hard by a double-dip U.S. recession, it would benefit enormously from a faster than expected U.S. recovery.

Less Exposed Transition Economies

As Central and Eastern Europe is dominated by small, open economies—exports account for an average of 30 percent of GDP—the region was effected by the global slowdown. Regional GDP is forecast to grow by 3.4 percent in 2002, down from 4.1 percent in 2001 and more than 6 percent in 2000 (see table 2 for selected countries). Strong investment growth and deep industrial restructuring in recent years, however, have left the Central European EU aspirants more resilient to external shocks. Their exports have held up remarkably well in the face of a deteriorating external environment: exports grew by around 10 percent in real terms last year in the Czech Republic, Hungary, and Poland.

In 2002 accelerating domestic demand will, to some extent, compensate for slowing exports. Increased uncertainty in the aftermath of September 11 led to a temporary downward correction in Central European currencies, but they swiftly recovered to their pre-September levels. Further real appreciation is expected in 2002, which will dampen the hoped for export-led recovery in 2003.

Russia was already in the midst of a slowdown in September 2001. Growth slowed from a record 8.3 percent in 2000 to an estimated 5 percent in 2001. In the short to medium term the Russian economy will be little affected by September 11 and its aftermath, but long-term benefits could accrue if Russia's support for the U.S.-led war on terror results in accelerated accession to the World Trade Organization and improved access to Western markets. In 2002-03 Russia's economic

Table 2. Economic Outlook in Two Groups of Transition Economies, 1997-2006
(average, percent)

Country group	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*
6 CEE countries [a]										
Real GDP growth	3.0	2.6	2.4	3.7	2.6	2.7	4.0	4.4	4.1	4.0
Inflation	49.2	11.2	7.3	8.5	6.0	4.5	4.0	3.5	3.2	2.9
4 CIS countries [b]										
Real GDP growth	0.6	–4.4	4.8	8.2	5.7	3.8	4.2	4.6	4.5	4.4
Inflation	14.8	25.0	75.8	21.0	20.0	14.4	2.4	10.7	9.1	7.2

CEE Central and Eastern Europe.
a. Bulgaria, the Czech Republic, Hungary, Poland, Romania, and Slovakia.
b. Azerbaijan, Kazakhstan, Russia, and Ukraine.
Source: Economist Intelligence Unit.

prospects depend crucially on international oil prices, which fell sharply in the last quarter of 2001. In the absence of further shocks to the global economy, and helped by production cuts initiated by the Organization of Petroleum Exporting Countries, oil prices should stabilize at around $18 per barrel this year, which would support growth of around 3.5 percent in Russia.

Accession Goes Ahead

There were fears in Eastern and Central Europe that September 11 would divert the EU's attention away from eastward enlargement and could lead to considerable delays in the process. These concerns were dispelled in November 2001, when the European Commission issued its annual assessment of the enlargement process, suggesting that 10 of the 12 applicants could enter the EU as early as 2004.

However, the EU's unofficial target date of 2004 is overly ambitious given the large number of contentious issues that still need to be tackled. In addition, heightened concerns about terrorism have slightly increased the regulatory and administrative burden on the East European applicants. Current EU members have agreed on a number of new initiatives, such as the common European arrest warrant, that will have to be shared by the new members, and extra attention will now be paid to reinforcing borders between the new members and so-called third countries (Ukraine, the Balkans, and other EU neighbors).

On the whole, however, September 11 will have little impact on the EU expansion process, and the EIU still expects a "big bang" enlargement, including all East European applicants except Bulgaria and Romania, in 2004.

The World Bank/IMF Agenda

U.S. Treasury Takes a Stand on the Grants Versus Loans Debate...

U.S. Treasury Secretary Paul O'Neill said on February 27 that the United States would consider helping the World Bank replace revenues lost because of a U.S. proposal to boost grants to the world's poorest countries. He told the House Financial Services Committee that "conceptually I have no problem" with the United States and other rich countries committing to replace the lost revenue from President George W. Bush's proposal to switch up to 50 percent of World Bank assistance from loans, which have to be repaid, to direct grants. O'Neill said that the administration plans to increase its contribution to a World Bank fund for the poorest countries by 18 percent, but he linked the increase to the administration's proposal. The 15 countries that contribute to the fund have not been willing to go beyond a 10 percent limit on grants for fear this would eventually erode the Bank's capital base. O'Neill maintains his stance that grants are better for poor countries in the long run.

...and Urges the IMF to Introduce Lending Reform

In testimony before Congress Paul O'Neill also called for fundamental reforms of the IMF, questioning its role as lender of last resort for countries that have made bad economic choices. "The IMF needs to demonstrate a greater willingness to focus its support on countries doing the most to help themselves," he said. John Taylor, U.S. Treasury undersecretary for international affairs, also spoke against "large, elephant-style bailout packages" in an interview with the *New York Times*. He argued that the creditworthiness of emerging economies can now be tracked more effectively than in the past, and that financial crises are therefore less likely than before to spread beyond the country of origin. Taylor stated that the United States and other governments should work to improve the flow of information between international borrowers and lenders.

MacArthur Foundation and World Bank Discuss Joint Research Projects

In January 2002 representatives of the John D. and Catherine T. MacArthur Foundation and the World Bank met in Washington, D.C. to identify areas for future research collaboration, including globalization and education and technology issues in Russia. The meeting was a follow-up to an earlier discussion between Nick Stern, senior vice president and chief economist of the World Bank, and Jonathan Fanton, president of the MacArthur Foundation.

The Bank is currently conducting two research projects relevant to the Foundation's interests in Russia, one on science and technology issues and the other on the knowledge economy. Reports on each of these topics will be completed later in 2002 and will be made available to MacArthur staff. The Bank is also working with the Russian government on the large-scale E-Russia informatics project. The MacArthur Foundation is interested in establishing technology transfer offices at

Continued on page 50

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Russia: WTO Member As Early As 2003?

Erik Berglöf and Sergei Guriev

The July-August-September issue of Transition featured a summary of "Russia in the WTO: Myths and Reality," a Centre of Financial and Economic Research (CEFIR)-Club 2015 report based on fresh research on a wide range of economic issues. The project's goal was to increase awareness and knowledge in Russia about World Trade Organization (WTO) accession in general and to dispel the most common myths about the consequences of membership. After dissemination, the report received immediate and lively feedback from economists, policymakers, and business strategists. It also became the subject of a high-level luncheon in Moscow hosted by the World Economic Forum. The story of the WTO report is a propitious example of how advanced research found a natural place in influencing the Russian policy debate.

Last summer "Russia in the WTO: Myths and Reality" was sent out to 2,000 top leaders in Russia and created a major stir. The report was featured on the cover and published in its entirety by RCB *Tovatny Rynok*, a leading Russian financial journal, and on http://www.polit.ru, a major Russian Internet journal. It was also published in the United States in *Russia Business Watch*, the official circular of the U.S.-Russia Business Council. The report generated intense discussion on CEFIR's web site, and the office of the chief Russian WTO negotiator contacted CEFIR for a follow-up study. (Editor's note: CEFIR is a Moscow-based think-tank, staffed by top, young, Russian economists.)

The WTO report also got the attention of the World Economic Forum, and served as the basis for a luncheon at the World Economic Forum meeting in Moscow in October. More than 100 business leaders representing commodity exporters, import substitution industries, banking, information technology and telecommunications, heavy machinery, and aircraft producers; top government officials; and key foreign investors gathered to discuss the advantages and disadvantages of WTO accession, as well as policies Russia should pursue to benefit fully from membership.

After discussion of the report the participants were invited to express their own judgments and expectations relating to WTO membership cluded that Russia stands to benefit from accession, but that accession should be accompanied by structural reform to maximize the accession dividend. The main conclusions of the meeting were that the primary benefits of accession would be Russia's greater access to foreign markets and the improved investment climate for foreign direct investment. Commodity exporters and other current and potential exporters would benefit from less antidumping pressure abroad,

Russia is expected to join the WTO in 2003-04

The World Economic Forum polled the workshop participants on the expected time of Russia's accession to the WTO. Most of the participants expect accession to take place in 2003-04. Although the discussion did not change the distribution of votes, it did help to raise awareness, with more participants expressing their views on the issue after the talk.

Expected accession year	*Before discussion*	*After discussion*
2002	1	3
2003-04	24	34
2005-08	7	11
After 2008 or never	1	0
Total votes	33	48

the transparency and protection of intellectual property rights, which would bring investment to the economy in general and to the information technology and telecommunications sectors in particular.

The participants also concluded that the costs of WTO accession are exaggerated for the following reasons:

- Because most industries do not actually pay the existing tariffs, with the exception of a few protected sectors such as banks, insurance firms, automobile manufacturers, and long-distance telecommunications, most Russian firms are already working in an open economy. Therefore in most cases accession will not result in lower effective tariffs and the costs of adjustment will therefore be low or moderate.
- While 50 to 90 percent of Russian banks are not competitive, their liquidation is not a cost, but rather a benefit to the Russian economy. These are not truly banks, and the banking sector reform approved by the government will lead to their closure anyway. However, opening up to foreign banks will provide Russian industry with access to financial services.
- A short-term cost is related to the currently subsidized telecommunications tariffs. After the accession consumers will have to pay higher prices. This problem may also have an important social dimension. Accession will, however, be beneficial for the sector's long-term development.

Nevertheless, the high accession dividend cannot be taken for granted because

- Russia will benefit most if it joins the WTO on general terms.
- Raising awareness within Russia is overdue. Entrepreneurs need to learn how to use WTO rules to protect their markets.
- During the accession negotiations Russia needs to ensure that it receives market economy status and access to steel, food, and consumer goods markets in countries of the Organisation for Economic Co-operation and Development.
- Russia needs to implement the banking reforms rapidly and irreversibly to enable the remaining 10 to 50 percent of banks to compete with their foreign counterparts. In addition to the plan already approved, the reform should upgrade the quality of Central Bank staff and reduce the monopoly power of Sberbank (the Savings Bank).
- To end hidden favoritism, the government must make bidding for public procurement open and transparent

In his concluding remarks, Deputy Prime Minister Alexey Kudrin confirmed that Russia's government considers WTO accession a top priority and called on both Russian and foreign business leaders for continuing support of this cause.

Erik Berglöf is the director of SITE and Sergei Guriev is a senior researcher at CEFIR.

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We are looking for three new full-time staff members, view more information here.

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View information and program from the first annual conference "Russia2015: A Long Term Strategy" that took place in December, 2001, organized by CEFIR; NES, Club 2015, and EERC.

Images from 'The WTO and Russia' A discussion with Grant Aldonas, *U.S. Under-Secretary for International Trade Administration and* Leif Pagrotsky, *Swedish Minister of Trade* - here together with SITE's director Erik Berglöf on Wednesday 21 November read more

CONTACT INFORMATION

Mailing address: SITE, Stockholm School of Economics, Box 6501, SE-113 83 Stockholm, Sweden

Street address: Sveavägen 65, 9th floor

Tel. (+46 8) 736 9670, Fax (+46 8) 31 64 22

General correspondence: Mailto:SITE@hhs.se

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Value of Law in Transition Economies

By Peter Murell

As part of its decade-long work in the area of institutions, the Center for Institutional Reform and the Informal Sector (IRIS), of the University of Maryland recently sponsored a conference focusing on how law affects the behavior of individual economic agents in transition economies. The conference papers, now available in a single volume, *Assessing the Value of Law in Transition Economies*, ask whether law can be effective in the rapidly changing and often chaotic environment of transition economies, what factors determine the success of legal and institutional reform, how law adds value to economic processes, and how use of the law varies with the characteristics of economic agents and with the nature of legal processes. This article is an overview of the book.

A flood of recent papers examines the role of institutions, particularly law, in growth and development. After many decades of simply being a sideshow, law is now central in the thinking of economists and in their current research. However, much of the current empirical work has been carried out at the macroeconomic level within a cross-country framework and examines the inter-relationships between levels of per capita income (or growth), aggregate measures of a country's institutions, and determinants of institutional quality. The amount of microeconomic empirical work on the role of legal processes in development and transition is still rather small. More than ever we are sure that law is important, but we still lack detailed empirical knowledge of how law works, which features of law are the most important, and how to produce effective legal change.

The aim of the recent conference and the publication of the related papers was to redress this imbalance. The central analytical agenda of the book is its focus on the microeconomic pathways through which legal and institutional reforms affect economic activity. Thus the papers eschew broad assessments that rely only on the application of general legal or economic reasoning or on the use of highly aggregate data. They examine the economic decisions of the individual actor, such as shopkeepers, lawyers, the courts, enterprises, bureaucrats, managers, and outside investors. The papers use diverse methodologies—theoretical and empirical, econometric and case study—and cover a broad range of countries, from Central European nations to China.

The book's themes range from decisions about litigation taken deep within the bowels of the firm to the constitutional and politico-economic setting within which legal initiatives take place. At the former level, Kathryn Hendley presents case studies of the genesis of disputes between trading partners in Russia, identifying the social and economic factors affecting decisions on litigation. Hendley's study shows that the nature of an enterprise's legal expertise and the assigned role of lawyers within the organizational structure play an important role in determining which disputes reach the courts. Hendley, Peter Murrell, and Randi Ryterman examine whether law and legal institutions add value to Russian transactions. In an econometric analysis of the outcomes of a sample of transactions, they show that the economic and institutional environment rewards those enterprises that invest effort in constructing contracts, that possess superior legal knowledge, and that reorient their legal work to new opportunities. Glenn Hendrix examines the Russian courts from the perspective of foreign companies, and concludes that the likelihood of a foreign business obtaining a fair outcome in the Russian court system is greater than is generally believed. The success of foreign litigants against domestic parties may indicate that the Russian judiciary is becoming more independent.

How typical is the evidence from Russia? Young Lee and Patrick Meagher examine business finance and commercial transactions in Kazakhstan and the Kyrgyz Republic. They show that growth-oriented financial transactions are consistently linked with the use of formal legal arrangements, but that such transactions are not common. Minxin Pei argues that the usual rhetoric about the absence of law in China is far removed from reality. He presents evidence to support the proposition that China's emerging legal system provides the basic protections required for successful economic transactions. He concludes that the legal system performs this role because the country's legal reform has solid political foundations and benefits from a pre-existing institutional framework that helps reduce the problems of corruption and political interference. Raja Kali uses the lens of theory to reflect on the recent empirical literature on business networks, and suggests that the existence of such networks stunts the effectiveness of formal institutions.

Three papers examine longer-term processes: investment, corporate finance, and corporate governance. Timothy Frye analyzes the investment activities of shops in Warsaw and Moscow. Using survey results, Frye concludes that the rule of law is stronger in Warsaw than in Moscow. He argues that the social order produced by an effective police force occurs prior to a concern about functioning courts in the calculations of small business people making investment decisions. Katharina Pistor examines equity market development in the most developed transition countries: the Czech Republic, Hungary, and Poland. She argues that the regulatory framework and the state's capacity to enforce this framework have been crucial. When considering the three sets of relevant rules—shareholder property rights, protection of potential investors, and trading rules—Pistor concludes that investor protection rules have been the most important. Michael Heller's essay examines corporate finance and governance in Russia. Heller uses property theory to explain why privatization and the new corporate law have not had the positive effects that reformers predicted. He argues that corporate governance in Russia provides an unfortunate example of a tragedy of the anti-commons.

The last two essays in the book focus on the interaction of the law and the activities of the state. Daniel Berkowitz examines the effects of a 1996 law on oil pipeline regulation in Russia. Using econometric evidence he argues that the law had a significant effect on regulator behavior, and suggests that corruption in Russia is not so pervasive as to make the details of law irrelevant. Leonid Polishchuk analyzes the decisions of Russian regions in choosing their legal and regulatory regimes. With regional choices not subject to the coordinating constraints of an efficient federal structure, the incentives of regional leaders favor control over local economies instead of the creation of impartial rules. The regions attempt to supplant federal legislation with their own laws and to develop "legal enclosures" that are insulated from the national legal system.

With such a diverse set of themes and evidence presented, the overall conclusions the book draws are general. Most important, the essays identify many areas where the processes of law do affect the behavior of economic actors. While Hendley, Murrell, and Ryterman's phrase "law works in Russia" verges on hyperbole, the essays argue that law does work in many spheres in the transition economies. This conclusion run counter to much of what has been written in the past. Therefore the book's empirical studies indicate the danger of forming judgments from anecdotal evidence and macroeconomic data, rather than from undertaking assessments of institutional quality at the detailed microeconomic level.

Many of the essays also identify areas where law is not effective. If law works in transition economies, it only works in parts of those economies and only under favorable conditions. However, identification of these conditions provides lessons for institutional reform on the nature of the reform process, on the properties of the surrounding economic environment, on the importance of the attitudes and knowledge of the economic actors, and on the ways in which different institutions provide necessary complements.

