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## Editor's Announcement

Dear Readers:

Thank you for helping to make *Transition* a success. Since our first issue in April 1990, the newsletter has grown rapidly. We now publish six issues a year in English and in Russian. Each issue is sent to approximately 13,000 subscribers in the transition economies of Europe and Asia, in developing countries, and in industrial countries.

As circulation has grown, costs for printing and mailing have mounted. Although subsidies from the World Bank and matching funds from the Soros Foundation continue to be available to support the costs of publishing and circulation in transition economies, these funds are no longer sufficient to cover publication costs in industrial market economies.

Starting in 1997 it will therefore be necessary to charge subscribers in member countries of the OECD. The subscription fee for 1997 will be \$30, just \$5.00 a copy. *Transition* will continue to be sent free of

charge to subscribers in transition economies (including those that have recently joined the OECD) and developing countries.

I regret having to initiate this charge. However, I expect that many of our readers in industrial countries will agree that *Transition* is well worth this nominal subscription fee. Because this announcement will not reach many readers until January 1997, the first two issues of 1997 will be sent to all readers at no charge. (Accordingly, the subscription fee for calendar year 1997 will be \$20.) Readers in Western Europe and North America will soon receive a letter describing the payment procedures for continuing their subscription.

Thank you again for your support in making *Transition* such a success.

Richard Hirschler  
Editor

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# Expanding NGO Participation in World Bank's Activity

## Recommendations of an Independent Consultant

A recent report of Quigley and Associates finds that there has generally been little substantive NGO participation in the World Bank's activity in Central and Eastern Europe. (*Participation—in the World Bank's terminology—means the process through which stakeholders influence and share control over development initiatives and over the decisions and resources that affect them; they develop "ownership" as solutions are worked out. Decisions made in a participatory context are generally more feasible and sustainable than decisions made by experts alone.*)

The report looked at private, self-governing, independent, locally registered nongovernmental (NGO) organizations that pursue activities to relieve suffering, promote the interests of the poor, protect the environment, provide basic social services, or undertake community development. It differentiated between two basic types of NGOs:

- Advocacy NGOs generally try to affect policy, usually at the national level. They have tended to receive the greatest attention from the international community, although they represent a relatively small segment of the overall sector.
- Operational NGOs are usually involved in service delivery, most often at the local level.

The report identifies a number of barriers separating the Bank and the NGO sector, some attributable to the Bank, others to the NGO sector. These barriers include the following:

- Governments as borrowers are the Bank's clients. In circumstances where the government-NGO relationship is new or strained, effective Bank-NGO partnerships are difficult to establish.
- On one side most Bank staff interact primarily with government officials—many of whom are uncertain about NGOs. As a result, Bank staff are generally not well informed about the NGO sector. There is a general lack of Bank incentives to develop relations. Some Bank staff are skeptical about partnerships with NGOs because of their lack of capacity and skill or because "they provide little value added." In many cases NGOs have capacity for only small-scale interventions, this may result in relatively high transaction costs for the Bank.
- On the other side, NGOs often have exaggerated expectations about what the Bank may bring to any partnership. Some see the Bank as a source of funding. Others, especially those working in fields such as the environment, are often suspicious or even hostile about the role played by the Bank. Few NGOs are well informed about Bank policy and procedures. Most NGOs would require significant training and institutional capacity building before they could easily partner with the Bank.

As the NGO sector develops, so does the potential for partnership with the Bank. These partnership possibilities span the Bank's project process, but they could be most prominent in project identification, design, monitoring, and advocacy, areas in which numerous NGOs have relevant expertise, experience, and capability.

Especially as the Bank program shifts toward more social issues, NGOs resources may prove extremely beneficial to helping the Bank reach its objectives. For example, NGOs are generally adept in reaching and mobilizing people (including groups that sometimes are difficult to reach, such as women and the poor). Since NGOs often operate at the grassroots level and employ local people familiar with local conditions, they are generally far more able to identify local needs than central governments or international financial institutions. NGOs can also be highly flexible, innovative, and their administrative costs are considerably less than government institutions or consulting firms.

### Recommendations

The report identifies the following measures that would help promote World Bank-NGO relationships and expand NGO participation in World Bank activity in Central and Eastern Europe [some of these recommendations are currently being carried out]:

- Publicize better the activities of the Bank and its policy of encouraging NGO involvement. Essential to this effort is implementation of the Bank's new disclosure of information policy. Project documents should be made more easily available and a greater share of material should be translated into local languages.
- Utilize NGOs to a greater extent to help identify appropriate stakeholders. Existing NGO databases can provide a useful starting point for Bank interactions with NGOs. The Bank should also create a mailing list of NGOs, as well as local,

regional, and national government agencies that would routinely receive information about Bank activities. Public hearings about projects under consideration, similar to those used by the EBRD, should be made an integral part of the decisionmaking process.

- Provide more training and incentives for Bank task managers and project officers regarding the benefits of enhanced interactions with NGOs [that has already been done in Russia]. A conference in Eastern Europe for governmental, business, and NGO leaders would be useful to present the Bank's activities and policies, as well as to promote dialogue among the sectors.

- Provide a budget line for enhancing interactions with NGOs. Participation action plans, without budgeted resources to support NGOs, are not credible. In particular, the special fund providing small grants to strengthen the capabilities of NGOs working with the most disadvantaged sectors of society could [be extended to] help fulfill the Bank's mission of addressing poverty. Examples might be small grants to pilot and then replicate self-help programs for the chronically unemployed and disabled. The Bank could leverage its resources—[allocated through small grant programs]—by insisting on matching funds from foundations and other funding sources.

- Select, identify, and train special NGO liaison officers in the Bank as a contact point for NGOs. This staff member should maintain or have access to a comprehensive database of NGOs and organize regular meetings with a cross-section of organizations. Bank missions should also regularly meet with NGO representatives.

- In negotiations with a government, the appropriateness of NGO involvement in Bank-financed projects should be underscored by citing examples of successful collaboration in other countries. The Bank could certainly recommend that a certain proportion of its support be channeled to activities conducted by NGOs.

This would support the Bank's interest in creating an enabling environment for constructive public policy.

*Excerpted from Quigley and Associates' recent report, "Towards Broader*

*and More Effective NGO Participation in World Bank Activities in Eastern Europe: Two Case Studies—Poland and Slovakia," October 1996.*

## Success Story of a Hungarian NGO Helping Romany to Help Themselves

Hungary's Autonomía Alapítvány (Foundation for Self-Reliance) was launched in 1990 as an independent, grant-giving foundation. The "founding father," Andras Biro, retired recently, but not before receiving, together with the foundation, the 1995 Right Livelihood Award—also known as the alternative Nobel Prize, "for resolute defence of Hungary's Romany (Gypsy) minority and effective efforts to aid their self-development." The new director is Anna Csongor, a longtime member of the foundation's management.

The foundation—sponsored by U.S. charities (Ford, Rockefeller Brothers, C.S. Mott, Levi Strauss, and anonymous donors), by the European Phare program, and by local donors (primarily the Soros Fund)—supports civil initiatives in three areas:

- Grants and interest-free loans to Romany (Gypsy) communities for income-generating projects in poverty-stricken regions of Hungary.
- Environment-friendly programs, primarily employment-generating projects for minorities.
- Grassroots movements.

### Principal Focus: Poverty Alleviation

Autonomía focuses mainly on initiatives that alleviate the poverty of and discrimination toward Romany in Hungarian society; projects are mostly in agricultural activities—such as growing watermelons and breeding animals—as most applicants are village people. During the

past six years, the foundation has supported about 500 local projects (the upper limit for any one grant or loan is \$10,000), totaling about \$500,000. Autonomía offers two types of assistance to communities:

- Survival grants or loans to secure the survival of individuals or families that lack material or human resources for an entrepreneurial project.
- Interest free development loans to unemployed Romany to help them secure work experience, housing resources, and practice in household farming. In the early stage of the foundation's activity, the repayment rate of loans was low. Autonomía had to rethink its strategy. Projects are now better prepared: loan application of organizations with the proper resources can only be considered. Also, an extensive monitoring program has been put in place. Monitors, young activists who are both Romany and non-Romany, are trained to build trust with the groups submitting proposals. Throughout the planning stage of the project, they encourage Romany organizations to make strategic decisions themselves. As a result a growing number of individuals in local Romany communities experiment with entrepreneurship.

Autonomía has organized the Romany Entrepreneur Training Project, an eighteen-month program to provide intensive training for Romany leaders to help them become for-profit and nonprofit organizational managers. (As of 1995, 30 percent of the program's former students had established their own ventures.)

In 1994, Autonomía established the first legal defense bureau for minorities in Hungary. It has been active in pursuing court cases and assisting Romany in protecting their legal rights. This initiative has been replicated on a broader scale in the Regional Romany Program (EUROMA). Financed by the European Commission and administered by Autonomía, the program provides training, legal advice, and communication services to Romany self-help organizations in Bulgaria, Hungary, Romania, and Slovakia. And in Hungary, Autonomía is striving to establish the first Romany radio station.

In 1995 the European Commission asked the foundation to provide technical assistance to its microproject scheme in Hungary under the Phare Democracy Program. The scheme is to promote a democratic society governed by the rule of law through providing grants between Ecu 3,000 and 10,000 (at present \$1 equals Ecu 1.24) to grassroots Hungarian NGOs. In the past two years Autonomía helped distribute grants totaling Ecu 800,000.

The Autonomía Foundation, like other Hungarian NGOs, is plagued by the present funding system that makes the grants they receive strictly project-related. NGOs have little chance to build sustainable capacities and to plan for the longer run; they are often unable to hire long-term professional staff, or to undertake vital financial transactions that cannot be accounted for as immediate project costs.

The foundation is planning ahead, nonetheless. It is considering taking over the role of a micro-credit agency for those who are unbankable, in other words, unable to acquire loans from the banks. Another idea is that—instead of being merely a grant provider—Autonomía should become shareholder in local Romany businesses or quasi-businesses, in

order to share responsibilities and accelerate community development.

*Excerpted from an article by Nancy E. Popson, "How to Develop a Sustainable Institution Involved in an Unpopular Issue: Autonomía Alpitvány—A "Success Story."*

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### Who Are the Romany?

The Romany (Gypsies)—close-knit, communal people with a common biological, cultural, and linguistic heritage—are currently dispersed in small groups throughout the world. They have been in Europe for more than 500 years. Their original homeland was northwestern India, proved by the relationship between their language, Romany, and the Indo-European dialects of that region. The term Gypsy is gradually being replaced with the word Romany, meaning "the people." The term Gypsy developed from a mistaken belief that Gypsies came from Egypt.

Popular modern stereotypes continue to define the Romany in terms of nomadism; however, most Romany peoples are sedentary—of the more than 1 million in Eastern Europe and the Balkans, probably no more than 10 percent are nomads. A salient characteristic is their strong sense of group cohesion and exclusivity, stressing the sacredness of Romany traditions in opposition to those of the outside world.

Discrimination against Gypsies has persisted in much of Europe to the present time. In the twentieth century, persecution reached its height during World War II, when about 400,000 Gypsies perished in Nazi concentration camps. The total number of Gypsies in the world today is estimated at between 3 million and 6 million. By far the largest concentrations are found in the Balkans,

Central Europe, Russia, and other FSU countries, with smaller numbers scattered throughout Western Europe, the Middle East, North Africa, and the Americas. (Evidence suggests that fewer than 100,000 Gypsies now live in the United States and Canada.)

Gypsies are fragmented into groups sometimes referred to as nations or tribes, generally defined by geographic area of settlement or recent origin. The European tribes include the Gitanos of Spain, the Manouche of France, the Sinte of Germany and Central Europe, the Romnichals of Great Britain, the Boyash of Romania, and the Romany of Eastern Europe and the Balkans. The Romany also make up the single largest Gypsy group in the United States.

The Romany in Hungary make up the largest minority, with 500,000 people, or 5 percent of the population. They settled in Hungary in the sixteenth century, and 75 percent claim Hungarian as their native language. Since the fall of communism, the Romany population has been plagued by a high, 48 percent unemployment rate. They remain largely undereducated, and their already dismal housing situation has further deteriorated. Financially successful Romany usually reject their ancestry and are thus lost to the community. Remarkably, some 200 independent ethnic Romany organizations have been formed throughout Hungary since 1989.

# Letter to the Editor

## Professors Kabaj and Kowalik Versus the Facts

Professors Kabaj and Kowalik presented their version of developments in Eastern Europe in *Transition*, vol. 6, no. 7-8, July-August 1995 (page 7). Their account was so much at odds with reality, and with what analysts—and East European analysts above all—should know, that it raised questions about almost every point they made. I will concentrate on two points only.

The first is the notion of “unduly cruel reforms,” a rallying cry for anticapitalist forces, whether from the utopian left or the anachronistic, precapitalist right. Since transition from the distorted, Soviet-type socialist economy to the capitalist market economy was unprecedented, early debate was necessarily conducted largely at the theoretical level. Analysts, well versed in the Soviet-type economy, could point a finger at the oversized industrial sector—to the large share of output that was not needed under a market economy system since it served no wealth-increasing purpose. With the start of the transition process, this type of output was eliminated.

A simple understanding of the socialist system should counter any argument that a decline in output could somehow be avoided. Nonetheless, it could conceivably be argued that at the start of transition there was some way (also unspecified by the authors) to extend output adjustment over time and therefore make it less dramatic.

But what might have been accepted—hypothetically—as an infallible truth in 1990 or even 1991, has been shown since to be without foundation. Countries that made serious stabilization cum liberalization efforts were the first to recover from what Professor Kornai aptly

calls “transformational recession” and to start to grow—and this time in a manner largely undistorted by the socialist past.

In contrast, East European countries that tried to introduce systemic change gradually or to soften the process (for example, Romania), or that undertook liberalization without much stabilization (Russia), or that were affected by the collapse of the socialist system but did not really undertake transition to a capitalist market economy (Ukraine), suffered from much larger output declines. This is understandable. The inevitable—that is, the elimination of output produced only to satisfy the absurd incentive structure of the Soviet Socialist system—took place regardless of whether a successful transformation followed. But in cases where it did not, new output by the generic private sector did not appear (or, at least, not on a large enough scale) and, hence, healthy economic growth did not ensue.

Another misrepresentation of reality by Professors Kabaj and Kowalik is the alleged “impoverishment of many”—and the use of statistics that will fail to impress those familiar with Soviet socialism. The use of a “real wage” indicator is ridiculous for economies where shortages were the rule and goods had to be acquired through the black market or other costly channels. The data showing absolute declines in food consumption are likewise unconvincing for those with an understanding of the type of economy Eastern Europe was shedding. Food consumption in these countries (and Poland, for which they cite sales figures, is no exception) was always distinctly lower than claimed by official statistics.

For one thing, the structure encouraged producers to reduce quality without reducing prices. So the quality of meat, cheese, milk, and the like deteriorated steadily. Sausages, for example, were

made with less meat. Thus, sales figures for sausages could not be considered a reliable indicator of meat consumption.

But this was only part of the distortion of consumption indicators. Because of perennial shortages, consumers generally bought more food than they needed since they never knew when certain items would be available again.

In summary, it is not clear that food consumption declined at all, let alone to the extent indicated by official statistics. Moreover, changing patterns of consumption—rather than the alleged impoverishment—need to be looked at when analyzing changes in a particular consumption category. There has, for example, been a dramatic increase in ownership of household durables during the transition. In Poland, the number of households owning a color television increased by 80 percent while households owning a car almost doubled. Marked increases were registered in sales of almost all durables, from washing machines to computers. Interestingly, these increases were recorded by all household categories, including pensioners and farmers. Thus, it must be suspected that whatever decline in food consumption took place, it may have reflected a greater value attached to the ownership of consumer durables—a natural reaction after so many decades of persistent shortages. These consumption patterns are strikingly at odds with claims of mass “impoverishment” and “enrichment of the few.”

*Jan Winiecki, Professor and Chair, International Trade and Finance, Viadrina-European University, Frankfurt-Oder*

*Editor's note: As debates on the cost of transition are still very much alive, we decided to publish this year-old letter, the original of which was regrettably lost in the mail.*

# So Far So Good? A Privatization Update

by John Nellis

Let us try to respond to some frequently asked questions related to privatization in transition economies:

- How much has been privatized in the transition countries? And what remains to be divested?
- What sale or divestiture methods have been used?
- What are the advantages and disadvantages of the various methods employed? What kind of privatization induces changes in companies that make them more competitive and likely to survive and thrive?
- What are the most acute, still unresolved privatization issues?

## Historic Magnitude and Pace

In the nontransition economies of the world, in the period 1980 to 1991, some 6,800 firms were privatized (excluding the former East Germany). By contrast, in fifteen transition countries of Central and East Europe and the former Soviet Union, by the end of 1994 an estimated 30,740 medium-size and large firms had changed ownership (the figure relates only to officially registered transactions, where the state sold a majority stake). Adding the 14,500 medium-size and large firms in Germany privatized by the Treuhandanstalt through the end of 1994, the total number of firms divested in these sixteen countries exceeds 45,300. The privatization process did not stop in 1995 and 1996; in many countries, such as Latvia, Romania, and Ukraine, it accelerated greatly.