The essays in this book reinforce the new literature on the aggregate effects of institutions, underpinning the developing conventional wisdom that law is important. However, we still have a long way to go in developing an empirically-based understanding of where and how law is important, and how to act on that knowledge to secure productive institutional change. *Assessing the Value of Law in Transition Economies* is the most comprehensive attempt to date to build this understanding for transition economies, but a huge amount of research in the same vein is needed to make institutional reengineering as productive a reform tool as current research promises it might be.

Peter Murrell, professor of economics and chair of the Academic Council of the IRIS Center, University of Maryland, is editor and co-author of Assessing the Value of Law in Transition Economies, available from the University of Michigan Press, Ann Arbor, 2001, 408 pp. To order go to http://www.press.umich.edu/titles/09763.html.

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For or Against? Public Perception of Local Governments in Central Europe

By Pawel Swianiewicz

For or Against? Public Perception of Local Governments in Central Europe is the first publication of the Local Government Policy Partnership program and tries to answer the following three basic questions:

- What is the public's view of the newly created local governments?

- How did general public opinion influence the various decentralization reforms of the past decade?

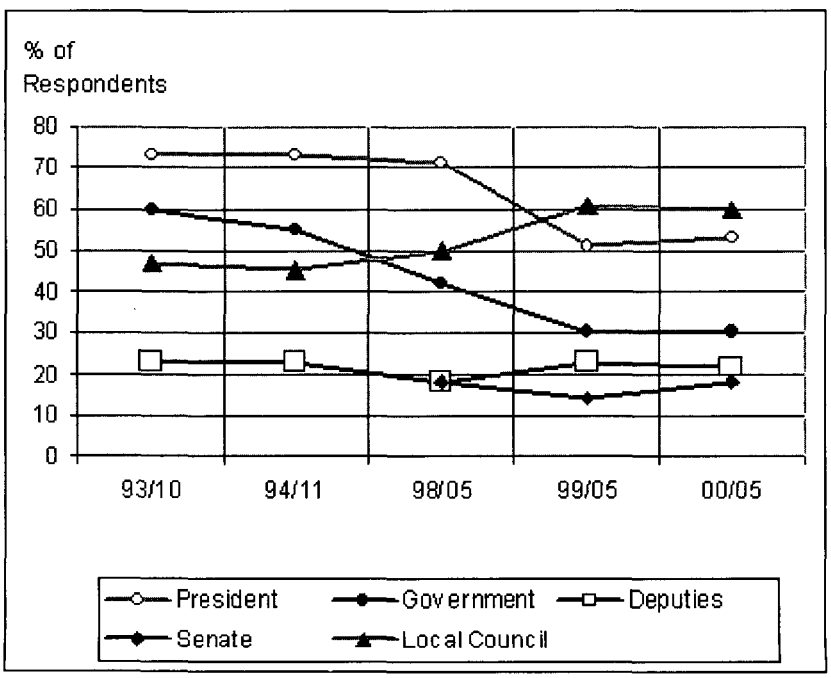
- What are the typical forms of communication with the public at the local level?

The book, which compiles findings by a number of investigators, tries to answer these questions based on research findings from four countries: the Czech Republic, Hungary, Poland, and Slovakia. It uses the results of previous surveys and information from various sources. The availability of information based on public opinion is in itself an indicator of the general public's involvement in the communication process. Time series and comparable survey questions are widely accessible in the Czech Republic, but less so in Slovakia. Hungary and Poland have been involved in several international research projects that supported the comparison.

The first question was addressed by analyzing various indicators of citizens' attitudes toward local governments. Voter turnout for local elections is usually lower than for parliamentary elections, but in Hungary, for example, seems to be stable or increasing, unlike turnout for parliamentary elections. Trust in local governments is generally higher than for other political institutions, such as the country's parliament or national government. Voter turnover at local elections for mayors at the two last elections could be interpreted as a signal of satisfaction with mayors' performance.

During the past decade most decentralization and local government reforms were typically implemented as top-down processes. Popular support might speed up this process in the Czech Republic or Poland, but

Development of Trust in Constitutional Bodies, the Czech Republic, 1993-2000



Source: Author.

Table 1. Frequency and Use of Internet Communication by 23 Major Hungarian Towns, January 2001

Category	*Number*
Cities having a web site, that offers	22
Descriptive information about the locality, its local government, etc.	18
Possibility of email contact with the mayor's office and/or local politicians	12
Access to council decisions	13
Temporarily not operational	2
Cities with no web site	1

Source: Author.

they were mostly regarded as political battles between various groups or were initiated by external forces. An exception was the public pressure to limit the salaries of Poland's top local government officials, which was initiated by the media and supported by 90 percent of the public.

Communications between citizens and local governments are highly developed in the countries studied, either because of processes required by law, such as public council meetings, hearings, consultations, or complaints procedures, or because of "marketing" methods, for example, surveys and focus groups. Citizen groups, experts, and NGOs are involved in the local decisionmaking process.

Local councils and administrations use various traditional forms of communication (local media, reports, bulletin boards, and so on) and the Internet (table 1).

The authors of the country reports try to explain differences in the level of acceptance of local institutions. One factor is the size of local governments: responses are generally more favorable in smaller municipalities than in large ones (table 2). The most positive views are expressed in municipalities with populations of 2,000 to 5,000, which seem to be the major beneficiaries of decentralization in countries with highly fragmented local government structures.

However, a higher level of education or of income are also important factors that are positively correlated to support for local governments; however, affluent, educated people are more likely to reside in large, urban municipalities. The Hungarian author's conclusion is that the relatively poor citizens of small villages are more dependent on public services provided by the local government, and consequently their support for decentralization is higher.

This book is not a typical product of the Local Government Policy Partnership program. It concentrates on changes in public attitudes toward local governments and on differences in approaches toward various components of municipal systems.

As local governments become increasingly important in citizens' everyday lives, political institutions and public actors that can demonstrate greater sensitivity toward public opinion are vital for the success of future reforms. The underlying message of this volume is that without regular and systematic analysis of public opinion, viable local government policies will become even more difficult to design and implement.

To order the book, edited by Pawel Swianiewicz and published in Budapest in 2001, email lgprog @osi.hu.

Table 2. Citizens' Perceptions of Whether They Can Influence Local Matters, Poland, Selected Years
(percentage of respondents)

Size of local government unit	*January 1992*		*June 1999*		*January 2000*	
	Yes	*No*	*Yes*	*No*	*Yes*	*No*
Total	**15**	**85**	**25**	**73**	**31**	**67**
Rural area	20	80	33	65	36	61
City of less than 20,000 people	16	84	25	71	32	67
City of 20,000-100,000 people	13	87	20	79	29	70
City of 100,000-500,000 people	12	88	18	77	26	71
City of more than 500,000 people	n.a.	n.a.	18	81	30	70

Source: Author.

In Census We Trust? Collecting Data in Transition Economies

By David Hayhurst

Official statistics are indispensable tools for policy-making in democratic societies: they serve governments, economic systems, and the general public by providing data about a country's demographic, economic, and social makeup. A census traditionally provides the government with basic statistics about general demographic trends among the population, as well as about major social and economic processes. It also provides vital data on housing, labor activities, educational levels, and other demographic information that are key for a government's understanding of its constituents. This is particularly true in small or remote administrative areas, which other nationwide surveys often ignore because such a task is far too expensive to be conducted by any entity other than national governments.

In line with decentralization, in recent years local governments across Europe have become increasingly responsible for policy and sound budgetary formulation within their jurisdictions. Thus accurate, frequently updated, and comprehensive data about local populations have become extremely important. However, gathering data, especially at the local level, can cause confidentiality problems.

In only a few decades the average citizen's daily exposure to sophisticated information technology has expanded enormously worldwide. The public is now far more aware of the power of information in the hands of corporations or criminals, enhanced by powerful computer technologies. Despite national data protection laws that were enacted with the aim of guaranteeing strict confidentiality of individual identities, the public throughout Europe has become suspicious, even questioning the state's rights to collect information and justify it by pointing to its need to formulate sound public policy.

For almost all Central and Eastern European (CEE) nations, the current round of national censuses is the first since their political transition (see the

Past, Recent, and Upcoming Population Censuses, Selected European Countries

Country	*Last population census*	*Recent/forthcoming population census*	*Statistical office web site*
Armenia	1989	2001	http://www.armstat.am
Belgium	1991	2001	http://www.statbel.fgov.be/
Bulgaria	1990	2001	http://www.nsi.bg/
Croatia	1991	2001	http://www.dzs.hr/
Czech Republic	1991	2001	http://www.czso.cz
Estonia	1989	2000	http://www.stat.ee/
Hungary	1990	2001	http://www.ksh.hu/pls/ksh/docs/
Kazakhstan	1989	1999	http://www.kazstat.asdc.kz/
Latvia	1989	2000	http://www.csb.lv/
Lithuania	1989	2001	http://www.std.lt/
Macedonia	1994	2001	http://www.stat.gov.mk/
Poland	1988	2002	http://www.stat.gov.pl/english/index.htm
Romania	1992	2002	http://www.cns.ro/indexe.htm/
Russia	1989	2002	http://www.gks.ru/default.asp/
Slovakia	1990	2001	http://www.statistics.sk/
Ukraine	1989	2001	http://www.ukrstat.gov.ua/
United Kingdom	1991	2001	http://www.statistics.gov.uk/
Yugoslav Republic	1991	2002	http://www.szs.sv.gov.yu/homee.htm

Source: Author

table). Regardless of concerns about how data have or will be collected, the findings of many CEE statistical offices will inevitably have profound social impacts. Demographic studies have consistently indicated relatively negative social trends—including falling male life expectancies, declining populations, huge jumps in unemployment levels, and intensifying brain-drains of both skilled and semiskilled workers—for much of the region in the postsocialist era. Census findings will help bringing these highly unsettling trends to the forefront of current affairs. These censuses are also litmus tests that measure the levels of public trust and confidence in the states' commitment to respect the guidelines guaranteeing data confidentiality. Such guidelines will also apply to all EU accession candidates in CEE. However, legal changes alone cannot be effective if public suspicion about the motives and intentions of those charged by the state with collecting sensitive data gains momentum.

Traditional Census Requires Consensus

Traditional population censuses are still the most frequent data gathering technique in southern Europe (Greece, Italy, Portugal, and Spain), the United Kingdom, and CEE. Unfortunately, counting each and every member of the public is an extremely complex and costly undertaking, which is the main reason censuses are generally conducted once a decade.

Conventional censuses tend to use pre-existing administrative data and state registers (such as tax roles and databases on housing and employment) only in support of organizing the collection and compilation of data gained from the census through questionnaires, personal interviews, and so on. To succeed, a census invariably demands the involvement of thousands of individuals. It also requires the procurement and storage of massive amounts of forms and other materials that need to be distributed to all corners of a country and then collected. As traditional censuses are such relatively rare undertakings compared with other statistical operations, they lack the streamlining of repetitive procedures used for more routine data collection activities. As a result, expenditures and the numbers of skilled staff required at all the various stages of census taking (enumeration, data collection, and collation) are much higher than state statistical managers are likely to be accustomed to. Another danger is that with societies becoming far more mobile and complex than in the past, much of the data gathered by traditional census methods may be outdated by the time the results are released.

Perhaps the biggest drawback to the traditional census is its reliance on goodwill between the questioners and those being questioned. The quality of information gathered depends greatly on the quality and motivation of the individuals delivering census forms, conducting face-to-face interviews, or otherwise dealing with respondents directly. If interviewees feel that the questioning process is a burden on their time and an intrusion on their privacy, the quality of much of the information collected will be tainted at best. For example, most Western European governments no longer ask direct census questions about personal incomes, a sensitive question for those worried about coming under scrutiny by tax authorities, regardless of their financial status.

Civil liberties advocates and like-minded groups in several countries, who see traditional censuses as an intrusion on personal privacy, have increasingly questioned the legitimacy of major data surveys such as population censuses. In addition, the need for increasingly expensive traditional censuses, and a growing sense that new information technology could make comparable data gathering cheaper and easier via other means, has led several governments to abandon standard census operations entirely in favor of reliance on pre-existing data sources, such as tax declarations, social insurance registers, and police reports.

Direct opposition to traditional census activities may have been influenced by Western European counterculture trends that came to the forefront in the late 1960s. Nearly 2.3 percent of the population refused to participate in Holland's 1971 general census following widespread public debate about privacy rights in relation to new computer technologies and costs. Following a poor response to a 1979 voluntary census test (nonparticipation in the test was close to 25 percent nationwide and nearly 50 percent in major cities) and the absence of new legislation on data protection, the government canceled the 1981 census altogether. In the mid-1980s the government replaced the decennial general census with a system that relies on regular inputs from municipal population registers, continuous labor force surveys, and surveys on national housing demographics conducted every four years. Not only is this cheaper than a traditional census, but data collection and collation are much faster.

In Germany various pressure groups organized a mass public campaign before the 1983 census based on concerns about privacy violation issues and suspicions that the data gathered would be used for other than strictly statistical purposes. The Constitutional Court ruled that the

practice of using census data to update population registers violated the individual's right to privacy as stipulated in the Constitution. Twenty years later the government was ordered to substitute a micro-census for the 1991 operations that would cover only 1 percent of the total population by direct enumeration, followed by supplementary surveys based on even more restrictive population samples. Germany is now proposing to base population estimates on local population registers. It also wishes to rely as much as possible on micro-censuses and other more readily available statistical sources. Most other Western European countries have retained enumeration-based operations, and at the same time introduced confidentiality measures. In the United Kingdom, for example, census forms do not include the names of natural persons, and census documents are sealed for 100 years and then opened for historical and genealogical research.

Burdensome Heritage in Transition Economies

In CEE countries state-citizen relations have obviously experienced an even more fundamental paradigm shift in the post-Cold War era. Almost all CEE states have recently completed their first postsocialist censuses or intend to do so in the near future. Budgetary constraints, however, are a major challenge to conducting accurate censuses. Poland, Romania, Russia, Slovenia, and Ukraine have recently cited fiscal difficulties in deciding to postpone census operations. Budgetary constraints can also negatively influence the methodology of census taking. Cutting corners should probably be expected in the least affluent countries, for example, by cutting once standard data gathering tools such as sampling, precensus surveys, and second-round controls.

However, most formerly communist countries face a more fundamental and common challenge in conducting their population censuses. Albeit to widely varying levels, statisticians gathering data for official use in any CEE state must cope with deeply entrenched popular perceptions of statistics being "political" in the most negative sense of the term. "During socialism, citizens had the attitude that statistics were just another political propaganda tool," explained an official from Ukraine's State Committee of Statistics.

Scandals involving statistical bureaus and various state and private sector agents in recent years have done little to bolster public confidence. In June 2000 in Estonia, the interior minister came close to labeling the Department of National Statistics "common criminals" for their handling of sensitive data from the census carried out three months earlier. An NGO watchdog group claimed that an illegal database had been compiled from the collected information. The department countered that this was merely a back-up mechanism. Nonetheless, it received angry phone calls from citizens demanding the return of their census forms.

Russia's general population census is scheduled for October 2002, following two budget-related postponements, but there are other difficulties too. For example, Russia has seen an enormous influx of migrants and refugees from the hinterland of the old Soviet empire to more urbanized areas, most of whom have never registered with the relevant authorities for fear of expulsion and have no intention of letting the authorities know of their existence. In addition, the belief that Russia's State Statistics Office (Goskomat) can safeguard data confidentiality has never been strong, and was further undermined in June 1998, when 20 senior Goskomat officials were charged with and found guilty of deliberately falsifying industrial production data and selling confidential business information to businesses' competitors.

While a number of CEE countries have made major progress toward ensuring better confidentiality of statistical data—most EU accession countries have adopted or updated their national statistical laws to comply with EU confidentiality requirements—most statistical agencies in the region still consider the protection of enterprise data more important than that of natural persons. Seven Eastern European countries (Albania, the Czech Republic, Estonia, Latvia, Hungary, Poland, and Romania) and two CIS countries (Tajikistan and Ukraine) allow external institutions to access original data on natural persons. Prior to the political transition state statistical offices in CEE had little need to view individual privacy rights as a fundamental concern, thus changing this prevalent psychological culture is a pressing challenge.

Another obvious major problem for statistical offices is the availability of the information technology needed for effective disclosure control. Regardless of legal requirements, confidentiality guarantees are difficult to offer if the technology needed to protect sensitive data is simply too expensive. There is, therefore, an obvious schism between the reality of recent initiatives taken by CEE states to improve statistical data confidentiality and the public's perception that enough has been done in this regard. Better communication could probably correct these misconceptions.

Pan European Harmonization Lies Ahead

The challenges facing comprehensive, cost-effective, technically feasible, and popularly supported data

gathering procedures have led to stronger incentives for solutions beyond national boundaries. Coordination in the content and conduct of censuses and other data gathering initiatives has increasingly gained ground in Europe.

As part of EU support to applicant states, the Common Declaration on Statistical Cooperation between the Statistical Office of the European Communities (Eurostat) and the national statistical offices of Bulgaria, the Czech Republic, Hungary, Poland, Romania, Slovakia, and Slovenia was signed in January 1994. In doing so, Eurostat made a formal commitment to help the signatory nations implement statistical standards, classifications, and methodologies that are used in the EU and in the West generally, including sharing information about how best to protect computer networks and gathered data. In 1995 the EU adopted a directive on the protection of individuals with regard to processing personal data and the free movement of such data. All EU member states are obliged to adapt national legislation to comply with this directive, and it also forms part of the EU's collection of regulations, the so-called *acquis communitaire*. Hungary, Lithuania, and Slovenia have already ratified the related convention and all other applicant countries are also planning to do so. They have much to do. In 2000 Eurostat sent questionnaires to the state statistical offices of member states and applicant countries asking about the general methodology of censuses. The responses revealed that for the time being wide differences exist among countries, whether in data gathering, data dissemination, or quality control standards.

The author is a freelance journalist, Budapest, Hungary,

Slovak Population Census 2001: The Politics of Ethnicity

By Eleonora Sandor

Ethnicity was a central focus of the May 2001 Slovak population census. This was not only because the country's ethnic composition—primarily changes in the proportion of the Hungarian and Roma minorities—had attracted political scrutiny, but also because financial aid from the state to organizations representing minorities and churches was to be determined by the results of the census.

Although initially lukewarm toward the idea of a population census, the public gradually became more interested as the date approached. By February 2001, 84 percent of those surveyed said that they were aware of the census's significance, and were ready to provide information without fears that it might be misused. Like its predecessor in 1990, the 2001 census was based on anonymous provision of data by citizens. The anonymity, combined with the electronic processing of questionnaires, minimized concerns about data protection.

Politicians unanimously supported the census and encouraged citizen participation across political boundaries, but dissenting voices appeared in the media. Newspapers questioned how willingly citizens would provide data to the state at a time when disappointment was growing because of the country's deteriorating economic and social indicators. A lack of information about how the government had used the results of the last census added to the sense of unease. Nevertheless, on the whole criticism of the census in Slovak newspapers was rare.

Religion

Citizens were asked to indicate their religious status/church. In contrast with other headings, the data sheet did not provide any additional explanation. According to the instructions on the supplementary material provided with the data sheet, religious status meant participation in or connection with the religious life of any of the churches. People could choose between 15 churches recognized by the state in addition to "no denomination" and "other." People who chose the latter had to indicate which church they belonged to. Respondents criticized the wording for not delving into the intensity of their religious life or into the concrete forms of their relationships with their churches. They also noted that the category "no denomination" was equivocal, and applied not only to atheists, but also to those who felt that their relationship with their church was not a formal one.

An earlier government directive had made it clear that further state support to individual churches would be determined by the results of the census, so for the churches, registering as many followers as possible became a vital issue. Leaders of both the Evangelical and Catholic churches asked all citizens who had been christened, irrespective of whether or not they were engaged in an active religious life, to fill in the census accordingly. Their campaign included letters and handouts. The

letter from the Catholic bishops emphasized that belonging to a religious community is "irrevocable," and hence even those who did not live according to religious rules should note on the census that they were affiliated with the Catholic church because "the church prays for its strayed children too." These kinds of confused messages inspired the youth wing of the Social Democratic Party to campaign against the provision of financial support to the church. Their posters encouraged citizens who disagreed with the financing model to check the "no denomination" option on the questionnaire.

Ethnicity

The 1990 census did not provide any optional categories for noting one's ethnicity. For the 2001 census the Slovak Statistical Office listed the most frequent ethnic groups—Slovak, Hungarian, Roma, Czech, Ruthenian, and Ukrainian, as well as "other"—on the data sheet. Another heading stated: "If the language of your parents was different, note the language that your mother used to speak with you." The data sheet did not provide any further explanations concerning ethnicity. The instruction leaflet did explain that people's mother tongue was not necessarily the determining indicator of their ethnicity and that people's ethnic status was whatever they believed it to be. Respondents could check only one ethnic group. With this approach to ethnicity, the Statistical Office stirred up a hornet's nest.

Representatives of unlisted minorities felt discriminated against and pointed out that many people would mark their original ethnic group only if it was indicated on the questionnaire. The Moravian minority protested the most. Even though Parliament's Human Rights Committee supported the Moravians' viewpoint, Pál Csáky, the vice-president responsible for minority matters, rejected the request based on Czech political pressure. The Ukrainian minority's complaint was specific. They asked that the census sheet not list Ukrainian and Ruthenian minorities separately, arguing that these were identical ethnic groups of which two "streams" were set against each other for political purposes. However, both the relevant parliamentary committee and the Council for National Minorities and Ethnic Groups found the complaint to be without merit. Based on the council's recommendation, the government solved the dilemma by attaching its own handout to the census sheet on which it listed the 11 national minorities and ethnic groups recognized by the government.

While 10 years earlier the government had rejected requests for bilingual questionnaires, in 2001 Slovak-Hungarian, Slovak-Ukrainian, and Slovak-Ruthenian census sheets and supplementary materials were distributed. After the Romas complained that they were being discriminated against, the government also issued a Slovak-Roma version.

Final Results

Editor's note: The May 2001 census showed that 5,379,455 people live in Slovakia. Only 92,000—14,000 more than in 1991—declared their ethnicity as Roma, but nongovernmental Roma groups said that the actual number was far higher, between 220,000 and 400,000, claiming that the difference was a consequence of intimidation and manipulation. The proportion of Hungarians dropped from 10.8 to 9.7 percent and that of Czechs from 1 to 0.8 percent, while 2,348 respondents gave their nationality as Moravian. Only 218 respondents said that their ethnicity was Jewish. The largest religious denomination was Roman Catholic, with 3.7 million members, or 68.9 percent of the population. Almost 50 percent of respondents were economically active, and unemployment was estimated at around 18 percent. Compared with the 1990 census, the returns showed that Slovakia's population is aging and birthrates are declining.

The author is a researcher at the Forum Institute for Social Studies, Bratislava, Slovakia. She may be contacted by email at SandElea @mail.ncsr.sk.

Modern Fairy Tale

Once upon a time Little Red Riding Hood took her picnic basket full of goodies and left for the next conference of the industrial countries to stand up against globalization.

From the Hungarian magazine *Hócipõ.*

Safeguarding Sensitive Personal Data

By Spiros Simitis

Sensitive personal data about individuals should be protected by laws and regulations that are precisely worded, the consequences of violating such laws should be clearly defined, and the data that others can ask for should be limited to what is necessary.

The definition and delimitation of "sensitive" personal data to protect individuals has a long history. Norway was one of the first countries that attempted to distinguish different kinds of personal data according to their sensitivity. French legislators were among the first to demand prohibitions against the use of such data. While the initial discussions were primarily debates on whether sensitivity is really a valid criterion for determining processing conditions, both the context and the purpose of the debates were revived in 1981, when the Council of Europe adopted the Convention for the Protection of Individuals with Regard to Automatic Processing of Personal Data. As a consequence, the existence of sensitive data as such ceased to be contested.

Currently—despite the differences between, for instance, the British, the Dutch, and the Spanish data protection acts—the consensus concerning sensitive data cannot be ignored. All the acts give sensitive data a special status. Thus in October 1995, when the EU adopted the Data Protection Directive, most member states had already subjected sensitive data to special rules, in many cases influenced by the Council of Europe. Not surprisingly, the directive confirmed that countries must handle sensitive data in a clearly distinct way. Countries like Austria and Germany, which had consistently rejected all abstract categorizations of personal data, for the first time expressly recognized the existence of sensitive data.

Paradoxically, the longer the list of laws governing sensitive data, the more questions are raised regarding the precise range of sensitivity and the credibility of a pointedly prohibitive approach. The situation seems to be clear when requesting restrictions on data covered by countries' constitutions, such as people's racial origins, political opinions, or religious beliefs, or dealt with in specific regulations, such as the state of people's health. The data protection laws simply uphold popular demand and, at the same time, underscore citizens' expectations that others' use of all such data will be prohibited. However, once the intent has to be transformed into concrete directions for the various processing operations, abstract references to sensitive data quickly prove untenable.

To remain credible and transparent, regulations must resist the temptation to declare that any processing of sensitive data is prohibited. All they can ask for is adequate protection. Lists of what is considered sensitive must be phrased unambiguously and in a way that they can be added to or replaced.

Furthermore, current lists of exceptions should be reduced to a few exhaustively enumerated and precisely defined cases. The seemingly incontestable exception heading every list, that is, the consent of the individual or data subject, is anything but convincing. Consent is, contrary to still widespread views, not a master key that opens all doors to any data that someone else might want to access. Employment relationships are only one of many examples that demonstrate how consent can be coerced. The chances of interfering with and influencing the processing depend essentially on the circumstances under which data subjects are asked to agree. Hence, both national laws and international documents, such as the International Labour Organisation's Code of Practice on the Protection of Workers' Personal Data, deliberately exclude consent whenever employers intend to use data regarding criminal convictions or genetic information, for example.

Probably the most critical items on the exception lists are clauses that legitimize access for public interest reasons or to combat criminal activities and to safeguard public security. Terms like public interest or public security are in reality a *carte blanche* that permits bypassing all restrictions. The references to both are, therefore, usually followed by a statement specifying that the conditions of access have to be regulated by law. However, all such provisions address merely the form, but not the substance, of the prospective rules. Therefore public interest and public security remain an inexhaustible source of interventions that adapt the processing of sensitive data to government policies.

Thus the crisis facing traditional social security systems has steadily intensified efforts to obtain ever more health data, not only to establish a solid database for the urgently

needed reduction of increasing health care costs, but also to devise measures meant to persuade individuals to buy fewer medications and to reduce the number of visits to doctors.

To sum up, provisions governing individuals' sensitive data that contain no more than a few general terms mean a risk of access to citizens' personal data. Moreover, they openly contradict legislators' stated intent to restrict the processing of sensitive data. The concept of sensitivity is reduced to an ornamental function, whereby access can readily be broadened. While exceptions cannot be avoided, however justified they may appear to be, they cannot be permitted as long as their wording is imprecise, their purposes and consequences are not clearly defined, and the data asked for are not confined to information that is clearly necessary and its use limited to unmistakably defined users.

The author is a professor at the Research Center for Data Protection, Johann Wolfgang Goethe University, Frankfurt. He can be contacted at simitis@jur.uni-frankfurt.de.

Training Trainers: Managing Multiethnic Communities in Bosnia

By Zsuzsa Katona and Petra Kovacs

Developing stable and participatory systems of government that are responsive to their citizens' special needs, including those of various minorities, is central to creating a stable and working democracy in post-Dayton Bosnia and Herzegovina. To regain the trust of the citizens of various ethnic origins, governments at the state, regional, and local levels should be guided by principles of fairness, nondiscrimination, and reconciliation. This was the main message of the Managing Multiethnic Communities—Training of Trainers workshop the LGI organized in Sarajevo in November 2001. The workshop attracted multinational teams of trainees from various training organizations and municipalities from both the Federation of Bosnia and Herzegovina and the Srpska Republica. The workshop revealed that more training was necessary for improving multiethnic community management.

Local authorities are implementing the bulk of the policy measures that address the needs of multiethnic societies based on experience that shows that services and other operations are only truly effective if designed and carried out at the local government level, close to those affected. Local-level implementation also means that policy decisions can involve stakeholders from all social groups. This is why training government officials on public policies and the role of local governments in a multiethnic environment is vitally important. Local public policies aimed at multiethnic communities can both help prevent conflict and assist with reconciliation and reintegration. Such policies will also promote citizens' participation in public affairs, thereby strengthening the state's legitimacy in the long run.

In such postconflict countries as Bosnia and Herzegovina, developing the infrastructure and strong local institutions that will accommodate ethnic diversity requires new knowledge, skills, attitudes, and values, as well as creative policies and extensive cooperation among the various local and international organizations engaged in various aspects of rebuilding and democratization.

The workshop's aim was to train a group of trainers who would specialize in training public policymakers, councilors, and officials, and who through their organizations would build up an ongoing technical assistance and consultancy relationship with local governments. The training promotes inclusive, bottom-up policies, implemented by skilled local decisionmakers facing the difficult task of rebuilding a multinational society while at the same time dealing with the sensitive issues of equal educational and employment opportunities as well as reconstruction and returning refugees.

Through the training the participants were able to learn how political, legal, and administrative concepts can relate to multiethnic communities. The training also included various exercises aimed at improving the participants' capacity to turn those concepts into practice through policy decisions. To this end, the training included several case studies based on concrete examples from the field. Moreover, the participants also became familiar with various participatory techniques and policymaking skills, such as conflict and force-field analysis, mediation, negotiation, and participatory planning.

The goal of the training was to create a team of trainers and experts,who would work both individually and in small teams, and who would adapt the training to local needs in Bosnia and Herzegovina. An additional objective was to equip the participants with a methodology whereby they could adapt what they had learned and plan their own training, and the international and local trainers could then jointly create a specific curriculum for the country.

Future training activities will build on the efforts of the various international organizations, such as OSCE, the United Nations Development Programme, and OHR, and of local NGOs that have already engaged in training or who have developed relationships with municipal and local governments. To support such a process, the LGI engaged with the United Nations Development Programme Bosnia in continuing the training of trainers program in the field of local governance of multiethnic communities. The cooperative project started in February 2002.

Project manager: Petra Kovacs, researcher, kovacsp@osi.hu. Contact person: Zsuzsa Katona, program coordinator, LGItraining@osi.hu. For more information about the Managing Multiethnic Communities Project please visit http://lgi.osi.hu/ethnic/.

Navigation to the Market: Regulation of and Competition among Public Utilities

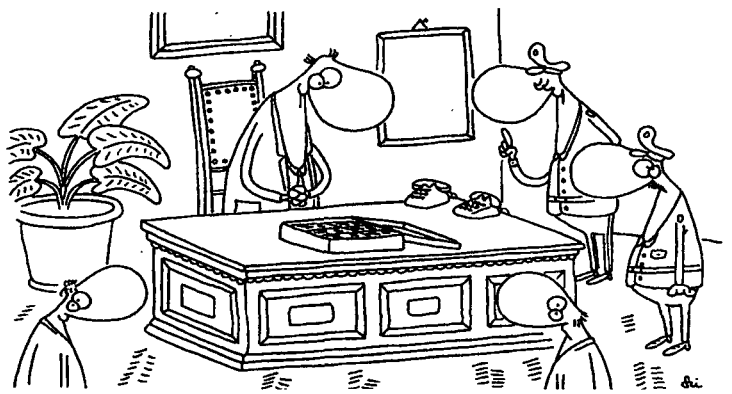
By Gabor Peteri and Tamas Horvath

In Central and East European countries the first step toward transforming local utility sectors was the restructuring of monopolies. Practically, this meant preserving monopolies in another structure to prepare them for the real changes to come with the ownership and establishment systems inherent to a market environment. In the second stage of transformation, privatization was implemented in some service areas.

The speed and character of these processes varied not only by country, but also by service. In Hungary and Poland, the extensive fragmentation of previously state-owned water companies was followed by the creation of several hundred service organizations. In Slovakia, by contrast, "municipalization" has so far been the exception rather than the rule. Most of the countries transferred solid waste management to local ownership. Service privatization that makes use of external capital is more widespread in Poland than in other countries of the region. In Romania, special semipublic forms of service organizations, *regie autonomes*, were created as regional entities.

During this period of transformation the primary task is not only to establish a market for state-owned, monopolistic sectors, but also to develop new public functions under market conditions. Transformation failures consist of "left behind" state failures and early market failures, which cannot be resolved by imposing more or less liberalization. The region can expect less foreign capital investment in this area than in others, because investors are wary of the absence of strict quality standards.

Excerpted from "Navigation to Markets," published in the quarterly journal Local Government Brief, formerly the LGI Newsletter, Fall 2001 issue, available on http://lgi.osi.hu/publications/default.asp?idx=inseries&id=4. To order fax: 361-327-3105, or go to the web site: http://lgi.osi.hu/index.html.



"Your honor, before you go overboard we must tell you that this is not bribery, but bait. You're under arrest."

From the Hungarian magazine *Hócipő.*

Articles provided by:
Bank of Finland
Institute for Economies in Transition

Mixed Picture of the Russian Economy

By Vesa Korhonen

After growing by 20 percent over the past three years, Russia's GDP is higher than at any time since 1993. The average standard of living is probably better than at that time, because after years of transition GDP currently contains proportionately more viable goods than it did before 1994. GDP per capita is still €6 to €7 a day (compared with €62 in the EU countries in 2000), although the ruble's domestic purchasing power raises the figure to some €16 to €25 a day. In 2001 GDP growth slowed to 5 percent, and the government's latest projection for 2002 is 3.5 percent.

Private consumption rose nearly 10 percent in both 2000 and 2001, while public consumption grew slightly since 1997. After plunging until 1998, capital formation continued its rebound in 2000-01, growing at a rate of 12 to 13 percent a year. Total exports were virtually stalled in 2001, industrial expansion and investment growth slowed, and unemployment increased slightly. The external surplus, which was still a hefty 10 percent of GDP during the whole of 2001, dropped to 6 to 7 percent in the final quarter of 2001 following the drop in oil prices.