Furthermore, many hundreds of thousands of small business have been privatized (in Russia alone at least 75,000; in the Czech Republic, 22,000; in Ukraine, 33,000). Also, there was explosive growth of new private firms and activities. There is no doubt that an incredibly large and rapid shift of ownership has taken place

in this region. In many transition states the bulk of economic activity is now in private hands.

Privatization lags in some areas. Contrary to early expectations, privatization has not advanced greatly in any agricultural sector that has been collectivized for longer than one generation. And only a few countries—Czech Republic, Estonia, and Hungary—have succeeded in privatizing many of their infrastructure enterprises.

Moreover, transition countries still hold on to a large portfolio of publicly owned firms. As of the end of 1995, in seven transition countries (for which data were available) about 25 percent of the enterprises remained in state hands; and in five of these about 35 percent of the value of the enterprise sector as a whole remained publicly owned. This is because some countries set aside certain firms or sectors as strategic or vital to national security and did not sell them, at least not in the first wave of mass privatization programs (for example, in the Czech Republic, Kazakstan, Lithuania, Mongolia, Russia, and Slovakia). There may be as many as 10,000 unprivatized, or minority privatized, medium-size and large industrial firms in Russia today. Many are in bad shape, unable to raise capital, and hanging on at a much-reduced rate of production. And even in privatized companies, in many countries the government or state-owned entities such as property funds have retained significant percentages of shares, in some cases a majority.

## Sale Methods

The following major privatization techniques were adopted:

- *Direct sales of various types*, either by negotiated trade sales (sometimes called case-by-case privatization; used in Hungary), or by bunching companies in a

multienterprise tender (Estonia, Germany, Latvia), or by holding a public offering for the shares of a company undergoing privatization (Poland).

- *Management buyout (MBO) or management and employee buyout (MEBO)*, whereby employees and managers in the firm being divested are given the opportunity to become the new owners: in an open competition (Czechoslovakia, Estonia), without competition (Russia), or in a competition but with advantages for insiders such as lower price or special credit arrangements (Latvia). Russia's first-phase mass privatization program was called a voucher program but was actually more of an MBO scheme with a voucher program attached to it. MBOs are being used extensively in Romania and in Slovakia's second phase of privatization. Both Slovene and Latvian privatizations have mainly ended up as MBOs.

- *Equal access voucher privatization*, an approach that gives the public at large the opportunity to obtain shares in companies (or in investment funds) by exchanging their vouchers, distributed to the public at low or no cost by the government. Equal access means that all citizens have the same opportunities and buying power from their vouchers and neither insiders nor any other group gets special claim on the assets. (Czechoslovakia's first privatization effort followed this scheme; and similar schemes of this sort were tried in countries as diverse as Albania, Lithuania, and Mongolia.)

## Who Will Restructure?

The evidence is strong that selling a majority stake of a state-owned firm to a core, experienced investor—often but not necessarily a foreign investor—produces good restructuring results. This is not surprising; they have the money and experience and are able to gain access to

new investment capital. But they are in short supply; a rough estimate is that from 10 to 15 percent of all enterprises up for privatization in transition economies will prove attractive to monied core investors. The conclusion is obvious: transition countries should do all they can to attract foreign investors, but they have to rely mainly on themselves, on their own policies, on their own capital, and on their own managers, to do much of the essential restructuring.

Thus, of methods other than sale to a strategic or foreign investor, which technique is best for restructuring? G. Pohl, S. Djankov, and R. E. Anderson extrapolate from the Czech and Central European experience and argue strongly that mass, rapid privatization, accompanied by hard budgets and few barriers to entry, can produce significant restructuring, even in the absence of numerous foreign investors. [*Restructuring Large Industrial Firms in Central and Eastern Europe: An Empirical Analysis*, *World Bank*, June 1996]. In Russia, mass privatization was not accompanied by sufficiently hardened budgets, nor were markets as competitive as in the Czech Republic. The result is that restructuring in privatized firms lacking a strategic investor (according to data up to the end of 1994) was relatively modest and hard to distinguish from that taking place in state-owned enterprises. To compound Russia's problems, its mass privatization scheme resulted in enterprise insiders possessing, on average, two-thirds of the shares in each of the 16,000 firms divested in the voucher auctions. This high a level of insider ownership is an obstacle to restructuring. Many believe and hope that major changes in privatized firms will show up as more time passes, and that in the coming months and years the positive effects of private ownership will become much more apparent.

Poland, on the other hand, has demonstrated good overall economic performance, led by hard budgets and a good

competition framework, despite the fact that the long-delayed mass privatization program has taken off only recently. Some economists have concluded from the Polish experience that restructuring can go ahead without changing ownership. Others have argued that good economic policies might substitute temporarily for the lack of ownership change, but in the longer run, government can hardly resist political pressures to transfer resources to state-owned firms, and that will inevitably diminish economic performance.

It was once assumed that no other transition economy could successfully use the tender method devised by the Treuhand in Germany; but Estonia used a modified version and divested the vast bulk of state assets in a short period. (It even succeeded in combining case-by-case sales with voucher exchanges for minority shares; and it is now proceeding with sales of infrastructure firms.) How did Estonia manage this? The successful outcome is attributal to committed leadership that was willing to take risks, to accept strategic and foreign investors, to replace old managers, to quickly put in place a macroeconomic framework conducive to business development, and to do battle with the many forces arrayed against reform in general, and privatization in particular.

The conclusion is that a particular method of privatization is but a tool and that what counts just as much, or more, is the skill and particularly the resolution of the persons, agencies, or government applying that tool.

### Missing Strategies

Many problems remain:

- The sale of firms not touched in the first privatization round, or of shares retained by governments, has almost everywhere moved very slowly (Moldova, Russia, Kazakstan).
- Most countries using voucher privatization managed to do it without widespread

corruption, but post-voucher divestitures have often been much more messy (Russia).

- A few countries using the voucher method ended up with widespread shareholding, but no dominant investors of any sort; the result is little change in corporate behavior and increasing disappointment among the shareholders (Mongolia and Lithuania).
- Mechanisms to promote secondary share trading are badly needed in many countries, as are steps to protect minority shareholder rights.

It was believed that the primary problem of privatized enterprises would be a lack of working and investment capital. Indeed, most owners and entrepreneurs in these countries do complain that they have great difficulty obtaining credit at anything near what they regard a reasonable price, or for any period longer than a year. Nonetheless, many observers argue that shortage of bank credit and capital is not the critical problem in transition enterprises. The critical shortage in many firms is knowledge of what to do beyond labor-shedding and cost-cutting: how to make the output attractive and capable of generating profits. Knowledge of how to do business in competitive markets is still in short supply.

In sum, how one privatizes, what one privatizes, even the speed with which one privatizes, can vary greatly from country to country, while still producing respectable results. The World Bank's 1996 *World Development Report* had it right when it noted that the initial transfer of ownership is but the first step in what is usually a long, evolutionary process of moving firms to the market. What is unavoidable is the fact of privatization itself; those countries that have tried to avoid, evade or postpone privatization indefinitely have only compounded their economic pain.

*The author is senior manager in the Private Sector Development Department, the World Bank.*

# A Taxonomy of Mass Privatization

by Saul Estrin and Robert Stone

The first mass privatization programs were undertaken in 1992, in Czechoslovakia, Romania, and Russia. Estonia and Lithuania joined the ranks in 1993, with the other transition countries, especially those in the former Soviet Union, developing programs more recently. By 1996, most transition economies had either introduced a privatization program or were considering doing so.

Mass privatization was supposed to solve a specific problem, that is, the need to rapidly privatize a large number of firms in circumstances where only a few potential buyers had sufficient funds to purchase company shares, where capital markets were so underdeveloped that these individuals could not expect to borrow such funds, and where valuation of companies was extremely difficult. Mass privatization injects sufficient liquidity into an economic system to enable the transfer of state ownership to private individuals, and it limits the inflationary impact by ensuring that the credits cannot be used directly to finance consumption.

In designing such schemes, authors of mass privatization plans had to make major decisions:

- Should the vouchers, which confer ownership of former state property and are given away free or for a nominal registration fee, be bearer (that is, those holding vouchers are legal owners) or registered? Should they be tradable? Bearer vouchers are tradable, but registered vouchers may or may not be. Variations are as follows (see table 1): bearer and tradable (B); registered and tradable (T); and registered and nontransferable, except between relatives and (or) on the death of the owner (N).