Fiscal policy continued to be the cornerstone of economic policy in 2001. Monetary policy again faced relatively rapid growth in the domestic money supply, fueled by the external surplus. To contain liquidity, interest rates on banks' deposits with the Central Bank were raised several times. After being broadly stable in nominal terms in 2000, the ruble fell 7 percent against the dollar last year. Since late summer, as market pressures grew and production growth slowed, fiscal policy shifted to maintaining a stable real exchange rate, and this is the stance for 2002. The real rate is at 75 percent of the pre-1998 crisis level against the currencies of Russia's main trading partners. Rapid growth in the money supply that amounted to 40 percent in 2001, wages that rose 45 percent, increases in regulated prices, a weaker ruble, and possibly sticky expectations kept consumer price inflation at 19 percent in 2001. Producer price inflation in most main sectors fell below consumer price growth. This year a smaller external surplus should help Russia meet its goal of no more than 2 to 14 percent inflation.

Last year the government took major legislative steps that included relaxing the taxation of companies and banks, curtailing the bureaucracy and reducing the extent of outside bureaucratic interference in company affairs, and improving protection for shareholders and creditors. Laws against money laundering and on investment funds were also passed. Moreover, Russia implemented its first labor code, its first law on private land ownership (albeit excluding agricultural land), and laws to reform the court and pension systems. Reforms of the gas, electricity, and rail monopolies and of the banking sector will still take some time, and nationwide rules governing the ownership of agricultural land and forests may be difficult to achieve.

The author is an economist at BOFIT. This is a shorter version of the article "Looking at the Russian Economy in 2001-02," published in the February issue of Russian Economy—The Month in Review and available on http://www.bof.fit/bofit.

Discussion and Online Papers

Niinimäki Juha-Pekka, **Bank Panics in Transition Economies,** no. 2/2002.

This paper compares recent bank runs in seven transition economies (Bulgaria, Estonia, Hungary, Latvia, Lithuania, Romania, and Russia) with the earlier U.S. experience. Improvements in bank transparency, such as new accounting rules, can reveal insolvency and trigger a bank run; however, bank runs in East Asia, Bulgaria, and Russia have also been accompanied by runs on national currencies. A bank may issue liquid demand deposits and avoid runs without deposit insurance, as long as it also issues less liquid time deposits. Self-fulfilling runs are prevented by eliminating the maturity mismatch.

Ali M. Kutan and Niina Pautola-Mol, **Integration of the Baltic States into the EU and Institutions of Fiscal Convergence,** no. 1/2002

Continued on page 42

The Cost of Russia's Transport Independence

By Juhani Laurila

Transit transport is the transportation of goods from one country to another through a third country. Three factors seem to influence the direction and volume of transit transport between the EU countries and Russia, namely:

- **The structure of trade**
- **The unwillingness on Russia's part to purchase transit transport services from its new border republics**
- **The geostrategic security** considerations relating to Russia's long-term needs as an energy exporter and short-term efforts to exert political pressure on its neighbors.

About 40 percent of total Russian exports and 60 percent of oil exports are transported via the Baltic states. Virtually all trade between the EU and Russia is transported through one of the six corridors shown in the table. More than 70 percent of Russian exports consist of oil, gas, and other raw materials, whereas about 90 percent of Russian imports consist of consumption and investment goods. This is reflected in the unit values of transit flows. The value of eastbound flows averaged $1,170 per ton, but only $158 per ton for westbound flows. The highest unit value goods transported to Russia— more than $2,100 per ton, and consisting mostly of automobiles and electronics—were delivered via Finland. The lowest unit value transit flow—less than $70 per ton and consisting primarily of natural gas and oil—went via Slovakia and Ukraine.

Consumption and investment goods from EU countries to Russia are delivered mostly in containers that provide flexibility in transport options. By contrast, exports of fuels and raw materials from Russia to the EU are tied to specific transport infrastructure, therefore any major redirection of Russian exports would require significant investments.

Russia's large construction program, the Baltic Pipeline System, seeks to funnel part of its trade transport with the EU through a number of ports located near St. Petersburg, and thereby divert transport away from the Baltic countries. All three Baltic countries earn a substantial amount of their GDP from transit: in 1999, 7 to 9 percent of GDP for Estonia, 8 to 10 percent for Latvia, and 4 to 6 percent for Lithuania. They are thus concerned about Russia's plans. Russia, however, seems reluctant to pay for transport services through former Soviet republics, as these services were available at no charge during the Soviet era.

Russia has also had trouble agreeing on transport fees with Ukraine, which led to the construction of a bypass to the Black Sea built on Russian soil. The plan to transport Barents Sea gas directly to Germany via a pipeline laid on the bottom of the Baltic Sea instead of via the Ukraine-Slovakia corridor or the Belarus-Poland corridor also reflects Russia's preference for direct transport outlets. Throughout the past decade Russia has continuously regulated Baltic transit by means of tariffs and licensing.

Russia seems to be prepared to opt for transport autarky to assure the independence of its foreign trade transport, even if this comes at a high cost. For instance, the cost estimates of the Baltic Pipeline System project are $3 billion to $5 billion. According to Western sources, equivalent additional capacity could be created by investing just $0.3 billion to $0.5 billion in existing pipelines from Russia to the port of Ventspils in Latvia. The heavily subsidized prices in Russia's transport sector may have created an illusion about the profitability of investments in domestic transport in comparison with using foreign transit transport services.

The author is an advisor at BOFIT. This is a shorter version of the article "Developments in Transit Transport between Russia and the EU," published in the January issue of Baltic Economies—Bimonthly Review and a paper (BOFIT Online No 1/2002) available at http://www.bof.fit/bofit.

Transit Transport Flows between the EU and Russia by Corridor, 1999
(millions)

	Total		*Westbound*	
Corridor	*Tons*	*Dollars*	*Tons*	*Dollars*
Total	193	42,273	181.3	28,579
out of which:				
Finland	2	6	76	30
Estonia	11	9	86	68
Latvia	22	25	95	70
Lithuania-Belarus	5	9	83	47
Poland-Belarus	24	38	94	72
Slovakia-Ukraine	37	14	98	80
Share out of the total	100	100	94	68

Source: Author.

Russia Is Transforming Fiscal Relations between Regions and the Center

By Merja Tekoniemi

Recent fiscal news from Russia has been filled with positive stories. The large surpluses, however, tend to overshadow the slow progress of fiscal reform, in particular, fiscal relations between the center and the regions. The confused state of center-regional relations in the 1990s resulted in a costly, inefficient, and unfair system of bilateral agreements. President Yeltsin sought to keep the country united while giving regions as much autonomy as possible. In recent years President Putin has aimed at re-establishing the dominance of the federal state. Nevertheless, the practices of the 1990s are still very much in evidence. The regions are overloaded with unfunded federal mandates, that is, costly tasks delegated to them by federal laws. The most important federal mandates concern implementation of the Veterans' Law and the Law on Child Allowances. How well these laws are followed depends on the region and on its particular financial situation. More than 80 percent of the tax revenues of the Russian regions come from taxes that must be divided between the center and the regions, and the tax split tends to vary each year. Fiscal relations between the center and the regions also continue to lack transparency and remain based on informal financing channels and individual agreements.

The first serious reform program in the area of fiscal federalism was approved in mid-1998. Many goals were never reached, although some promising results were achieved. For example, the principles for distributing financial resources from the federal budgetary fund for financial support—the main formal channel for leveling financial inequities between the regions—were amended to encourage regions to pursue more rational and responsible budgetary policies. A budgetary compensation fund was created to finance some of the federal mandates that regions were incapable of handling. Currently budgetary transfers account for about 17 percent of consolidated regional and local budget revenues. The authorities have also attempted to improve budgetary planning and legislation and to introduce uniform rules for fiscal relations between the center and regions instead of individual agreements. The decision made in the 2001 federal budget to direct 100 percent of value added tax revenues to the federal budget and 99 percent of personal income tax revenues to regional budgets is a step toward separating federal and regional taxes.

In August 2001 the government approved a program for 2002-05 to reform interbudgetary relations. The program seems to acknowledge Russia's most pressing fiscal federalist problems. It seeks to increase regional authorities' freedom to conduct independent budgetary policies in a framework of clearly defined budgetary responsibilities and obligations. As the revenue base is still insufficient for regions to cope with all their responsibilities, there is a tendency to fix certain taxes at certain budgetary levels for a longer-term basis. This should clarify the present situation and help budgetary planning. Value added tax and customs duties would continue to go solely to the federal budget, and excise taxes would continue to be split as at present. The profit tax would also be divided as in 2001, with 31 percent of revenues going to federal coffers and the rest to regional budgets. As now, the most important tax revenue stream conceded entirely to the regions would be personal income taxes. In combination with profit tax revenues, they accounted for more than 40 percent of all regional revenues during January-November 2001.

On the expenditure side, the autonomy of regional budgets has increased, while joint expenditures with the center have been reduced and federal mandates have been decreased and will eventually be eliminated. Perhaps the most important single change is housing reform, which will reduce a huge financial burden on regional budgets. However, social expenditures should increase. If the basic framework of the new program is implemented, this would be an important contribution to structural reform in Russia. It would also have important repercussions on regional economic policies and could lead to the intensification of regional economic growth based on clearer budgetary rules and policies.

The author is an economist at BOFIT. This is a shorter version of the article, published in the January issue of Russian Economy—The Month in Review, available on http://www.bof.fit/bofit.

Discussion and Online Papers

Continued from page 39

From the Baltic perspective, the EU's Maastricht fiscal targets (keeping a member state's budget deficit under 3 percent of GDP) should be considered as long-term goals as opposed to short-run objectives of fiscal policy. Empirical evidence indicates that during 1996-2000 Estonia and Latvia were more successful in maintaining fiscal discipline than Lithuania. The Stability and Growth Pact signed in July 1997 would offer enough room for automatic fiscal stabilizers in Estonia and Latvia, but not necessarily in Lithuania.

Pekka Sutela, **Managing Capital Flows in Estonia and Latvia,** BOFIT Discussion Papers no. 17/2001, 63 pp.

Estonia since 1992 and Latvia and Lithuania since 1994 have been able to combine a fixed exchange rate, liberalization of the capital account before having a well-functioning and fully supervised financial system, and large current account deficits. At the same time they have undergone deep structural and institutional changes, which have been faster than in several other transition economies. How have they been able to manage such a combination of characteristics that would usually be regarded as inconsistent?

The answer does not lie in clever management or control of financial markets combined with sound fundamentals, as the Baltic countries have lacked several such markets that might be sources of instability. They have hardly any interbank markets; public debt is absent or relatively small; banking systems have been sold to credible foreign owners, as has much of industry; stability has been supported by generally responsible fiscal policies; and labor markets, not discussed in this paper, are flexible. After the small boom of 1997, the Baltic stock exchanges have generally been inactive. Not only are these economies extremely small, but their degree of monetization is low. Few assets and markets for speculative capital flows are available.

This partly reflects sound fundamentals, but mostly it is an unintended consequence of policy decisions. Their experience is unlikely to be easily repeated in other countries. In addition, several risks are involved. Maintaining a visible trade deficit of 15 to 20 percent of GDP is only feasible as long as significant transit and tourism revenues are forthcoming. Maintaining a current account deficit of 6 percent of GDP is only sustainable as long as foreign direct investment flows continue. The bottom line is that the Baltic region can only avoid becoming another Mezzogiorno as long as it remains an interesting investment target.

Byung-Yeon Kim, **Determinants of Inflation in Poland: A Structural Cointegration Approach,** no.16/2001

Byung-Yeon Kim, Jukka Pirttilä, and Jouko Rautava, **Money, Barter, and Inflation in Russia,** no.15/2001, 40 pp.

Jarko Fidrmuc and Iikka Korhonen, **Similarity of Supply and Demand Shocks between the Euro Area and the CEECs,** no.14/2001, 38 pp.

Vadims Sarajevs, **Convergence of European Transition Economies and the EU: What Do the Data Show?** no.13/2001, 40 pp.

Jan Winiecki, **The Role of the New, Entrepreneurial Private Sector in Transition and Economic Performance in Light of the Successes in Poland, the Czech Republic, and Hungary,** no.12/2001, 42 pp.

Jian-Guang Shen, **China's Exchange Rate System after WTO Accession: Some Considerations,** BOFIT Online no. 17/2001

China's foreign exchange system currently combines a virtual peg to the U.S. dollar with direct capital account controls. With accession to the World Trade Organization, China's capital control regime can be expected to lose its effectiveness in the face of accelerating liberalization of trade and investment.

While the country may experience an increase in nominal and real shocks in the medium term, the easing of capital controls is an inevitable prerequisite for promoting the development of China's domestic financial markets and integration with the global trade system and capital markets.

Soft pegs with wide fluctuation bands or similar arrangements that retain certain capital controls could thus be adopted in the interim. Then, as China's financial markets develop and enterprises and banks begin to adhere consistently to market principles, it could introduce a more flexible foreign exchange regime, such as a managed float with relaxed capital controls.

Russia to Demonopolize Its Power Sector—but How and When?

In mid-December the Russian government set a timetable for demonopolizing its power sector. By 2005 the electricity generation, distribution, and marketing activities of RAO Unified Energy Systems (UES) would be pursued in separate, competing spin-off companies, announced German Gref, minister of economic development and head of the restructuring effort. The process would begin in 2001 by changing legal and regulatory framework to prepare for a competitive market. Only in 2004-05 would stakes in the power stations be sold to private investors. The state will maintain full control of transmission lines, while competition will be encouraged in generation and sales.

The state owns 52 percent of UES. Minority shareholders own about 30 percent and have sharply criticized the power overhaul as a recipe for asset stripping. Many minority shareholders say the government should free electricity charges and allow UES to work profitably and grow in value before selling pieces of the company. Other critics predict a chaotic breakdown of the unified system that, while old and sometimes faulty, has provided heat and light across 11 time zones for decades. Russian President Vladimir Putin—in response to the criticism—has decided to form a new working group to study the overhaul of UES, suggesting he is unsatisfied with the breakup plan. The group is to report back to Putin by April 15. It effectively postpones the government's original plan to approve a detailed timeline in February.

The government has still to decide how quickly state-set power tariffs will rise or how minority shareholders in UES will be treated as the electricity giant is broken up. Russia is hoping to attract foreign power utilities as strategic investors, but few are likely to become interested until the government frees electricity charges. Russian consumers, however, are likely to oppose bigger electricity bills.

UES, which controls coast-to-coast power lines and 70 regional power stations, lacks funds for investment because state-set power charges are low. Gref said Russia could face an energy crisis in the near future unless $30 billion (€33.51 billion) is invested in new equipment in the next 10 years. The capital depreciation of UES's electricity network is estimated at 40 percent. In recent years, only 8 to 9 percent of depreciated capital has been renewed. The outlook across the network is varied but poor for the following reasons:

- **Nuclear power.** The 29 reactors in operation at Russia's 9 nuclear power stations generate 13 percent of the country's electricity. About half of these reactors are regarded by experts as highly unsafe. The working life of a reactor is set at 30 years. Nine are between 25 and 29 years old and due for retirement within the next 5 years, and another 6 are 20 to 24 years old and due for retirement within 10 years.
- **Thermal power stations.** Thermal power supplies 64 percent of Russia's electricity. Although the working life of the turbo-generators used at thermal power stations is set at 25 years, generators older than 25 years account for about half of total thermoelectric capacity. Many of the smaller generators are 40 to 50 years old, and some are even of prewar vintage. Of the high-voltage electrical motors at the thermal power stations, only 10 to 15 percent belong to contemporary models.
- **Hydroelectric power stations.** Hydroelectric power is the source of 19 percent of Russia's electricity. About 60 percent of the 256 generators with a capacity of 50 megawatts and above at hydroelectric power stations are at least 25 years old and have not undergone substantial reconstruction. Some generators date back to the late 1950s; the oldest were produced in 1940-41.
- **Electric power substations.** Much of the equipment at electric power substations is also badly worn out. Overall depreciation is estimated at 61 percent. About 30 percent of transformers and 43 percent of high-voltage switches (in the range 110 to 500 kilowatts) have exceeded their set working life of 25 years. A sharp decline in the reliability of the switches is expected in the next few years.

Anatoly Chubais, head of UES and chief proponent of the three-step restructuring, called the electricity overhaul the "last frontier of liberalization in this country." In the mid-1990s Chubais helped oversee the widely criticized sale of state oil and metals companies for rock-bottom prices, and some UES investors fear the electricity breakup will lead to similar insider deals.

Based on reports of Dow Jones Newswires, the Moscow-based newspaper Kommersant, and the Wall Street Journal.

Articles provided by:

The Urban Institute
A Nonpartisan Economic and Social Policy Research Organization

Small Businesses Face Large Obstacles

Findings of a Survey in Ukraine

By Olga Kaganova

The size of the unofficial or gray economy, including informal employment, is enormous in Ukraine. According to Management Systems International, fewer than 25 percent of entrepreneurs and 40 percent of very small enterprises (one to five employees) are officially registered. The Ukrainian government and international donors assign a high priority to the development of small enterprises. As part of their joint efforts to identify the direction of further reform in Ukraine, they commissioned the Urban Institute to analyze the situation and the growth prospects of small and medium enterprises (SMEs) in the Kharkiv *oblast*. (Supporting SMEs is part of the USAID Regional Economic Development Program for Eastern Ukraine.) The study—based on a representative sample of 200 SMEs in the *oblast*, with 122 returned questionnaires—found that recent official initiatives targeting SMEs had failed to address the actual obstacles facing small enterprises.

Scrutinizing Small Businesses

In Kharkiv *oblast* small enterprises (up to 50 employees) employ at least 400,000 people, accounting for about 25 percent of total employment. Of these, at least 200,000 people work within the informal sector. Other estimates suggest that up to 330,000 people work informally at small enterprises. SMEs together (up to 250 employees) account for at least 45 percent of all employment.

Employment at medium and large enterprises in Kharkiv *oblast* decreased by more than 20 percent between 1995 and 1999. At the same time, hiring at small enterprises has more than compensated for this decrease. In addition, new employment is concentrated in the service sector, indicating structural shifts in the *oblast's* economy. As in the EU and the United States, most SMEs in Ukraine are involved in the wholesale and retail trades and in general contracting. However, unlike their Western counterparts they are absent from the real estate business and from the provision of financial, professional, and scientific services, because the *oblast's* government directly provides many of these services. As concerns real estate, the local government has acquired a near monopoly position, and so has effectively crowded out private SMEs.

The survey reported some other interesting findings, namely: (a) the SMEs in Kharkiv *oblast* provide many opportunities for women and part-time workers; (b) the majority of SME transactions are with other companies and individuals, not with the government, and are with other enterprises within the *oblast*; (c) the vast majority of transactions are in cash, not in kind or on credit; (d) the SMEs plow back their earnings into the business to cover operating and capital funds; and (e) the SMEs avoid borrowing or leasing by using equipment they already own or that belongs to their employees.

High Taxes and Rampant Corruption

International donors and the media, both local and foreign, generally agree on the major obstacles to SME development in Ukraine. The Urban Institute's survey confirmed that in Kharkiv *oblast*, SMEs confront the same obstacles as they do at the national level. They cited the following obstacles in order of importance:

- **The tax system.** This is a hindrance not only because the rates are high, but also because the system is complex, changes frequently, and facilitates corruption.
- **Frequently changing legislation.**
- **Lack of working capital.** This is the result of burdensome taxes and administrative controls.
- **Administrative controls.** These are largely exercised by the tax authorities. After the Tax Administration, the Fire Department and the Sanitary and Epidemiological Service are the most frequent inspectors. These two regulators issue more permits to SMEs than any other regulators. Approving more permits provides a reason for undertaking more inspections, and thus provides fertile ground for corruption. More than 50 percent of the firms surveyed reported demands for payments above those legally required for permits, licensing, and in-

spections either occasionally or more frequently. Another 10 percent reported that they were asked for additional funds every time an inspection took place. On average, these payments accounted for about 16 percent of each firm's profits.

Central government support for SMEs has focused on small enterprises and entrepreneurs, culminating in the Law on the National Program in Support of Small Business Development in Ukraine, enacted in December 2000. Obstacles listed in this law are in general the same as those identified by the SMEs themselves, so the views of business and the central government are getting closer, at least conceptually. The law's plan for implementing a new public regulatory policy could greatly enhance the environment for small business development, although it is too early to evaluate the practical results of the national program. However, the law indicates that the central government still greatly underestimates the significance of small business for the economy. For instance, it declares that small businesses are responsible for 9 percent of total national employment, while the Management Systems International survey estimated that small business employ 34 percent of the work force.

Efforts to assist small enterprises in Kharkiv *oblast* materialized through two regional assistance programs in 1999-2000 and 2001-02. These programs raise several concerns, namely:

- A remarkable mismatch is apparent between the obstacles identified by SMEs and those identified by the regional programs. The existing tax system, for example, ranked by SMEs throughout Ukraine as their most significant problem, was only mentioned in passing among other issues in the earlier program and was not mentioned in the present program at all.
- The programs promote government activities in certain areas—such as brokerage services for obtaining production space or equipment and the provision of loans, information, and market studies—where the government's efficiency is questionable, based on other countries' experience. Most important, small businesses are not expecting the government to provide such services.
- The programs underestimate the number of small businesses, and thus the real size of this sector.

Both the national and regional programs fail to consider employment in the informal economy, and thus disregard its role. This prevents the development of policies that could legalize and formalize jobs and activities that already exist in the informal sector, which is as important as creating new jobs.

Main Recommendations

The study has led to a number of recommendations as follows:

- **Reduce the fiscal burden imposed on small enterprises.** At least three areas are relevant in this context:
  –Introducing elements of fiscal decentralization would allow local governments to effectively reduce the tax burdens of small enterprises in their jurisdictions
  –Using the fiscal latitude already available to them, local governments can reduce the fiscal pressure on small enterprises
  –Revising permit requirements across the board, starting with those of the fire and sanitary departments, and reviewing whether they are really needed, and if so, how to simplify the procedures for obtaining them.
- **Reduce administrative controls and government corruption.** Two useful new directions for policy worth considering are
  –Eliminating corrupt practices, which should become an explicit feature of government support to small enterprises.
  –Downsizing government agencies at all levels.
- **Integrate informal small enterprises in the formal sector.** This could proceed along two lines as follows:
  –Inducing participants in the informal economy to legalize their activities by providing new incentives and disseminating information about existing incentives more effectively
  –Studying and using international experience in reducing the informal sector, especially in other industrial and urbanized transition countries.
- **Begin changing the role of the government from provider to enabler.** This is a long-term goal, and the first areas that may be ready for such a switch include
  —**Providing information**: the government should focus on improving the conditions for small enterprises and leave the collection and analysis of market data to the private and nongovernmental sectors
  —**Reassessing its role in financing**: the government could shift its efforts from the provision of direct financial support through government loans and subsidies to developing public-private mechanisms and specialized financial instruments
  —**Reducing its involvement in real estate and related services**: the government should focus on liberalizing the real estate market instead of acting as a broker of public property.

Olga Kaganova is a senior associate at the Urban Institute. This article is based on the report "Small and Medium Enterprises in Kharkiv Oblast: Assessment and Recommendations" by Brien Desilets and Olga Kaganova of the Urban Institute, with participation by Grigory Artyemenko, Alina Alieva, Fedir Demydyuk, and Olena Sergeeva. For more information, contact the author at okaganov@ui.urban.org.

Efforts for Better Targeting Social Assistance in Russia

By Jerome Gallagher

A hallmark of the administration of social assistance under the socialist regimes in Eastern Europe and the former Soviet Union was the universal nature of eligibility for benefits, either to all citizens or to categories of deserving citizens, for instance, the physically disabled. Since the collapse of the Soviet Union, the Russian Federation has taken limited steps to improve the targeting of benefits. Such improvement faces major challenges, because most programs are administered by local government agencies. The question thus arises as to how willing local program administrations are to improve their targeting and how receptive they are to more progressive program administration in general.

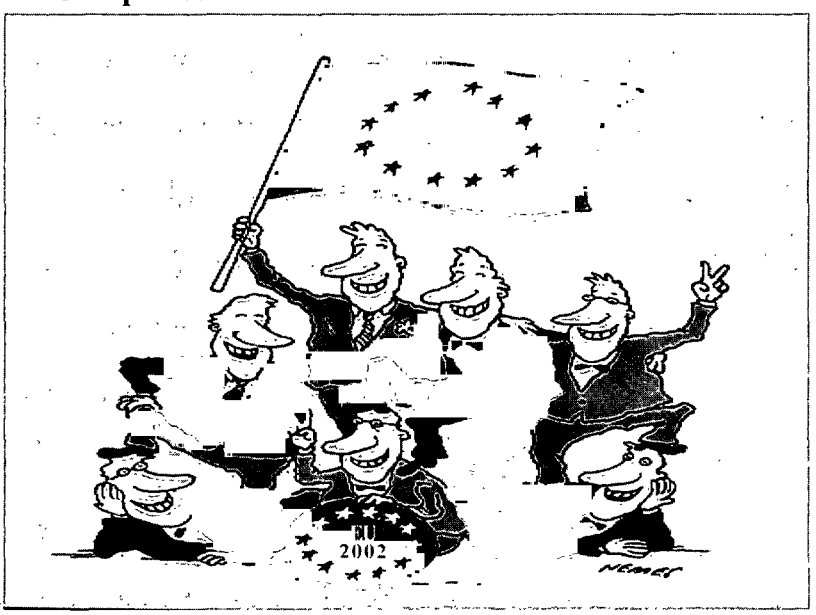
Assessments of two pilot programs implemented in Russian cities from 2000 to 2001 shed some light on this question. The first program, the school lunch pilot, introduced means testing for the school lunch program on a citywide basis. Eligible families received cash payments and all children paid the same price for their lunches in cash. The second, the jobs pilot, is a new, local, means-tested program that provides cash support to families while unemployed workers search for work. Continued receipt of funds is conditional on a minimal job search effort.

The results suggest that local social assistance administration is indeed open to improvement. The various program implementers, including social assistance program staff at all levels, exhibited little resistance to the more focused targeting. Crucial to the success of the programs, in addition to the positive attitude of those implementing them, was the ability of program administrators to set clearly defined policy goals, build on their recent experiences of implementing other targeting initiatives (particularly the national housing allowance and child allowance programs), and learn from other implementers and technical advisors.

Despite the successes of these projects the implementation of reforms at the local level still faces considerable obstacles. In particular, both municipalities failed to produce thoroughly documented and standardized program procedures. As a result of vague or absent official regulations and policy documentation, government officials in many cases relied excessively on upper-level administrators to solve mundane procedural questions. Similarly, coordination of multiple agencies often relies on personal relationships rather than formal responsibilities, and thus when priorities among the agencies are not aligned, implementation is delayed. Also, both the bureaucratic municipal environment and the local economic environment constrain the maneuvering space of program implementers. These obstacles may significantly undermine the integrity and credibility of reform goals.

Jerome Gallagher is a research associate at the Urban Institute. This article is drawn from the Urban Institute report "Strengthening Local Administration of Social Assistance in Russia" by L. Jerome Gallagher and Raymond J. Struyk, Washington, D.C., 2001. For copies of the full report write to jhall@ui.urban.org. The report can also be downloaded from http://www.urban.org/centers/iac/russia_soc-assis.html.

EU Group Photo



From the *Hungarian Economy.*

A New Housing Strategy for Armenia's Earthquake Zone

by Steven J. Anlian

Twelve thousand families remain displaced as a result of the devastating 1988 earthquake in then Soviet Armenia. The World Bank's Armenia Municipal Development Project included a requirement for the Armenian government to commission a study to develop a new housing strategy for the earthquake zone. In 1998 the Urban Institute, along with its partners, the Institute for Urban Economics in Moscow and the American University of Armenia, conducted an in-depth analysis and developed a new approach to address the government's obligation to compensate eligible families. The goal is to provide permanent housing to those still displaced by the earthquake while restoring the original city centers. The strategy deals principally with alternatives to new construction. New cities, started by Moscow in 1989, have remained half-built "graveyards of good intentions." These grandiose Soviet plans are now being abandoned, or at least put on hold, given today's economic realities. The new strategy is a consumer-oriented policy that promotes urban renewal while providing eligible beneficiaries with significant choices about the types of replacement housing they will receive.

The approach can be summed up as a three-pronged strategy of voluntary redistribution through market mechanisms; reinforcement by means of strengthening unoccupied, damaged, multiunit buildings; and renovation of private homes in both urban and rural areas. The U.S. Agency for International Development (USAID) has recently initiated the Armenia Earthquake Zone Recovery Program, which includes funds of $20 million over two years to implement the redistribution component, which will employ housing vouchers, and the renovation component, which will use housing improvement grants. With the help of the Lincy Foundation of California, the government of Armenia will focus on the reinforcement component.

The use of housing vouchers, known as housing purchase certificates, to deal with the demand for housing in transition countries is based on the USAID's success in supporting the rapid resettlement of Russian military officers from the Baltic states in the mid-1990s and a recent pilot program in Gyumri, Armenia. In Gyumri, more than 300 displaced families were permanently housed in just a few months at an average cost per family of $3,300. Both programs were implemented by the Urban Institute.

The new Housing Improvement Grant Program has both urban and rural subcomponents. The rural program focuses on grants to complete unfinished, single family housing started by various former Soviet republics and abandoned with the collapse of the Soviet Union in 1991. Families assigned to this housing are still living in modified shipping containers near their lots, but have been unable to complete their houses because of a lack of resources. To lower the cost per family to below the grant ceiling, many of these large village homes are being converted to duplexes.

The Urban Housing Improvement Grant Program will provide grants to condominium associations for critical repairs and upgrades to buildings that sustained limited damage during the 1988 earthquake, were not condemned, and have continued to provide shelter, although they are deteriorating rapidly. The associations will be required to cofinance the repairs and/or make in-kind contributions, organize short-term relocation of residents where required, and assure that an adequately funded operational and capital budget is in place to ensure that the buildings are properly maintained in the future. This new model will have broad application throughout Armenia and the region, where local governments faced severe problems with occupied residential buildings because of years of deferred maintenance.

The earthquake zone strategy is to be implemented by a balance of three–pronged strategy:

- **The physical planning component** introduces a phased program in the original city districts, organized around a logical, sequential selection of sites to be cleared of the containers and temporary shacks in conjunction with building strengthening activities and/or construction, if economically warranted and desired by residents. This site by site approach, which will start with the most viable sites in terms of the maximum number of housing units that can be developed at the lowest cost, is directly linked to the distribution of benefits (housing subsidies), thereby providing the government and donors

with flexibility in managing the program.

● **The social planning component** recommends that households in temporary accommodation must meet two basic conditions for eligibility: they lost their homes in the earthquake and have never received compensation from either the government or a donor.

● **The financial/economic planning component** gives each eligible household the option of accepting a housing voucher to use immediately to purchase permanent housing that already exists in the marketplace. Vouchers can be a particularly effective tool for quickly freeing up community facilities, such as schools and museums, now occupied by displaced families.

The objective is to use the existing surplus housing stock. Should demand put pressure on the supply of existing units, the supply can be augmented by rehabilitating some of the vacant stock either by repairing damaged multiunit buildings or by renovating units through home improvemen" grants. Rehabilitating or completing units can be a less costly alternative than new construction, and many unfinished buildings are available. Policymakers can exert some control over the program's potentially negative impact on the market in the short term caused by a sudden rise in the demand for units by controlling the rate at which they issue housing vouchers.

The USAID's new program also includes urban planning and economic development components to help harness capital investment. The housing vouchers and grants, while relatively modest as individual inputs, in the aggregate will result in a significant infusion of capital into the regional economy. As a result of this collaboration by donors, the expectation is that Armenia's northern regions will have finally recovered from the 1988 earthquake during the next three years.

Steven J. Anlian is a senior associate at the Urban Institute. More information on the Armenia housing strategy and the Urban Institute's housing activities is available from the author at Sanlian@aua.am or from the institute at www.urban.org.

Condominiums in the Kyrgyz Republic: Building Communities and Managing Housing Effectively

By Charles Undeland

Soon after independence, the Kyrgyz Republic embarked on massive privatization of its housing stock as a political gesture to empower citizens and as a quick way to provide a substantial part of the population with some means of accessing capital. By 1994 considerably more than 90 percent of the Kyrgyz Republic's housing had been privatized. Yet despite the political and economic benefits of rapid privatization, the housing reform created a problem, in that it did not address the maintenance of the common areas of apartment buildings: no provisions had been made regarding the ownership of, or responsibility for, these common areas during the privatization process.

Mostly due to systemic inertia, the Soviet era maintenance agencies that took care of common areas continued to be responsible for management. In the past about 80 percent of these organizations' operations had been subsidized. They continued to collect some fees from residents, but funds went to support the maintenance organizations' bloated work force, with actual repairs being paid for additionally on a case by case basis by the residents.

The government began to redress the situation when it passed the new Civil Code in 1996, which stated that the common areas of apartment (multifamily) buildings were jointly owned by the owners of units in the buildings.

With assistance from a U.S. Agency for International Development housing reform project, in 1997 the government passed the Law on Condominiums, which established a framework for unit owners to set up associations (condominiums) to organize or contract the maintenance of buildings' common areas. Condominiums were to be established voluntarily by unit owners.

Following passage of the legislation, to promote the formation of condominiums across the country the Urban Institute provided technical assistance and training, fostered several NGO advocacy groups, and partnered with the Soros Foundation to organize a grants competition for condominiums.