- Should company shares be brought to the market continuously (C) or in waves

**Table 1. Mass Privatization Programs in Central and Eastern Europe and the CIS<sup>1</sup>**

| Country <sup>2</sup>   | Shares in waves or continuous issue <sup>3</sup> | Vouchers bearer tradable nontradable <sup>4</sup> | Investment in PIFs allowed encouraged compulsory <sup>5</sup> | Independent fund managers or self-managed funds <sup>6</sup> |
|------------------------|--|---|---|--|
| Albania (1995)         | C <sup>7</sup>                                   | B   | E <sup>8</sup>  | I  |
| Armenia (1994)         | C  | B   | A <sup>9</sup>  | I  |
| Belarus (1995)         | C  | B   | E <sup>10</sup>   | S  |
| Bulgaria (1995)        | W  | N   | E   | S  |
| Czech Rep. (1992)      | W  | N   | E   | I  |
| Estonia (1993)         | C  | T <sup>11</sup>                                   | A <sup>12</sup>   | I  |
| Georgia (1995)         | C  | n/a   | A <sup>13</sup>   |  |
| Kazakstan (1994)       | W  | N   | C   | I  |
| Kyrgyzstan (1994)      | C  | B   | A <sup>14</sup>   | I  |
| Latvia (1994)          | C  | T   | A <sup>15</sup>   |  |
| Lithuania (1993)       | C  | N   | A <sup>16</sup>   | I  |
| Moldova (1994)         | W <sup>17</sup>                                  | N   | E <sup>18</sup>   | I  |
| Poland (1995)          | W  | T   | C <sup>19</sup>   | I  |
| Romania (1992)         | C  | B   | C <sup>22</sup>   | I  |
| Romania (1995)         | W  | N <sup>21</sup>                                   | A   | tb <sup>23</sup>   |
| Russia (1992)          | C  | B   | E   | S  |
| Slovak Republic (1992) | W  | N   | E   | S  |
| Slovenia (1994)        | C  | N   | A   | I  |
| Ukraine (1995)         | C  | N   | A   | S  |

Source: Authors.

Notes:

1. Excluded from the table are Azerbaijan, Croatia, Hungary, Macedonia, Serbia, Turkmenistan, and Uzbekistan.

2. The year in brackets is the year in which distribution of vouchers began.

3. **W** means that large numbers of companies are offered together at infrequent intervals (e.g., hundreds of companies, at intervals of three months or more), **C** means that relatively small numbers of companies are offered at relatively frequent intervals (e.g., fewer than 200 companies at a time at intervals of less than three months).

4. **B** means that vouchers were bearer (and therefore by definition tradable), **T** means that vouchers were registered, and that citizens could trade their vouchers before and during the subscription process, **N** means that vouchers were registered and were not transferable, or were transferable only between relatives and/or on the death of the owner.

5. **A** means that the citizens were allowed to exchange their vouchers either for company shares or for shares or units in privatization investment funds, but that the practice was not particularly encouraged by the privatization process, **E** means that the process did positively encourage citizens to invest in PIFs and **C** means that citizens could only invest in PIFs and that direct investment of

vouchers in companies was not possible.

6. **I** means that the PIFs were obliged to have separate management companies and independent custodians, **S** means that the creation of self-managed funds was allowed, alongside funds managed by independent managers.

7. Although a continuous issue was originally intended in Albania, only eighty companies were offered in two tranches in 1995, and a further twenty firms were due to be offered in the summer of 1996.

8. In practice, only one or two PIFs had applied to receive vouchers in Albania by July 1996.

9. Although a legal entitlement exists to invest vouchers in PIFs in Armenia, this choice was very limited in practice.

10. The results of the first voucher auction in Belarus were canceled in March 1995 and PIF licenses were suspended from then until August 1996.

11. Vouchers were nontradable in Estonia at the outset of the program, but cash trading was legalized in the spring of 1994.

12. In Estonia, citizens could also exchange vouchers for other things such as apartments or land.

13. Although a legal entitlement exists to invest vouchers through PIFs in Georgia, this choice was very limited in practice.

14. In Kyrgistan, citizens could invest their vouchers in housing as well as shares. They can sell their vouchers to funds, but no formal mechanism exists for them to subscribe for funds, which are not therefore, strictly speaking, PIFs.

15. In Latvia, citizens could also exchange vouchers for other things such as apartments or land.

16. In Lithuania, citizens could also exchange vouchers for other things such as apartments or land.

17. Although the design of the Moldovan program was based on the offer of companies in waves, in practice the "waves" were small in the early stages, and thus had many of the characteristics of a continuous issue.

18. In Moldova, in addition to investment funds, the law also permits the creation of "trust companies," which buy shares upon instructions from voucher-holders.

19. Citizens in Poland were given vouchers that could be exchanged for shares in PIFs.

20. In 1991, Romania introduced a scheme based on the distribution of certificates of ownership in five Private Ownership Funds. In 1995, a supplementary mass privatization program was introduced involving the distribution of coupons that could be exchanged for company shares of POF shares, following which the POFs are to be transformed into financial investment companies.

21. Certificates of ownership were bearer, coupons were registered and nontradable.

22. Certificates of ownership in POFs in Romania could under certain circumstances be exchanged for company shares.

23. The structure of the POFs in Romania upon their transformation into financial investment companies has yet to be decided.

(W)? Waves usually involve the simultaneous offer of 25 percent or more of companies eligible for privatization. The latter allows the buyer a direct comparison between alternative options—but is administratively more demanding.

•Should capital market intermediaries' investment in privatization investment funds (PIFs) be merely allowed (A), actively encouraged (E), or compulsorily set up as a central element in the whole proposal (C)? Should the funds' management be independent in separate companies (I) or should they be self-managed (S)?

Table 1 identifies nineteen mass privatization schemes in eighteen transition countries (Romania designed two programs). Azerbaijan, Croatia, Hungary, Macedonia, Serbia, Turkmenistan, and Uzbekistan have not introduced mass privatization schemes, though some of them are currently considering it.

The Armenian and Russian models differ only in whether PIFs are encouraged or merely allowed—not a great difference (see table 2). In the Polish model, citizens were given entitlement to shares in PIFs, rather than in commercial companies. The three models from the former Soviet Union differ from the two from Central Europe primarily because of the use of continuous sales rather than waves of shares. There were also differences in PIFs' holding limits, ranging from a minimum of 33 percent in Poland to a maximum of 20 percent in the Czech scheme.

Recent mass privatizations in the Balkans and Kazakstan have opted for the Czech-Slovak approach. The Lithuanian model, with nontradable vouchers, merely allowing PIFs, and continuous sales of shares has attracted imitation not only in the other Baltic states, but also in Slovenia and Ukraine.

Available evidence indicates that the Czech-Slovak and Polish mass privatizations are associated with more out-

sider ownership. While mass distribution to the population, combined with no tradability, together with waves in privatization, helped to disperse ownership, the funds are playing key roles; they are compulsory in Poland and, though only encouraged in the Czech legislation, were given potency by effective advertising. It remains to be seen whether the role of outsiders will also be relatively pronounced in the later applications of the Czech and Polish models—that is, Bulgaria, Kazakstan, Moldova, and Romania.

The evidence suggests that insider ownership dominated in Russia following mass privatization, despite the strong role ascribed to PIFs. But the Russian scheme has set in place fundamentals of private ownership, capable of adjustment to outsider control as capital markets develop. Insider control derived from the discount offered to employees, in the context of bearer vouchers and a continuous privatization process. The Armenian program seems even more likely to favor insiders. The Lithuanian model relies on nontradable vouchers with fewer discounts to insiders during the mass privatization auction process. Some countries (especially Lithuania and Slovenia), adopting the Lithuanian model, allowed insiders to acquire shares on favorable terms through other mechanisms, so the effects on ownership distribution in this model are less clear.

Countries where vouchers were registered and tradable, and which at a minimum encouraged PIFs, would see the most extensive capital market growth. The Czech and Polish models have clear advantages. The Lithuanian model does not encourage PIFs while the Russian model does not have registered vouchers. The Armenian model has the least potential for capital market development.

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**Table 2. Models of Mass Privatization**

| Privatization model | Countries following this model |          |      |
|---------------------|--------------------------------|----------|------|
|                     | Shares                         | Vouchers | PIFs |
| Russian             | C                              | B        | E    |
| Armenian            | C                              | B        | A    |
| Lithuanian          | C                              | N        | A    |
| Czech-Slovak        | W                              | N        | E    |
| Polish              | W                              | —        | C    |

Source: Authors.

# Quotation of the Month: "Continued Partnership with the People"

## Managing Director Caio Koch-Weser on the World Bank's Role in Central and Eastern Europe

As the situation of the Central and Eastern European countries changes, so too the country strategies of the World Bank Group. These are tailor-made to meet the member countries' special needs, depending on whether we are dealing with middle-income countries with good policies and access to global capital markets, or countries that are still struggling with the social impact and political economy of the reform process. Our clients' unique country features are clearly reflected in the composition of the World Bank Group's more than \$10 billion loan portfolio with Central and Eastern European countries, and in the array of nonlending services we are providing.