The idea behind the formation of condominiums is that they should

● Lead to more effective management of multifamily housing stock as unit owners set their own maintenance priorities through elected leaders and police themselves on making payments

- Serve as a community-building mechanism wherein diverse individuals work together to resolve common problems
- Act as platforms for democratic practices in voting leaders in and out, deciding on self-taxation in the form of fees, and adopting rules for living in the buildings.

Performance of Condominiums

By 2001 more than 300 condominiums were officially registered, comprising over 40,000 units, or roughly 20 percent of the Kyrgyz Republic's housing stock. The percentages are considerably higher outside Bishkek, the capital. In May 2001 the Urban Institute conducted a nationwide survey of members and officers from 50 condominiums, local government officials, and the general public to assess how condominiums were working. Its conclusions are as follows:

- **Condominiums operate with significant resident involvement and oversight.** An average of 70 percent of condominium members attended general meetings, 98 percent of condominiums had audit committees, and in 83 percent of cases members had received audit reports.
- **Condominiums improve management.** Ninety percent of unit owners believe that their buildings would be in worse condition if a condominium had not been organized and 52 percent reported that they felt the value of their unit had increased as a result of the formation of a condominium. About half of the expenditures for maintenance were spent on roof repair.
- **Financial management and overall financial health is poor.** Only 6 percent of managers stated that condominium members paid their fees in full and on time. Furthermore, 57 percent of managers noted that nonresidential owners did not pay any kind of fee. Unit owners paid roughly $8 per unit per year to maintain the common areas. At the same time, condominiums were able to mobilize significantly larger resources for emergency repairs or if cofinancing was available.
- **Heating is the most problematic communal service.** While generally two-thirds of the respondents were satisfied with the provision of cold water, sewerage facilities, power, gas, and solid waste collection, only 40 percent expressed satisfaction with heating provision.

What the Future Holds

Condominiums will be crucial to improving the efficiency of basic services. Payments for cold and hot water are based on capitation, and district heating is based on unit area, which means that consumers have no incentive to cut wasteful use. Installing meters and thermostats for heat to individual units will be extremely expensive.

However, installation for entire apartment blocks is more likely, provided that the building has a governance mechanism both to collect fees and regulate heat consumption. A few condominiums have, at their own expense, metered the supply of heat to their buildings. Savings from the reduced cost of actual consumption alone—without any improvements in insulation—are estimated to have been 20 percent over the course of the heating season, which in three years will be enough to cover the $2,000 needed to install the meter.

Additional capital is needed to conduct major repairs, but two conditions must be met before this is possible.
- First, overall financial management and collection rates must be improved to make condominiums attractive clients to lender banks.
- Second, Kyrgyz Republic law does not provide for a lien in favor of the condominium as security for cases in which owners fail to make payments to cover the cost of maintaining common areas.

Most multiunit housing is still not organized into condominiums; however, the formation process should receive a boost if Parliament carries through with proposed changes to the condominium law that would make the registration process less onerous.

This article is based on findings in "Grassroots Democracy in Brick and Concrete: Survey Results on the Development of Condominiums in the Kyrgyz Republic" by Sabina Gradwal, Carol Rabenhorst, and Charles Undeland. The authors can be reached care of Carol Rabenhorst, csrabenh@ui.urban.org, or Charles Undeland, cundeland@ui.kg. Further information about this program and other Urban Institute projects related to condominiums or local governments can be found at www.urban.org.

Voice of the Poor

Now that the economy is doing well, can we finally loosen our belts?

From the Hungarian magazine *Hócipõ*

World Bank\IMF Agenda

Continued from page 24

Russian universities that could house science centers. The Bank is aware of the difficulties Russia's nonprofit organizations are facing because of taxation issues and the obstacles to developing an indigenous philanthropic sector, and will investigate possibilities for developing philanthropy in Russia with the support of an adequate legal and tax framework. Jonathan Fanton, president of the MacArthur Foundation that confirmed: "This consultation has been the first step in what should be a continuing process of communication between the two institutions."

Partners Developing Mekong Delta Meet in Hanoi

Representatives of donor countries and institutions and the advisory board of the Mekong Project Development Facility met in Hanoi, Vietnam, in mid-January to review the results of operations in 2001 and to discuss its action plan for 2002. The facility is a multidonor initiative for helping small and medium enterprises in Cambodia, the Lao People's Democratic Republic, and Vietnam managed by the International Finance Corporation (IFC). It is funded by the Asian Development Bank, IFC, Australia, Canada, Finland, Japan, Norway, Sweden, Switzerland, and the United Kingdom. The project will expand the provision of help to various aspects of local small and medium enterprises' operations, such as marketing, accounting, management information systems, technology, and quality assurance as well as easier access to financing. The latter has somewhat improved with the more favorable environment for private enterprises. With funds of $18 million, the first regional venture capital fund, the Mekong Enterprise Fund, is providing domestic entrepreneurs with risk capital.

Using Knowledge for Development in EU Accession Countries

Knowledge and innovation are critical to the competitiveness of EU accession countries. That was the central message of a conference organized in Paris on February 19-22 by the World Bank in coordination with the European Commission and the Organisation for Economic Co-operation and Development. With their high literacy rates and well-developed educational infrastructures, the countries of Central and Eastern Europe are widely seen as poised for transformation into knowledge-based economies. They are making great progress in creating the "four-pillar" environment:

- An economic and institutional framework that promotes the efficient use of knowledge and the flourishing of entrepreneurship
- An educated and skilled population to create, share, and use knowledge
- A dynamic information infrastructure
- An efficient innovation system of firms and research centers to tap into the growing stock of global knowledge and create new responses to local needs.

As Peter Drucker, professor of social science and management, pointed out in his opening remarks: "Transition to the knowledge economy has been potentially as wrenching a transformation as the transition from agricultural to modern economies. For the Central and Eastern European countries, which still have to manage the historical shift from agricultural and industry-based economies to service-based economies, the urgent task is to radically improve the productivity of agriculture and industry through knowledge inputs, while avoiding the potentially huge social problems of redundancy. This can only be accomplished through the transformation of traditional education systems and through a major investment in life-long learning." See also http://www.worldbank.org/eca/kedforum.

Johannes Linn: Spread Knowledge and Put It to Work

Today the evidence suggests that knowledge is more important to people's well-being than capital, labor, and the other factors that make our economies grow, wrote Johannes Linn, World Bank vice president for Europe and Central Asia in a recent issue of the *International Herald Tribune*. With the EU set to expand to the East, acquiring and using knowledge and new information technologies are crucial to the pre-accession countries of Central Europe if they are to catch up with the living standards in current EU member states. During the 1990s members' economies surged as new technologies were applied. Ireland's focus on education and information technologies was key in changing its once rural economy into Europe's largest exporter of computer software. Finland transformed itself in a single decade from a distressed exporter of wood and paper into a knowledge-intensive economy. Low inflation, good fiscal and monetary policies, and regulations that encourage investment and technology transfers are prerequisites

for a knowledge economy. As Ireland has shown, an educated and skilled population is vital for developing the skills to create, share, and use knowledge to its full potential. Significant broadening of access to the Internet, satellite networks, data storage centers and broadcasting facilities is also essential said Linn.

Russia, World Bank Sign Agreements on Three New Loans

On February 8 Johannes Linn, World Bank vice president, and Yuri Ushakov, Russia's ambassador to the United States, signed agreements on three new loans worth a total of $260 million. The largest loan, $122.5 million, will be used to upgrade water supply and sewage systems in 14 towns and cities across Russia. Another 9 cities will get a total of $85 million to modernize their heat supply networks. A $50 million loan will be allocated to reform the universal education and elementary vocational training system in three pilot regions, the Chuvashia, Samara, and Yaroslavl regions.

Debt Relief Urged for Poorest Seven Former Soviet Countries

Donor countries met in London in late February to consider new financial support, including foreign debt relief, for Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, Tajikistan, and Uzbekistan, the seven poorest countries of the former Soviet Union. For the group as a whole, real GDP fell by an average of almost 50 percent between 1990 and 1995, and poverty and inequality increased substantially. Per capita incomes in 2000 ranged from $158 in Tajikistan to $652 in Azerbaijan, which are among the poorest countries in the world. The conference, organized by the IMF and the World Bank, was hosted by the U.K. government. The combined government and government-guaranteed external debt of the seven countries is more than $11 billion. In a report prepared for the conference (see http://www.worldbank.org/eca/cis) the organizers urged donors to provide "generous debt relief" to the most heavily indebted states of Georgia, the Kyrgyz Republic, and Moldova. Together with Armenia and Tajikistan, the five countries' average debt to total GDP ratio is 73.5 percent. Most money is owed to multilateral lenders such as the World Bank, with much of the rest owed to Russia and Turkmenistan for energy imports. Georgia has already secured some help with its debt by means of a rescheduling deal agreed on last year with the Paris Club of international creditors. The Kyrgyz Republic has also asked for assistance, and the report says that Moldova and Tajikistan are likely to be next.

By contrast, Azerbaijan is in a relatively strong position because of its growing exports of oil and gas. Uzbekistan is also a commodity exporter—of cotton—and has stabilized its foreign debt in the past two years after rapid growth in the late 1990s. However, for all the countries the report advocates further economic restructuring to continue the transformation from central planning to a market economy.

IFC Launches Joint Venture in China to Improve Housing

IFC will invest in Advantage China Holdings, Limited in order to establish joint venture companies in China to provide mortgage services and boost residential housing construction and purchases. China plans to develop 500 million to 600 million square meters of residential housing in the coming 10 years. Beijing Advantage, the first joint venture company, is expected to begin operations in the first half of 2002. IFC's investment represents a 24.5 percent direct ownership stake in ACHL. Other shareholders include a Dutch company and Advantage Services Holding, Limited based in Hong Kong, China. "In China private home ownership is expanding rapidly and lenders need to manage their exposures as they increase their mortgage lending portfolios. This new institution should help alleviate credit concerns," pointed out Javed Hamid, IFC's director for East Asia and the Pacific. In fiscal 2001, which ended in June 2001, IFC committed more than $100 million worldwide for projects that reinforced links between the housing market and the financial and capital markets.

World Bank Assesses Ukraine's Mining Industry

Ukraine's coal industry requires urgent restructuring, and the large increases in subsidies proposed for the sector will do little to address issues of mine safety, energy security, environmental damage, alternative employment generation, and transparency, said World Bank Country Director Luca Barbone. Around 200 mines employ 600,000 miners, most of them in the Donbass basin in eastern Ukraine. Three-quarters of the mines are ranked in the highest risk category, and of these 35 percent are also categorized as representing a coal dust hazard. Last year 250 miners died in mining accidents. Negotiations about a $100 million loan to help Kyiv restructure the mining industry were postponed indefinitely by the government. Nonetheless, World Bank and Ukrainian experts are continuing their assessment of the sector, and by June will make recommendations to address its economic and social problems. Between 1996

and 2000 the World Bank already provided $300 million to restructure the mining industry.

IMF Delays Loan Disbursement

On February 8 the IMF completed its latest mission to Ukraine. The government and the IMF mission failed to agree on a refund of $1.1 billion of value added tax (VAT) to exporters. The IMF has repeatedly said that failure to refund the VAT discourages companies from paying taxes. It regards this government debt as a hidden budget deficit that may jeopardize macroeconomic stability, including currency stability. The disagreement prevented the unfreezing of a $2.6 billion Extended Finance Facility loan. Fund approval is important to Kyiv as a broader confidence signal to investors, as well as being crucial ahead of substantial foreign debt repayments. The IMF initially intended to disburse three installments this year totaling $550 million. Financing will not be resumed until the government solves the VAT repayment issue and satisfies the IMF that it will accelerate structural reforms.

....while Ukraine Publishes New Economic Indicators

Ukraine's GDP increased by 9.1 percent in 2001, well above the 2000 rise of 5.8 percent. The economy is expected to grow 6 percent in 2002. Inflation was 6.1 percent in 2001, compared with 25.8 percent in 2000, but is forecast to rise to 9.8 percent in 2002. In December 2001 the unemployment year-on-year index declined to 3.7 percent. Wage arrears fell by 39 percent between January and November 2001, while average monthly nominal wages rose by 30 percent year-on-year to around $65. On January 1 this year minimum wages were raised from $23 to $27. Foreign exchange reserves doubled to $3 billion, despite heavy repayments of external debt. Strong exports, tighter budgetary policies, and a reduction in a variety of categories of arrears contributed to a change of investor rating. On January 24 Moody's upgraded Ukraine's foreign currency ceiling for bonds to B2 and the ceiling for bank deposits to B3, both of them up from Caa1. Local currency government bonds were upgraded to B2. The outlook for all ratings is stable. The agency believes that together with improvements in debt management, Ukraine's default probabilities have lessened. In 2002 the country must repay $1.6 billion dollars of foreign debt and a further $1.8 billion in 2003. Debt was 34.9 percent of GDP in 2001, down from 37.2 percent in 2000.

A Matter of Urgency

"Kovacs, don't make any excuses, I don't give a damn about the procurement law, go to the nearest store and buy any toilet paper you find!"

From the Hungarian magazine *Hócipő*.

Conference Diary

For the Record

Russia 2015: A Long-Term Strategy
December 14-15, Moscow, Russia

This first annual two-day conference was jointly organized by the Centre for Economic and Financial Research; the New Economic School; the Economics Education and Research Consortium; and Club 2015, a group of leading Russian managers and entrepreneurs.

The first day of the conference was policy oriented and defined, discussed, and prioritized government, business, and academic activities crucial for Russia's longer-term development and integration into the global economy. The second day offered an unparalleled opportunity for qualified economists from the CIS who study or work abroad to learn about the research opportunities available at some of the best academic institutions in Russia.

Keynote speakers were German Gref, minister of economic development and trade; Alexander Pochinok, deputy minister of labor and social development; and Andrew B. Somers, president of the American Chamber of Commerce in Russia.

The conference program can be downloaded from http://www.cefir.org.

Forthcoming

The 13th Annual International Scientific and Practical Conference: Development Strategies of the Region's Economic Potential: Investment Priorities and Infrastructure
April 8-10, 2002, Chernivtsi, Ukraine

Organizers: Ministry of Education and Science of Ukraine; Chernivtsi Trade and Economics Institute; Kyiv National Trade and Economics University; Ukrainian National Academy of Science, Institute of Regional Research.

Topics: Regional policy of the state, strategic priorities for developing the region's economic potential, strategic management of the region's economic development, development of domestic trade, development of international trade, formation of regional trade infrastructure, models of formation of regional infrastructure, attracting investment to the region.

Information: Prof. Ihor Shkola, Scientific Office, room 328, ChTEI Kyiv National Trade and Economic University, Tsentralna Ploscha (Central Square), 7 Chernivtsy, 58002, Ukraine, tel.: (380-3722) 2-23-03, 2-21-22, email: ?horShkola@chtei.cv.ua, main@chtei.cv.ua, sercher1106@yahoo.com.

Beyond Transition Development Perspectives and Dilemmas
April 12-13, 2002, Warsaw, Poland

The conference will continue the discussions held at the previous CASE conference entitled Ten Years After: Transition and Growth in Postcommunist Countries, held in Warsaw in late 1999, and will focus on the challenges that post-transition countries will face in the near future. The conference agenda will concentrate on perspectives and key dilemmas, such as globalization, liberalization, EU enlargement and the euro zone, labor market flexibility, and international tax competition. The conference is also intended to answer questions on how the emerging markets may benefit from other countries' experiences and what policies they should chose to reduce the distance from industrial countries, as well as what they should do to minimize the danger of social conflicts and economic crises.

Topics: Is there room for national monetary policy in the global economy? EU enlargement: the admission of candidate countries to the euro zone, how to make national labor markets more flexible, consequences for the CIS countries, labor migration and free movement of the labor force in an enlarged Europe, and financial sector development in the transition countries in a comparative perspective. International tax competition and tax reforms, privatization, and corporate governance.

Information: Center for Social and Economic Research, Sienkiewicza 12, 00-944 Warsaw, Poland, tel.: (+48 22) 622 66 27, 828 61 33, fax: (+48 22) 828 60 69, email: case@case.com.pl.

Conference on Economic Development and Reconstruction Policies in Southeast Europe: The Role of SMEs
April 25-27, 2002, Inter-University Center, Dubrovnik, Croatia

Sponsored by the American and British embassies in Zagreb, the British Academy, the Croatian Academy of Arts and Sciences, the Friedrich Ebert Stiftung, and the Soros Foundation.

Topics: Include the employment effects of entrepreneurship, European integration and economic development in southeast Europe (discussant: Xavier Richet, University Marne-la-Vallee, France), determinants of small and medium enterprise

(SME) development in transition countries and insights from the East German case school, the current state of the SME sector in southeastern Europe and opportunities for inter-regional cooperation, the role of SMEs in Kosovo's reconstruction and institutional barriers, enterprise networks as a model for economic recovery of war-damaged areas, and financial structures to promote private sector development in southeastern Europe.