In the more advanced countries—the Czech Republic, Estonia, Hungary, Poland, and Slovenia—liberalization, stabi-

lization, legalization, and privatization have progressed the fastest. These countries are already attracting significant private flows, and are moving rapidly toward accession to the EU. This has two broad implications for us:

- First, it increases the demand for Bank Group policy advice and learning about the policy experiences of other countries.
- Second, it reduces the demand for Bank Group financing per se, and tilts its composition toward catalytic instruments such as guarantees. Thus, our nonlending services are increasing in importance, focused on the needs of accession to the EU.

Meanwhile, MIGA and the IFC are active in these countries, working directly with private sector partners—offering guarantees to foreign banks and firms in the case of MIGA, and supporting local investors in the case of the IFC. Within these broad principles, we are continuing to provide support through a mix of lending, policy advice, and technical assistance focused on support for Phase II reforms:

- We are working on the **financial sector** with all these countries, but our assistance is increasingly moving away from broadly based adjustment support—and toward more finely targeted policy advice and technical assistance, coupled with projects designed to address specific problem areas. For example, we are working in Hungary and Slovenia on institutional development plans for banking supervision, in line with the criteria for EU accession; and in Poland, we are providing support to help the government restructure specialized banks.

• We are supporting **enterprise reform**. A current example is our support for Hungary's privatization program, which targets substantial reductions of the state's remaining shareholdings in enterprises over the 1995-97 period.

• We are providing a broad program of assistance on **pension reform**—supported by lending and nonlending instruments—across most of the advanced countries. We are supporting sustainability analysis of current systems and reform scenarios, the design and implementation of multipillar reforms, the drafting of private pension and insurance legislation, and the setting up of prudential regulatory and supervisory authorities. A key role for the Bank is as a broker of knowledge—connecting interested parties in the Czech Republic, Hungary, Poland, Slovenia, and other countries with those working on the same issues in Argentina, Australia, Chile, Switzerland, and elsewhere around the world.

In the second group of countries in Central and Eastern Europe—Bulgaria, Croatia, Latvia, Lithuania, and Romania—reform has been stop-and-go. The result of this is that these countries are not attracting capital flows yet, and their preparation for accession to the EU is less far along. These countries' residual financing needs are thus greater than those of countries in the first group, but we can provide substantial funding if the fundamental problems are addressed head-on. These circumstances thus call for a different blend of advice, policy dialogue, and financing than in the more advanced countries.

### Phase I and Phase II

Basic elements of Phase I transition reform:

- Liberalization of prices, foreign exchange, foreign investment, and commercial activities.
- Stabilization of fiscal and monetary policies.
- Creation of institutions; design, introduction, and enforcement of laws that "legalize" the market economy and protect private property.
- Privatization, in the first round mainly of small and medium-size enterprises.

Phase II transition reform involves:

- Changes in the financial sector—privatizing banks, developing the capital market.
- Changes in the public sector—privatizing remaining state enterprises and parts of utilities; restructuring finance and management of the health and pension systems, with an increased role for the private sector.

Given the slow progress on reform, there is a clear need to promote greater popular understanding of the gains from reform and to build consensus about the necessary measures and sequence. Against this background, the Economic Development Institute (EDI)—the Bank Group's education arm—is helping to strengthen channels for communication on economic reform issues with civil society, including the press.

While we are working with these countries on the Phase II reforms, we are also still very much involved in the consolidation of the Phase I reforms, especially stabilization and first-round privatization. Their financial sectors remain fragile, and recent banking crises in Latvia and Lithuania, and currently in Bulgaria, have amply demonstrated the vulnerabilities on this front. We are providing, at the governments' request, significant technical assistance and advice to Latvia and Lithuania in dealing with their banking sectors. In Bulgaria, we are heavily involved in a dialogue aimed at stabilizing the economy; and in Romania, we are supporting improvement in banking supervision and capital adequacy standards. All this advice is being (or could be) supported by adjustment and banking sector restructuring operations.

On enterprise reform, we are supporting the privatization of hundreds of companies in Romania, and the restructuring of public sector natural monopolies through structural adjustment lending. In Bulgaria, we are focusing on those state enterprises that generate 80 percent of losses through a program of closure and privatization, restructuring, and the introduction of a mass privatization program.

Reflecting the situation on the ground in these countries, our support for pension reform is at an earlier stage than in the first-group countries. Our Board has just approved a Social Insurance Administra-

tion Project for Bulgaria, which is designed to help improve the management and financial viability of the current pay-as-you-go system and lay the groundwork for more fundamental reforms. In Romania, we are also assisting with improved management and labor training and with the preparation of the legal basis for the introduction of a defined contribution-based social insurance program. We are supporting Latvia's major pension reform program through technical assistance. We are working closely with Croatia in the design of the first stage of its pension reform program.

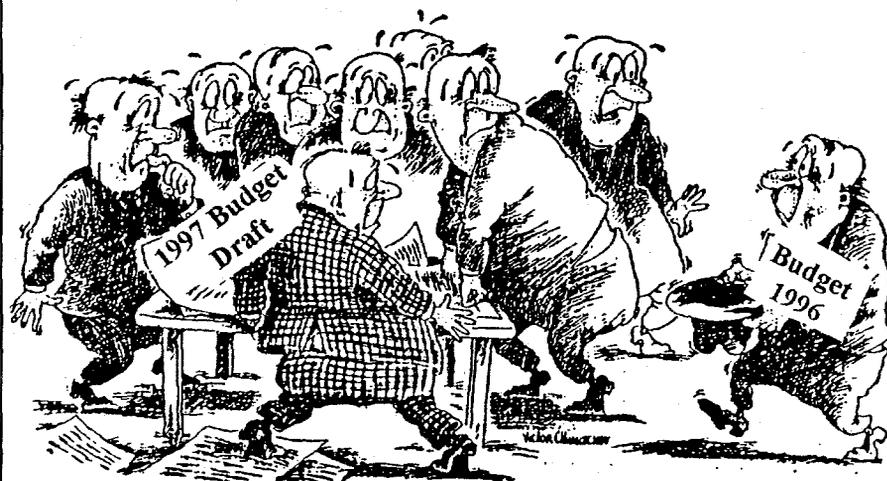
The World Bank Group looks forward to continued partnerships with the people of Central and Eastern Europe—beyond transition, into sustained growth and sustainable development. We need continued partnership of the European Union through our joint programs of technical assistance—and more important, in our joint efforts to help the Central European countries prepare for accession. We need

the continued partnership with the EBRD, EIB, and the European private sector in order to enhance investments and private sector participation.

Our analysis of the "good-policy scenario" suggests that the leading reformers will have regained pretransition income levels by 1998—and Poland earlier—and that by 2005 all the Central and Eastern European countries will have done so. It is none too soon to be looking beyond that—beyond catch-up with the past and toward catch-up with the future—a future that the people of Central and Eastern Europe determine for themselves.

*These excerpts are from World Bank Managing Director Caio Koch-Weser's presentation "Agenda for Transition, Second Phase," given at the Annual Conference of the Central Europe Business Forum in Warsaw, Poland, in October 1996.*

### Budget Debate in Russia



From the Russian paper *Finansovye Izvestia*.

# Rebuilding Postsocialist Infrastructure

## Excerpts from the EBRD's *Transition Report 1996*

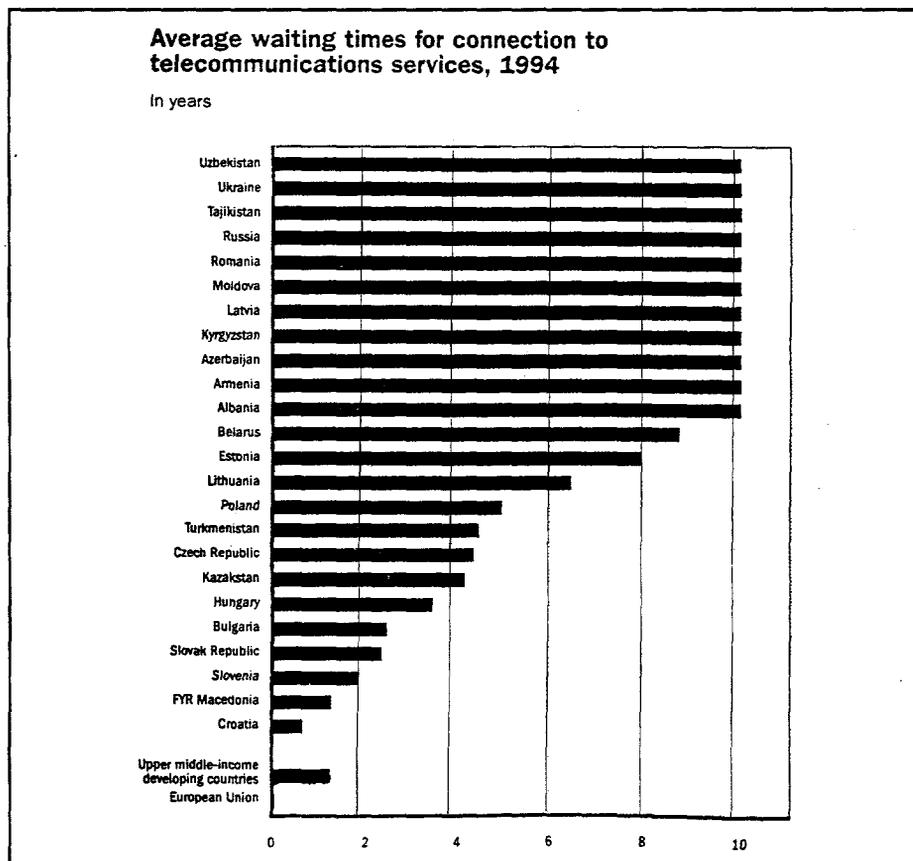
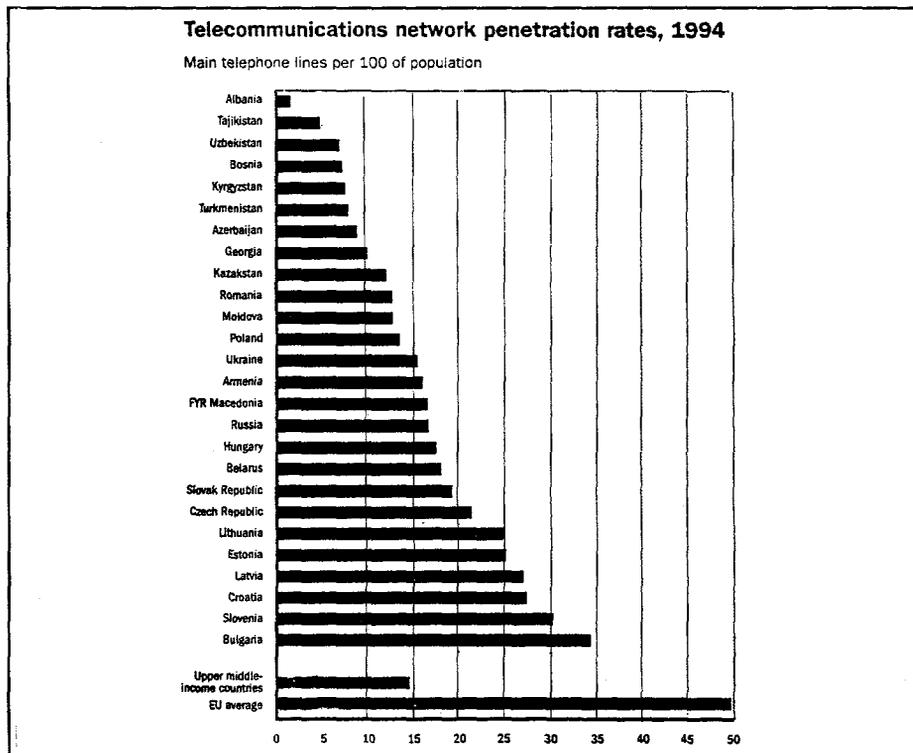
Public ownership and provision of infrastructure services has been widespread in all economies, because those services have been recognized as natural monopolies, crucial to the functioning of economic activity and everyday life; thus, there was concern that their unregulated private supply could lead to monopoly pricing, and significantly affect the environment.

It is now increasingly understood that these considerations do not automatically imply public ownership or public provision of these services. If there is scope for competition among service providers, or scope for their effective regulation, private participation is possible. Governments are taking an increasingly commercial approach to publicly provided services, too.

In centrally planned economies infrastructure services, such as electric power, water, and rail freight transport, were abundantly supplied to enterprises—with little regard for their costs of production or the consequences for the environment—under a strategy of directed growth. As Lenin once announced “communism equals Soviet power plus the electrification of the whole country.” Relatively little was invested in telecommunications, that is, in telephone networks (due to an ideological bias in favor of material production and concerns for security and bureaucratic control). Moreover, basic infrastructure services to households, such as electricity, water and wastewater, and urban transport, if available, were provided free or for a nominal charge.

The transition to a market—and the move toward private provision of infrastructure services—pose serious challenges for the provider, who must:

- Recognize costs (tariff levels and struc-



tures must ensure more efficient allocation of services).

- **Meet new market demands** (telecommunications and road transportation must be expanded, and rail service and electric power provision must be adjusted to ensure greater reliability, even if it means a lower service level).

- **Address concerns for the environment** (wasteful use of water and electricity must be stopped, and higher environmental standards, including nuclear safety, must be achieved).

The move to commercial infrastructure services—the commercialization of state-owned service providers, private entry into selected areas, and privatization—has the potential to help overcome both the legacies of central planning and the weaknesses of public provision:

- It can provide insulation from political influences in order to achieve cost-reflective tariffs.

- It can unlock access to private finance for needed investments.

- It can encourage selection of the most capable service providers and strengthen their incentives to improve performance.

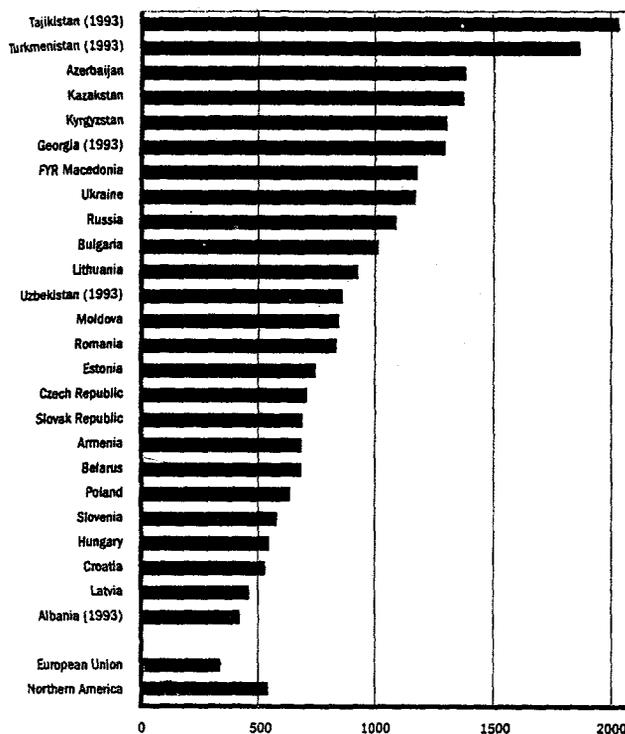
Commercial infrastructure must be accompanied by effective regulation and competition. **The role of competition** is increasingly recognized due to:

- **Constantly changing technologies** and provision of alternative services. Gas turbine generation enables efficient electricity production at a lower scale. Cellular telephony has already demonstrated the potential for competitive provision in transition economies. The declining cost of radio transmission is likely to ease access to local telecommunications, soon making it potentially competitive. The rapid expansion in road haulage and personal transportation are posing greater competitive challenges to the dominance of railways in transportation.

- Growing recognition that **activities may be separated by function, or even by ownership**. Thus, electricity generation,

### Electricity intensity of output, 1994

Electricity consumption per US\$ 1,000 of GNP at PPP exchange rates



Sources: International Energy Agency and World Bank.

which has the potential to be competitive, can be separated from high-voltage transmission, which is a natural monopoly. This, in turn, can be separated from local distribution, where there are elements of natural monopoly alongside the potential for limited competition.

Competition has demonstrable beneficial effects on infrastructure service provision.

- It improves the operational and financial performance of the service providers: competitive pricing eliminates inefficiencies; competitive market entry and exit select service providers, in response to demand by consumers; performance comparison stimulates competitors to provide better services.

- It avoids the high costs imposed by regulation. One of these costs is the economic and sectoral expertise of the regulators themselves. Furthermore, the risk of state intervention adds another element of uncertainty to the calculations

of private investors. Investors need to know that the profitability of their investments will not be compromised by future regulatory decisions, which may be designed to exploit the fact that capital investments, once "sunk," cannot move elsewhere. Investment in infrastructure is extremely capital-intensive, has a long lead time and subsequent operating life, and once made, cannot change either its function or its location.

### Telecommunications

The overwhelming priority in telecommunications is investment, in both new and existing capacity. Given the fiscal constraints, the bulk of this investment comes from the private sector. Although the fixed network has long been considered a natural monopoly, the falling cost of fiber-optic transmission and the possibility of bundling telecommunications services with other services (cable TV, electricity distribution) make duplicating

parts of the main network affordable. The extra costs involved are diminishing relative to the overall value of services provided and to the potential benefits from competition.