Cultural Legacies of the Soviet Experience
April 26, 2002, Stanford University, U.S.A.

Sponsored by the Center for Russian and East European Studies at Stanford University and the Institute of Slavic, East European, and Eurasian Studies.

Information: University of California, Berkeley, Institute of Slavic, East European, and Eurasian Studies, 260 Stephens Hall #2304, Berkeley, California 94720-2304, tel.: 510-642-3230, fax.: 510-643-5045, email: iseees @uclink4. berkeley.edu, Internet: http:// socrates.berkeley.edu/~iseees/.

14th Annual Bank Conference on Development Economics (ABCDE)
April 29-30, 2002, Washington, D.C., U.S.A.

The sessions will be as follows: Opening address: James D. Wolfensohn, president, World Bank

- Keynote address: John Taylor, undersecretary for international affairs, U.S. Treasury Department
- Session One: Trade and Poverty, Ann Krueger and L. Alan Winters
- Session Two: Africa's Future: Industrial or Agricultural Development? Paul Collier and Adrian Wood
- Session Three: Education and Empowerment, Ravi Kanbur and Alan B. Krueger
- Session Four: Investment Climate and Productivity, Kenneth Rogoff and Andrei Schleifer.

This year the ABCDE will also include parallel afternoon sessions sponsored by the World Bank Economists' Forum. Day one will include the following five afternoon sessions: Intellectual property rights, the WTO, and Developing Countries; Restructuring and Agricultural Development in Transition Countries; Network Industry Privatization; Service Delivery and Quality of Life in Urban Areas: Spatial Perspectives; and Health and Development. Day two will include the following five afternoon sessions: Has Financial Globalization Gone too Far? Financing Constraints to SME Growth: Does Size really Matter? Making Public Services Work for Poor People; Subnational Governments and National Development Strategies: Incentives for Coordinated Action; and Economic Geography of Poverty: Micro Perspectives.

Participation by non-Bank and non-IMF staff is by invitation only.

Information: For general information see http://www.worldbank.org/research/abcde/. For ABCDE morning sessions contact Boris Pleskovic, Research Administrator, Development Economics Vice Presidency, World Bank, 1818 H Street, N.W., Room MSC4-402, Washington, D.C. 20433, tel.: 202-473-1062, fax. 202-522-0304, email: bpleskovic@worldbank.org. For afternoon Economic Forum sessions contact David Rosenblatt, Senior Economist, Development Economics Vice Presidency, World Bank, 1818 H Street, N.W., Room MC4-363, Washington, D.C. 20433, tel.: 202-473-7930, e-mail: drosenblatt@worldbank.org.

International Conference on Globalization and Catching Up in Emerging Market Economies
May 16–17, 2002, Warsaw, Poland

Members of TIGER's scientific advisory board from Chile, China, India, Israel, Italy, Japan Hungary, Poland, Tanzania, Russia, and the United States will discuss prospects, conditions, and challenges for faster economic growth of emerging market economies. Douglas C. North, 1993 Nobel Laureate in Economics, will deliver the conference's special lecture. More information about the conference is available on http:// www.tiger.edu.pl.

2002 EBRD Business Forum: Sharing the Benefits of Long-Term Investment
May 19-20, 2002, Bucharest, Romania

Topics: Transition and accession, investing in agribusiness, financing infrastructure modernization, improving efficiency in energy use, enforcing contracts in Central and Eastern Europe, southeast European capital markets, and business briefing on the "Transition Report Update 2002."

Country presentations will offer participants a comprehensive review of business and investment issues for each of the bank's 27 countries of operations. Government officials and business people from the country being discussed will share their knowledge of the investment climate, business opportunities, regulatory framework, and recent policy decisions. The European Bank for Reconstruction and Development, the largest single investor in the region, will also contribute its broad experience to the discussions.

Information: Annual Meetings Unit, tel.: 440-20-7338-6625, fax: 440-20-7338-7320, email: aminvitations@ebrd.com.

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.

Negotiating Russia's WTO Accession: Strategic Lessons from Multilateral Trade Liberalization and Club Enlargement
June 24-25, 2002, Moscow

The Centre for Economic and Financial Research is bringing together a group of prominent academics and policymakers to examine the theoretical and policy issues pertinent to Russia's accession into the World Trade Organization (WTO). The aim is to increase awareness of international trade theory as an important area of economics among Russian economists, while informing academic and policy circles in Russia about cutting-edge research in the areas of multilateral trade liberalization and trade negotiations. Equally important, it will give Western economists working on trade theory and policy an opportunity to discuss the policy implications of their most recent research papers in the context of Russia's accession negotiations.

Topics: The major themes of the conference will be as follows:

- Consequences of WTO accession for Russia's economy and for the world economy in general
- Sector-specific aspects of Russia's accession negotiations (services, agriculture, investment, intellectual property)
- Political economy of trade reforms and reciprocal trade liberalization in the context of Russia's WTO accession
- Lessons and consequences of China's accession negotiations for Russia's accession
- The WTO legal system and the credibility of domestic reforms in Russia on the eve of accession
- Institutional design and principles of the General Agreement on Tariffs and Trade and the WTO
- Reciprocity, nondiscrimination, and renegotiation in trade policy cooperation
- Gradualism in reciprocal trade liberalization.

Information: Assistant Professor Mikhail Klimenko, University of California, San Diego Graduate School of International Relations and Pacific Studies, email mklimenko@ucsd.edu, is coordinating the meeting. More information will be available at http://www.cefir.org.

Spatial Inequality and Development Conference
June 27–29, 2002, London School of Economics, London, U.K.

Organizers: Cornell University, London School of Economics, and the World Institute for Development Economics Research.

Amid growing concern about increasing inequality, the spatial dimensions of inequality have begun to attract considerable policy interest. In China, India, Mexico, Russia, and South Africa, as well as in most other developing and transition economies, there is a sense that the spatial and regional inequality of economic activity, incomes, and social indicators is on the rise.

Spatial inequality is a dimension of overall inequality, but it has added significance when spatial and regional divisions align with political and ethnic tensions to undermine social and political stability. Also important in the policy debate is a perceived sense that increasing internal spatial inequality is related to greater openness of economies and to globalization in general.

Despite these important popular and policy concerns, remarkably little systematic and coherent documentation of what has happened to spatial and regional inequality over the past 10 to 20 years is available. Correspondingly, understanding of the determinants of internal spatial inequality in a globalizing world is insufficient.

The conference seeks to attract contributions that document and analyze within-country spatial inequality and its determinants, especially during the increased globalization of the last two decades. It will take a broad view of inequality, covering the distribution of such variables as economic activity, economic structure, population, income, social indicators, infrastructure, and public expenditure. While the main focus is on the empirical

analysis of recent history, contributions that conceptualize the measurement of spatial inequality or analyze its evolution in a longer historical frame will also be considered.

The papers presented at the conference will be collected in a volume edited by Professor Ravi Kanbur, Cornell University, and Professor Tony Venables, London School of Economics, and published by a leading academic press. Decisions on papers accepted for presentation will be communicated by the end of December 2001.

Information: Ravi Kanbur, Cornell University 309 Warren Hall, Ithaca, NY 14853, U.S.A. Fax: 607-255-9984, email: sk145@cornell.edu.

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.

Presentations in the following areas are welcome:

- Codetermination, works councils, European works councils
- Other forms of workers' participation in decisionmaking
- Employee ownership
- Self-management, labor-managed firms
- Cooperatives
- Profit sharing
- Economic and industrial democracy
- Social enterprises in welfare services.

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

Association for the Study of the Cuban Economy, 12th Annual Meeting
August 1-3, 2002, Omni Colonnade Hotel, Coral Gables, Miami, Florida, U.S.A.

The association invites papers on a variety of subjects related to the Cuban economy and society, including macroeconomics, banking and finance, agriculture and the sugar industry, tourism, social and political aspects of economic development, education, health, environmental policy, law and legal institutions, civil society, gender issues, governance, infrastructure, and civil-military relations.

The main theme for this year's meeting will be The State, Institutions, and the Market Economy. As the world enters the 21st century we have learned that where there is no state, there can be no development. We have also learned that private property cannot exist without a governmental apparatus ready and able to secure not only individuals' rights like free speech and social justice, but also people's holdings. The state must lay the foundation for the market if the market is to flourish. In short, institutions and the rule of law are central to the development process. Papers dealing with these topics will be particularly welcome.

Information: Proposals for panels, roundtables, or individual papers should be sent to Jorge Pérez-López, Chair, Program Committee, 5881 6th Street, Falls Church, VA 22041, U.S.A. or perezlop@erols.com as soon as possible, with more detailed abstracts by March 1, 2002. People interested in serving as discussants, session chairs, or participants in roundtable discussions should also contact Mr. Pérez-López.

The Sixth Annual Conference of the International Society for New Institutional Economics, "Institutions and Economic Performance"
September 27-29, 2002, Massachusetts Institute of Technology, Cambridge, Massachusetts, U.S.A.

The society aims to bring together scholars from all over the world who are unified by two propositions: institutions matter and institutions are susceptible to analysis. In addition to economics, the conference program will include sessions on the application of new institutional economics to political science, law, and organizational behavior.

Information: To register for the conference and find out more information about the society please consult our web site at www.isnie.org or send an email to isnie@wueconc.wustl.edu.

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World Bank Working Papers

Daniel Lederman, Norman Loayza, and Rodrigo Reis Soares, **Accountability and Corruption: Political Institutions Matter,** WPS 2708, November 2001, 37 pp.
To order: Patricia Soto, room I8-018, tel.: 202-473-7892, fax. 202-522-7528, email: psoto@worldbank.org.

Ritva Reinikka and Jakob Svensson, **Explaining Leakage of Public Funds,** WPS 2709, November 2001, 35 pp.
To order: Hedy Sladovich, room MC3-311, tel.: 202-473-7698, fax: 202-522-1154, email: hsladovich@worldbank.org.

Martin Ravallion and Dominique van de Walle, **Breaking up the Collective Farm: Welfare Outcomes of Vietnam's Massive Land Privatization,** WPS 2710, November 2001, 42 pp.
To order: Catalina Cunanan, room MC3-542, tel.: 202-473-2301, fax: 202-522-1151, email: ccunanan@worldbank.org.

Carsten Fink, Aaditya Mattoo, and Randeep Rathindran, **Liberalizing Basic Telecommunications: The Asian Experience,** WPS 2718, November 2001, 28 pp.
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Helo Meigas, **Using Development-Oriented Equity Investment as a Tool for Restructuring Transition Banking Sectors,** WPS 2723, November 2001, 23 pp.
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J. Michael Finger and Julio J. Nogués, **The Unbalanced Uruguay Round Outcome: The New Areas in Future WTO Negotiations,** WPS 2732, December 2001, 19 pp.
To order: Robert Simms, mail stop MC3-303, tel.: 202-473-7156, fax: 202-522-1159, email: rsimms@worldbank.org

Bernard Hoekman, Constantine Michalopoulos, Maurice Schiff, and David Tarr, **Trade Policy Reform and Poverty Alleviation,** WPS 2733, December 2001, 44 pp.
To order: Rebecca Martin, room MC3-308, tel.: 202-473-9065, fax: 202-522-1159, email: rmartin1@worldbank.org.

Aaditya Mattoo, Marcelo Olarreaga, and Kamal Saggi, **Mode of Foreign Entry, Technology Transfer, and Foreign Direct Investment Policy,** WPS 2737, December 2001.
To order: Rebecca Martin, room MC3-308, tel.: 202-473-9065, fax: 202-522-1159, email: rmartin1@worldbank.org.

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To order: Sara Crow, room MC2-358, tel.: 202-473-0763, fax: 202-522-2578, email: scrow@worldbank.org.

Patrick Honohan and Anqing Shi, **Deposit Dollarization and the Financial Sector in Emerging Economies,** WPS 2748, December 2001, 30 pp.
To order: Agnes Yaptenco, room MC3-446, tel.: 202-473-8526, fax: 202-522-1155, email: ayaptenco@worldbank.org.

Carolina Sánchez-Páramo, **Unemployment, Skills, and Incentives: An Overview of the Safety Net System in the Slovak Republic,** WPS 2753, January 2002, 60 pp.
To order: Carolina Sánchez-Páramo, room I8-105, tel.: 202-473-2583, fax: 202-522-0054, email: csanchezparamo@worldbank.org.

Hua Wang, Nlandu Mamingi, Benoît Laplante, and Susmita Dasgupta, **Incomplete Enforcement of Pollution Regulation: Bargaining Power of Chinese Factories,** WPS 2756, January 2002, 21 pp.
To order: Hua Wang, room MC2-626, tel.: 202-473-3255, fax: 202-522-3230, email: hwang1@worldbank.org.

Boris Pleskovic, Anders Åslund, William Bader, and Robert Campbell, **Capacity Building in Economics: Education and Research in Transition Economies,** WPS 2763, January 2002, 51 pp.
To order: Boris Pleskovic, room MC4-385, tel.: 202-473-1062, fax: 202-522-0304, email: bpleskovic @worldbank.org. The other authors may be contacted at aaslund@ ceip.org, baderw@ndu.edu, or campbelr@indiana.edu.

The development of the institutional capacity to create and evaluate economic policies remains a critical need—and constraint—in most transition economies if they are to complete the successful passage to fully functioning market economies. To take an active role in the transition process economic policymakers, business leaders, government officials, and others need a thorough grounding in market-based economics. This requires strengthening economics education and providing support for qualified economists to teach economics at all levels and to carry out high-quality research and policy analysis. Although the education systems in a handful of countries have already risen to the challenge, in many other transition countries the structure of educational and research institutes remains grounded in the communist model. This paper presents findings from a comprehensive study assessing the state of economics education and research in 24 countries in East-Central Europe and the former Soviet Union. The Czech Republic, Hungary, Russia, and Ukraine were included to highlight five educational centers of excellence that they host. Building new indigenous capacity for teaching and research on market-based economics is particularly critical in regions such as the Caucasus, Central Asia, and Southeast Europe.

Wim P. M. Vijverberg and Jonathan Haughton, **Household Enterprises in Vietnam: Survival, Growth, and Living Standards,** WPS 2773, February 2002, 27 pp.
To order: Emily Khine, room MC3-347, tel.: 202-473-7471, fax: 202-522-3518, email: kkhine@worldbank.org.

Eric Edmonds and Carrie Turk, **Child Labor in Transition in Vietnam,** WPS 2774, February 2002, 57 pp.
To order: Rina Bonfield, room MC3-354, tel.: 202-473-1248, fax: 202-522-3518, email: abonfield@worldbank.org.

Pravin K. Trivedi, **Patterns of Health Care Utilization in Vietnam: Analysis of 1997-98 Vietnam Living Standards Survey Data,** WPS 2775, February 2002, 55 pp.
To order: Rina Bonfield, room MC3-354, tel.: 202-473-1248, fax: 202-522-3518, email: abonfield@worldbank.org.

Paul Glewwe, Stefanie Koch, and Bui Linh Nguyen, **Child Nutrition, Economic Growth, and the Provision of Health Care Services in Vietnam in the 1990s,** WPS 2776, February 2002, 50 pp.
To order: Emily Khine, room MC3-347, tel.: 202-473-7471, fax: 202-522-3518, email: kkhine@worldbank.org.

Beata K. Smarzynska, **The Composition of Foreign Direct Investment and Protection of Intellectual Property Rights: Evidence from Transition Economies,** WPS 2786, February 2002, 26 pp.
To order: Paulina Flewitt, room MC3-333, tel.: 202-473-2724, fax: 202-522-1159, email: pflewitt@worldbank.org. The author may be contacted at bsmarzynska@worldbank.org.

While existing literature has examined the impact of intellectual property protection on the volume of foreign direct investment, little is known about its effect on the composition of foreign direct investment inflows. The author uses a unique firm-level dataset from Eastern Europe and the former Soviet Union. She finds that weak protection deters foreign investors in technology-intensive sectors that rely heavily on intellectual property rights. The results also indicate that a weak intellectual property regime encourages investors to undertake projects focusing on distribution rather than on local production. The latter effect is present in all sectors, not just those that rely heavily on intellectual property protection.

Zvi Lerman, Csaba Csaki, and Gershon Feder, **Land Policies and Evolving Farm Structures in Transition Countries,** WPS 2794, February 2002, 176 pp.
To order: Maria Fernandez, room MC3-542, tel.: 202-473-3766, fax: 202-522-1151, email: mfernandez2 @worldbank.org.

This study reviews the role of land policies in the evolving farm structures of the transition economies in Central and Eastern Europe (CEE) and the CIS. It demonstrates how different policies with regard to private property rights in relation to land, degrees of control of land rental and sale markets, and procedures for restructuring former collective or state farms resulted in significantly different farm structures in CEE countries compared with most of the CIS. In particular, more secure land rights, greater emphasis on individualization of land, and more liberal land market policies in CEE generated a farming sector with a relatively large share of family farms (which are not necessarily small) and viable corporate farms. By contrast, limited tenure security, ineffective individualization of land rights, and restrictive land market policies in most CIS countries

produced a farming structure dominated by large and generally nonviable jointly owned farms that continue to function much like the old inefficient collectives. Family farms are slow to emerge in transition countries with inadequate land policies. The agriculture sector in countries dominated by inefficient farm organizations is characterized by low productivity and misallocation of resources.