Competition in the core telecommunications services (local, domestic long distance, and international) remains limited. Liberalization has been most extensive in local services. But the inverse tariff structure makes local services less attractive (local calls are usually below cost-recovery level). In Poland, more than seventy licenses have been awarded for private entrants in local services, but only fourteen of these have initiated operations. A

large hurdle is that entrants must create a new local infrastructure network rather than build on the existing one.

In most transition economies, price regulation is still the province of government ministries; and in some cases, the same ministries are responsible for overseeing ownership and management of telecommunications assets. Only Hungary, Latvia, and Poland have established independent regulative powers.

The priorities for privatization of telecommunications are therefore as follows:

- Distortions in tariff structures (for ex-

ample, very low tariffs on local calls) need to be removed to create incentives for private investment.

- International, domestic, long distance, and local services should be liberalized according to a credible timetable. Long delays in introducing competition should be avoided. Enhanced services and cellular telephony should be quickly liberalized.

- Price regulation, licensing, and establishment of conditions of access to fixed networks need to be assigned to a regulatory body. This body should not be involved in the ownership and management of any state assets in the sector. It should be insulated from day-to-day political pressures, but still accountable.

### Electricity

In the move to privatization, the overall priorities in the power sector are threefold. First, tariffs reflecting costs need to be established for both firms and households. Firms have the potential for investment in energy-saving techniques. However, in most countries, the discrepancy between price and cost is great for households, with their low average income limiting the scope for closing the gap quickly. Given the legacy of low tariffs in transition economies, as well as the potential importance of electricity in household budgets, the challenge is to find ways to structure tariffs so that they promote efficiency, but are also perceived as fair. This would lead to a long-term decline in electricity intensity in the transition economies from the current high levels. But it will not satisfy power needs in the medium term, particularly in countries that are able to accelerate economic growth. Current capacity is largely in poor condition, uneconomical at world fuel prices, or highly polluting. Many generating units need to be upgraded, that is, fitted with pollution control mechanisms.

### Changing Telecommunications Sector

| <i>Services legally open to private entry<br/>(number of private entrants)</i> | <i>Country</i>  |
|--|---|
| Cellular telephony   | Albania (1), Belarus (1), Bulgaria (2), Croatia (2), Czech Republic (3), Estonia (3), FYR Macedonia (1), Hungary (3), Kazakstan (1), Latvia (2), Lithuania (3), Poland (3), Romania (1), Russian Federation (9), Slovak Republic (1), Slovenia (2), Ukraine (2), and Uzbekistan (1) |
| International long-distance services   | Ukraine (1)   |
| Domestic long-distance services  | Poland (1), Russian Federation (1), and Ukraine (1)   |
| Local services   | Hungary <sup>1</sup> (16), Kyrgyzstan (14), and Poland (14)   |
| <i>Privatization of dominant operator<br/>(share of private ownership)</i>     | Czech Republic, (49 percent), Estonia (49 percent), Hungary (67 percent), Kazakstan (49 percent), Latvia (49 percent), and Russian Federation (49 percent)  |
| <i>Regulatory institutions</i>   |   |
| Separate telecoms department within ministry                                   | Czech Republic, <sup>2</sup> and Slovak Republic <sup>3</sup>   |
| Separate telecoms authority  | Hungary, <sup>4</sup> Latvia <sup>4</sup> (for tariffs), and Poland <sup>5</sup>  |
| Antimonopoly office  |   |

Sources: EBRD and World Bank.

1. Of the 54 local telephone companies, concessions to operate 16 of these companies have been awarded to consortia that do not include the dominant Hungarian telephone operator, MATAV.
2. Ministry of Communications retains authority for licensing new service providers. Authority for resolving disputes over the terms of inter-connection with the fixed network remains unclear.
3. Telecommunications office within the Ministry of Transportation, Posts and Telecommunications is responsible for monitoring service quality, while the ministry itself is the licensing authority. The Ministry of Finance sets tariffs.
4. Telecommunications office within the Ministry of Economy proposes tariffs and issues licences for private networks and services, but final decision on tariffs rests with the Ministry of Science.
5. The Telecommunications Law established an independent tariff council to set tariffs, while the Ministry of Transport and Communications is responsible for overall telecommunications policy, radio frequency management, mobile licensing, and relations with international telecommunications organizations.

A second priority for the power sector will be to establish complementary policies to improve collection rates (in Albania, 70 percent of households do not pay their bills; in Russia and Ukraine, large and well-connected state enterprises have failed to pay their bills and have not been cut off), to promote investments in energy conservation, and to ease the adverse impact of privatization on the poor. (One route would

be to introduce lifeline tariffs, with low charges for consumption up to a certain level and substantially higher charges thereafter.)

Finally, the power sector needs strong and independent institutions to regulate tariffs, control environmental pollution, and promote nuclear safety. Only when progress is made in these three areas is there likely to be signifi-

cant private investment in improving existing capacity in the sector. Already, significant restructuring has been accomplished, even without privatization: separating generation, transmission, and distribution; and breaking up generation and distribution into separate operating companies.

Privatizing power generation companies would ensure reasonable competition; but the prospect for privatization in the short term is limited by the sector's lack of financial viability given current tariff levels and structures. In the meantime, the unbundling of the electricity sector provides scope for competition in the right to supply the market through bidding on long-term contracts, provided private suppliers' access to the grid can be guaranteed on nondiscriminatory terms.

### Water and Wastewater

Privatization of the water and wastewater sector will require establishment of policies that encourage the following:

- Private sector involvement in management and service delivery through competition for the market.
- Enhanced financial viability of service providers through setting cost-based tariffs. Metering and other investments in water conservation must also be encouraged, especially by agricultural and industrial users. Water polluters—especially industrial and agricultural users—must pay the full cost of the damage they inflict.

Achievement of these policy priorities will be best assured by the establishment of independent and transparent regulatory institutions. These bodies must be structured however, so that they are responsive to local conditions, since the quality of water services can be affected by regulatory decisions made in other sectors. For example, the poorly regulated discharge of industrial effluent can

## Changing Electricity Sector

### Comprehensive unbundling

(number of enterprises)

Generation: Armenia (5), Hungary (8), Poland (35), Ukraine (6)  
 Distribution: Armenia (53), Belarus (6), Czech Republic (8), Hungary (6), Poland (33), Russian Federation (72), Slovak Republic (3), Ukraine (27)

### Independent power generators

(number of projects) Hungary (3), Czech Republic (1)

### Privatizations<sup>1</sup>

(number of privatized enterprises)

Integrated utilities:<sup>2</sup> Czech Republic (1),<sup>3</sup> Kazakstan (1),<sup>4</sup> Russian Federation (1)<sup>5</sup>  
 Generators: Hungary (3), Kazakstan (1), Poland (1)  
 Distributors: Czech Republic (8),<sup>6</sup> Hungary (6), Russian Federation (72)<sup>7</sup>

### Regulatory Institutions

Separate department within ministry:  
 Armenia,<sup>8</sup> Belarus, Bulgaria,<sup>9</sup> Georgia, Lithuania,<sup>10</sup> Ukraine<sup>11</sup>

Separate energy authority:  
 Hungary, Russian Federation

Anti-monopoly office: Kazakstan, Kyrgyzstan

Sources: EBRD and World Bank.

1. Including partial divestiture.
2. Including regional integrated utilities.
3. CEZ (Czech Power Company) (high-voltage transmission and some generation) partially privatized using vouchers.
4. Regional integrated utility, Almaty.
5. RAO EES Rossi (Russian Joint Stock Company for Electric Power and Electrification) (high-voltage transmission and some generation) partially privatized using vouchers and through direct sales to insiders.
6. Partially privatized using vouchers.
7. Partially privatized to insiders, with the remaining shares owned by the integrated utility, RAO EES Rossii (high-voltage transmission and some generation).
8. State Committee on Prices deals with tariff issues; an independent reeregulatory authority is to be established.
9. Committee on Energy, which reports to Council of Ministers.
10. Establishing an Independent Regulatory Agency. As an interim step the government has established an Energy Pricing Council, which submits proposals to the Cabinet.
11. An independent regulatory authority is to be created as part of the 1995 reorganization of the Ministry of Power.

damage water quality to such a degree that any subsequent intervention is unable to reverse the damage.

## Transport

Privatization of the transport sector will require policies that address some long-term goals. The sector needs to adapt to a likely long-term shift from rail to road. Appropriate road infrastructure will need to be provided and the railways will need to be restructured to benefit from their comparative advantage and to reduce their dependence on state aid.

Competition within the market needs to be introduced or extended where feasible, such as in road haulage, air transport, and intercity bus services. The functional separation of the railways involves establishing separate operating units along functional lines: freight haulage, passenger services, and infrastructure (tracks, signaling, stations). In a later stage, those operating units can be developed into separate corporations, with their relationship formalized in legal contracts.