Adam Wagstaff, **Inequalities in Health in Developing Countries: Swimming against the Tide?** WPS 2795, February 2002, 40 pp. *To order: Hedy Sladovich, room MC3-311, tel.: 202-473-7698, fax: 202-522-1154, email: hsladovich@worldbank.org.*

World Bank Discussion Papers

Michael S. Borish, Khaled Sherif, George Clarke, and Paul Siegelbaum, **Structural Adjustment in the Transition: Case Studies from Albania, Azerbaijan, Kyrgyz Republic, and Moldova,** World Bank Discussion Paper 429, 2002, 192 pp.

For 10 years the countries of Central and Eastern Europe and the former Soviet Union have been transitioning to economies based on market principals. While there has been some success in this process, most of the CIS (Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan) continues to grapple with weak economies, low public confidence, and political instability. This study reviews the transition efforts of four of these countries: Albania, Azerbaijan, the Kyrgyz Republic, and Moldova. These countries have been marred by war, banking crises, and pyramid schemes that prevented economic growth and poverty reduction.

Other World Bank Publications

Building Peace in South East Europe: Macroeconomic Policies and Structural Reform since the Kosovo Conflict, a copublication of the World Bank and IMF, 2002, 48 pp.

Prior to the eruption of the Kosovo conflict in 1999, Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the former Yugoslav Republic of Macedonia, Romania, and the Federal Republic of Yugoslavia were already lagging behind Central Europe and the Baltics in terms of their economic performance and institutional development. The crisis became a defining moment for all the countries in the region. The broad approach developed by the international community in response to the crisis included reconstruction and, as a final goal, economic prosperity for the region. This paper documents the region's progress in terms of economic growth and government reforms. It points out that bringing private investment into the region depends upon effective governance and policy development.

Daniel Kaufmann, **Business Environment and Enterprise Performance Survey (BEEPS) (Datasets)**, January 2002, available at http://info.worldbank.org/governance/beeps/.

BEEPS, developed jointly by the World Bank and the European Bank for Reconstruction and Development, is a survey of more than 4,000 firms in 22 transition countries conducted in 1999-2000 that examines a wide range of interactions between firms and the state. Based on face-to-face interviews with firm managers and owners, BEEPS was designed to generate comparative measurements in such areas as corruption, state capture, lobbying, and the quality of the business environment, which can then be related to specific firm characteristics and firm performance. BEEPS interactive dataset gives access to the results of the BEEPS survey for a wide range of different users. You can download the entire dataset (in EXCEL format) and the survey questionnaire, or you can follow the simple step by step instructions to obtain data, produce charts, and do simple comparative analyses on the questions and countries that interest you.

Branko Milanovic, **Household Expenditure and Income Data for Transitional Economies**, January 2002, available at http://www.worldbank.org/research/transition/house.htm.

The startling drop in incomes and increase in inequality accompanying the transition to market economies in Eastern Europe and the former Soviet Union raise critical questions: Who is most likely to be poor? How well are existing social assistance programs reaching those who most need help? What kind of programs would be most effective in reducing poverty? As part of a project analyzing poverty and social assistance in the transition economies, a Bank research team created a database of household expenditure and income data from recent surveys—the HEIDE database. The entire database and data descriptions are available in ZIP format (5430K). Country data and their descriptions can also be individually downloaded.

Jeffrey Carmichael and Michael Pomerleano, **Development and Regulation of Non-Bank Financial Institutions,** March 2002, 248 pp.

The principal role the financial system plays in any country is to provide the infrastructure to allow surplus resources to be allocated to those

individuals and companies with deficits. The positive impact of a functioning financial system upon a country's economic growth is well documented. In most countries the financial system extends beyond traditional banking institutions to include insurance companies, mutual funds, market makers, and other financial service providers. These nonbank financial institutions provide services that are not necessarily suited to banks, serve as competition to banks, and specialize in sectors or groups. Having a multifaceted financial system, which includes nonbank financial institutions, can protect economies from financial shocks; however, in developing countries that lack a coherent policy framework and effective regulations, nonbank financial institutions can exacerbate the fragility of the financial system.

This book helps build awareness of the potential of nonbank financial institutions for developing countries. It aims to help policymakers create coherent policy structures and sound regulatory and supervisory environments for the development of these institutions. It assists policymakers in learning the essential functions and characteristics of nonbank financial institutions with chapters on insurance companies, mutual funds and pension schemes, securities markets, and leasing and real estate companies.

João do Carmo Oliveira and Jorge Martinez-Vazquez, **Czech Republic: Intergovernmental Fiscal Relations in the Transition,** World Bank Technical Paper 517, 2001; 112 pp.

This report describes the most significant elements of intergovernmental fiscal relations in the Czech Republic, including the administrative structure, expenditure and revenue assignments, fiscal imbalances and transfers, access to borrowing and indebtedness, and budgeting.

Bernard Funck and Lodovico Pizzati, eds., **Labor, Employment, and Social Policies in the EU Enlargement Process: Changing Perspectives and Policy Options,** 2002, 428 pp.

Central and Eastern European countries continue to face challenges as they transition to a market economy and integration within the EU. Key to this transition is the implementation of suitable labor market policies. In June 2001 the Bertelsmann Foundation and the World Bank sponsored a conference that addressed the challenges labor markets in these countries face. This volume contains the papers presented at the conference. Included in the presentations are recent labor trends, existing labor market policies and social protection mechanisms, and alternative strategies for employment creation.

Growth Challenges and Government Policies in Armenia, World Bank Country Study, 2002, 200 pp.

This study evaluates growth trends in Armenia during 1994-2000. It details the major weaknesses of existing development patterns and suggests a package of policy recommendations designed to hasten enterprise restructuring, attract investment, and encourage the creation of new businesses in the medium term (three to five years). The study identifies three elements that represent critical constraints to sustainable economic growth in Armenia, namely, a poor business and investment environment, weak managerial skills, and uncertainty about the country's economic and political prospects in an unstable region.

Jorge Martinez-Vazques and Jameson Boex, **Russia's Transition to a New Federalism,** WBI Learning Resources Series, February 2001, 99 pp.

Slovak Republic: Living Standards, Employment, and Labor Market Study, World Bank Country Study, 2002, 200 pp.

As a transition economy, the Slovak Republic has achieved a high ranking in terms of human development. Nevertheless, many families and individuals live in poverty. While key variables contributing to poverty are readily identified, the lack of education, employment, and data make it difficult to accurately monitor poverty in the Slovak Republic. This study makes key policy recommendations to reduce poverty by reducing unemployment while instituting measurement processes to evaluate the impact of reforms. The recommendations to reduce poverty include actions in the following three specific areas:

- Increasing the demand for labor by attracting more private investment
- Developing a better match between skills and market demands through education and training
- Encouraging citizens to rely less on government benefits and giving them more incentives to work.

The World Bank Research Program 2001: Abstracts of Current Studies, 2001, 180 pp.

This publication is a compilation of reports on research projects initiated, under way, or completed in fiscal 2001 (July 1, 2000, through June 30, 2001). The abstracts cover 150 World Bank research projects and are grouped under 11 major headings, including poverty and social development, health and population, education, labor and employment,

environment, infrastructure and urban development, and agriculture and rural development. The abstracts detail the questions addressed, the analytical methods used, and the findings to date and their policy implications. Each abstract identifies the expected completion date of each project, the research team, and reports or publications produced.

CASE Publications

To order: CASE, Center for Social and Economic Research, ul. Sienkiewicza 12, 00-944 Warsaw, Poland, tel.: 4822-622-6627, fax: 4822-828-6069, email: case@case.com.pl.

Georgy Ganev, Marek Jarocinski, Rossitza Lubenova, and Przemystaw Wozniak, **Credibility of the Exchange Rate Policy in Transition Countries,** CASE Report, 2001, 68 pp.

Janusz M. Szyrmer, ed., **Ukraine: Monetizing a Transition Economy,** Harvard/CASE Ukraine Project, 2001, 200 pp.

UNICEF Publications

To order: UNICEF Innocenti Research Centre, Piazza SS. Annuniziata, 12, 50122 Florence, Italy, tel.: 39055-20330, fax: 39055-244817, email: ciusco@unicef.org, Internet: www.unicef-icdc.org.

A Decade of Transition—The Monee Project CEE/CIS/Baltics, Regional Monitoring Report, no. 8, 2001, 189 pp.

Richard Berthoud and Karen Robson, **The Outcomes of Teenage Motherhood in Europe,** Innocenti Working Papers no. 86, July 2001, 64 pp.

Bruce Bradbury, Stephen Jenkins, and John Micklewright, eds., **The Dynamics of Child Poverty in Industrialized Countries,** Cambridge, U.K., Cambridge University Press, July 2001.

Roumiana Gantcheva and Alexandre Kolev, **Children in Bulgaria: Growing Impoverishment and Unequal Opportunities,** Innocenti Working Papers no. 84, January 2001, 63 pp.

Other Publications

Central European Initiative (CEI)/ United Nations, **Investiguide 2001-2002—Project Opportunities and Contacts for the CEI Region,** 2001, 189 pp.
To order: http://www.ceinet.org, or http://www.unece.org.

This guide serves a network of people active in business, governmental, and international organizations who share the same vision of improved opportunities in the region or a borderless Europe with lower crime; fewer disparities; and an absence of war, terrorism, and humanitarian crises. "Business without frontiers" is both a political and a profitable concept that needs to be promoted within the context of the varying needs of countries in the region and in relation to the ongoing EU enlargement process.

Project opportunities and contacts across the CEI region are presented in the form of a matrix system, providing an explanatory perspective for each country and project and outlining those countries, activities, and economic sectors that benefit from such projects.

The principal sources used for Investiguide's statistical data are the UNECE database, the databases and web sites of selected national statistical agencies, statistical yearbooks, and the official publications of international financial institutions and organizations.

Adolf J. H. Enthoven and others, **Accounting, Auditing and Taxation in the Russian Federation –An Update, 2001,** Center for Intrnational Accounting Development, The University of Texas at Dallas, St.Petersburg State University, East–West Management Institute, New York, 2001, 160 pp.

Russia's public and private sectors should adhere more closely to internationally accepted business practices as one means of curing the former communist country's current economic, financial and social ills. By implementing international accounting methods, the Russian government would encourage the foreign investment and domestic capital markets so necessary to further develop the country's emerging free-market economy. There is an urgent need to view accounting as a separate discipline and body of knowledge as opposed to merely bookkeeping and recording. Accounting courses based on international accounting principles should be part of business education programs at Russian colleges and universities.
To order: Center for International Accounting Development, The University of Texas at Dallas, P.O. Box 830688, Richardson, Texas 75080, U.S.A., fax.: 972-883-2192.

Brigitte Granville and Peter Oppenheimer, eds., **Russia's Post-Communist Economy,** Oxford University Press, Oxford, U.K., August 2001, 551 pp.

This volume offers a multi-author survey and analysis of economic developments in the Russian Federation since the collapse of communism and the break-up of the Soviet Union in 1989-91. It covers the period 1991-8

and in some areas extends to 1999-2000.
To order: Oxford University Press, Great Clarendon Street, Oxford OX2 6DP, U.K., tel.: 01865-556-767, Internet: www.oup.com

Eva Kigyossy-Schmidt, **Business Related Services in Central and Eastern Europe—A Cross Country Approach,** 2002, 262 pp.
To order: WA-Bertelsmann Distribution GmbH, Postfach 77 77, An der Autobahn, D-33310 Gutersloh, tel.: 052-41-8057, fax: 052-41-46970.

The focus of this book is on the examination of specific procedures for the collection and evaluation of information concerning business-related services in Central and Eastern European economies. Experts from formerly planned economies and, for reasons of comparison, from Ireland, analyze and assess the state of selected business services and formulate policy recommendations to accelerate the restructuring process.

Jeni Klugman and Albert Motivans, eds., **Single Parents and Child Welfare in the New Russia,** U.K., Palgrave, June 2001, 264 pp.
To order: Macmillan Direct Customer Services, Brunel Road, Houndmills, Basingstoke, RG21 6XS, England, tel.: 44-1256-302699, fax: 44-1256-364733, email: md1@macmillan.co.uk.

Luc Moers, **Institutions, Economic Performance, and Transition,** Tinbergen Institute, Research Series no. 269, January 2002, 213 pp.

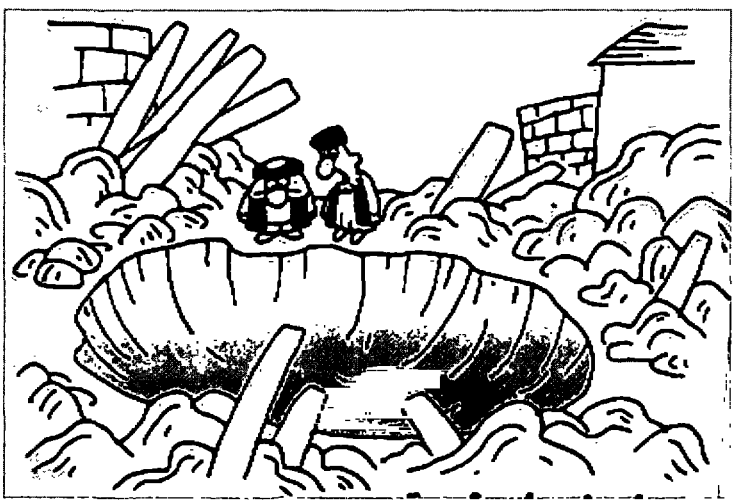
The output collapse in the transition countries was much worse than initially expected. It seems primarily to be an institutional supply-side phenomenon. Transition has destroyed the formal institutions of central planning without automatically replacing them with the required market institutions. Coordination problems illustrate that lock-in of transition countries inefficient equilibrium is a clear possibility. Once a certain degree of macroeconomic stabilization has been accomplished, the institutional environment becomes the more important determinant of growth in transition countries.

The survey collects data in Russia on restructuring ownership, competition, budget constraints, and, particularly, institutions from January 1992 through September 1999. It shows a devastating restructuring crisis, massive privatization, rather weak competition, unexpectedly hard budget constraints, an overwhelmingly negative assessment of formal and informal institutions, and largely the same ruling networks as before the start of market reforms. Ensuring the quality of property rights and the growth of the economy in general is the best strategy to reduce capital flight. The quality of institutions proves more important than a host of variables that are generally considered significant. It implies that more stress should have been given to institution building in the economic transition, certainly early on in the process.

Helen O'Neill, **Ireland's Economic Transition: The Role of EU Regional Funds—and Other Factors,** Occasional Paper no. 1, 2000, Institute for Economic Research, Slovenia, 17 pp.
To order: IER, Kardeljeva ploscad 17, 1000 Ljubljana, Slovenia, tel.: 3861-4328-151, 5345-787, fax: 3861-5342-760, email: recnikm@ier.si, Internet: http://www.ier.si

Adam Torok, ed., **Periodical of the Hungarian Academy of Sciences—ACTA Oeconomica,** 51(3), 2000/2001, 433 pp.
To order: ACTA Oeconomica, IE, P.O. Box 262, H-1502, Budapest, Hungary, tel.: 361-309-2600, fax: 361-319-3136, email: vanyai@econ.core.hu

Worries of Local Health Experts...



Right now only a hospital has accidentaly been destroyed, but once the market economy prevails, all our national health service could be at risk, just like in Hungary.

From the Hungarian magazine *Hócipõ*

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telephone: +380 44 4636337
fax: +380 44 463 5970
Email: marketing@icps.kiev.ua
Website: http://www.icps.kiev.ua

轉軌通訊

If you would like to receive the Chinese version of the *Transition Newsletter* please write to:

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SITE
Stockholm Institute of Transition Economics and East European Economies
STOCKHOLM SCHOOL OF ECONOMICS

Box 6501, SE-113 83 Stockholm,
Sweden, Sveavägen 65, 9th floor
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TRANSITION

Senior Editor: Richard Hirschler
Room MC3-374
Telephone: 202-473-6982
Fax: 202-522-1152
Email: rhirschler@worldbank.org

Production Manager:
Jennifer Vito
Telephone: 202-473-7466
Fax: 202-522-1152
Email: jvito@worldbank.org

Editor: Alice S. Faintich
The Word Doctor
10509 Brevity Drive
Great Falls, VA 22066, U.S.A.
tel. and fax: (703) 759-6434
email: Asfaintich@aol.com
http://hometown.aol.com/asfaintich/TheWordDoctor/info.htm

The World Bank
1818 H Street, N.W.
Washington D.C. 20433
Telephone: 202-477-1234
Fax: 202-477-6391
World Wide Web:
http://www.worldbank.org/

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