Competition for the right to provide transport services needs to be through competitive bidding to ensure a more commercial approach and greater responsiveness to customer demand in areas as diverse as urban bus transport, toll motorway concession, and the management of airports. In these areas, competition cannot be directly in the market.

Where competition is strong and market entry is not blocked, there is little reason for price regulation. In urban transport, basic economic principles suggest that government subsidies to operators may be necessary to help support public transport, which is needed to reduce urban congestion and pollution levels.

## Changing Transport Sector

### Functional separation of state railways:<sup>1</sup>

Bulgaria, Czech Republic, Hungary, Poland, Romania, Russia,<sup>2</sup> and Slovenia

### Concessions for ports and airports (number of projects)

Hungary (1), Kazakstan (1), and Turkmenistan (2)

### Motorway concessions (number of projects)

Hungary (2), Poland (bidding stage), and Romania (bidding stage)

### Regulatory institutions: (separate motorways authority)

Hungary, Poland, and Romania

Source: EBRD and World Bank.

1. The functional separation of railways involves establishing separate operating units within the state railway along functional lines—typically, freight haulage, passenger services, and infrastructure (tracks, signaling stations).

2. Commitment under the 1995 Statement of Modernization Strategy and Commercialization Principles for Russian Railways.

## Production of electricity by primary energy source, 1994

| Transition<br>country       | Total<br>production<br>GWh |         | Nuclear<br>(percent) | Hydro |
|-----------------------------|----------------------------|---------|----------------------|-------|
|                             |                            | Thermal |                      |       |
| Albania                     | 3,450                      | 3       | 0                    | 97    |
| Armenia                     | 5,658                      | 38      | 0                    | 62    |
| Azerbaijan                  | 2,400                      | 0       | 0                    | 100   |
| Belarus                     | --                         | 0       | 0                    | 0     |
| Bulgaria                    | 38,133                     | 56      | 40                   | 4     |
| Croatia                     | 8,147                      | 40      | 0                    | 60    |
| Czech Republic              | 58,705                     | 75      | 22                   | 3     |
| Estonia                     | 9,151                      | 100     | 0                    | 0     |
| FYR Macedonia               | 5,511                      | 87      | 0                    | 13    |
| Georgia                     | --                         | 0       | 0                    | 0     |
| Hungary                     | 33,486                     | 58      | 42                   | 0     |
| Kazakstan                   | --                         | 0       | 0                    | 0     |
| Kyrgyzstan                  | 12,499                     | 6       | 0                    | 94    |
| Latvia                      | 4,440                      | 26      | 0                    | 74    |
| Lithuania                   | 10,055                     | 16      | 77                   | 7     |
| Moldova                     | 8,228                      | 97      | 0                    | 3     |
| Poland                      | 135,347                    | 97      | 0                    | 3     |
| Romania                     | 55,136                     | 76      | 0                    | 24    |
| Russia                      | 875,942                    | 69      | 11                   | 20    |
| Slovak Republic             | 24,740                     | 32      | 49                   | 19    |
| Slovenia                    | 12,681                     | 37      | 36                   | 27    |
| Tajikistan                  | --                         | 0       | 0                    | 0     |
| Turkmenistan                | --                         | 0       | 0                    | 0     |
| Ukraine                     | 202,994                    | 60      | 34                   | 6     |
| Uzbekistan                  | 47,000                     | 86      | 0                    | 14    |
| Eastern Europe <sup>1</sup> | 675,363                    | 74      | 16                   | 10    |
| Baltics <sup>1</sup>        | 23,646                     | 50      | 33                   | 17    |
| CIS <sup>1</sup>            | 1,154,721                  | 67      | 14                   | 19    |
| European Union              | 2,267,240                  | 51      | 35                   | 14    |
| United States               | 3,473,616                  | 72      | 20                   | 8     |

Source: International Energy Agency.

1. Average of countries for which data are available.

# Armenia's Economy: A Success Story in the Making

by Paulo Drummond, Balazs Horváth, and Nita Thacker

Since its independence in 1991, Armenia has had to cope with a number of political and economic challenges: the economy was seriously shaken following the collapse of the trade and payments agreements with the FSU countries and the shock of the consequent deterioration in terms-of-trade. The country suffered another blow when a trade blockade was imposed by Azerbaijan and Turkey as a result of the Nagorno-Karabakh conflict. The economy suffered further jolts as the institutions of a market economy replaced the central planning system.

Output plummeted by more than 60 percent between 1992 and 1993. Inflation accelerated to over 1,200 percent during 1992 as prices were liberalized, and in 1993 it exceeded 10,000 percent, in part as a result of the flood of old Soviet rubles. In 1994, with the signing of a cease-fire agreement with Azerbaijan and Nagorno-Karabakh, the government was able to turn its attention to the enormous macroeconomic imbalances that had developed on the domestic front.

In mid-1994, with the support of a succession of IMF, World Bank, and EBRD loans, as well as concessional loans and grants conferred through bilateral agreements, the authorities implemented tight fiscal and monetary policies accompanied by widespread structural reforms.

## Recipe for Change

Armenia's stabilization effort was successful because it adhered to consistent, tight fiscal and monetary policies and implemented key structural reforms. On the monetary front, the national currency—the dram—was introduced in

November 1993 in order to regain control over domestic monetary policy. From mid-1994 onward, the central bank tightened monetary policy, limiting broad money growth to 40 percent during the second half of the year (compared with 460 percent in the first). Subsidies and cheap credits to enterprises were eliminated, credit to banks began to be allocated through auctions, and real interest rates turned positive. Following a period of explosive growth in the number of banks, the central bank gradually developed an effective supervision mechanism, consolidated the banking sector through closure of small insolvent banks, enhanced provisioning, and, to foster competition, opened the banking sector to foreign investment.

Midland Armenia Bank, the first foreign bank in Armenia, began operations in March 1996 and accounts for about a

third of the total authorized capital of banks in the country. Midland attracts remittances and investments from within Armenia, but also from neighboring states and from the Armenian diaspora in the United States and Western Europe. Midland's move appears to have boosted business confidence, and it is reported that other major foreign banks are considering establishing an Armenian branch.

Nonetheless, the fragility of the banking system remains one of the most acute problems facing policymakers, with the systemic risk in this sector reflected in persistently high nominal interest rates. Almost all the country's thirty-five banks are undercapitalized: only five currently meet the minimum capital requirement of US\$350,000 that is due to come into force in January 1997. According to the central bank, the introduction of tight capital and regulatory standards will force

## Prime Minister Switch

Armenian Prime Minister Grant Bagratian resigned on November 4 in a move aimed at soothing tension caused by President Levon Ter-Petrosian's tight reelection in September. Bagratian had become a lightning rod for opposition groups who said that economic reforms had been too drastic and benefited too few people. The president promptly appointed a new prime minister, Armen Sarkisian, a 43-year-old physicist by training and Armenia's ambassador to Britain since 1992. Choosing a diplomat rather than a trained economist to head the new government suggests that, in light of the country's gradual economic recovery, Ter-Petrosian's current priority is to promote internal dialogue and reconciliation.

A staunch supporter of radical economic reforms and tight monetary policies, the

38-year-old Bagratian had headed the government since February 1993 and is credited by the West with Armenia's much-improved macroeconomic performance. Despite the blockade of trade routes by Azerbaijan and Turkey and the conflict with Azerbaijan over Nagorno-Karabakh, Bagratian's government managed to achieve steady economic growth (the first in the Commonwealth of Independent States) and to curb inflation. It was during his tenure that Armenia became one of the biggest per capita recipients of loans from the world's leading financial organizations. Bagratian said his main achievement as premier was an "ideological revolution" in a society that now sees no alternative to a market economy.

*Based on news agency reports.*

banks to seek new sources of capital, merge with others, or close.

On the fiscal front, budgetary expenditures were sharply curtailed by eliminating subsidies. At the same time, several new tax measures were adopted, including the introduction of the VAT and the personal income tax, amendments to the enterprise profit tax, and a drastic reduction in exemptions. As a result, the budget deficit, which peaked at 56 percent of GDP in 1993 (the year the government took over several functions of the central bank), fell to 16 percent in 1994, and to less than 10 percent in 1995. According to the finance ministry, the 1996 budget deficit will also be less than 10 percent of GDP. Central bank financing of the budget deficit equaled 32 percent of GDP in 1993, but dropped to a mere 3 percent in 1994 and was less than 1 percent in 1995,

in part due to the increased availability of external financing.

### Structural Changes

Structural reforms included the following measures:

- **Privatization of agricultural land.** In early 1991, Armenia became the first CIS country to privatize agriculture; by late 1993, about 87 percent of agricultural land had been transferred to private ownership, leading to a positive supply response to price reform and increased agricultural output.

- **Price liberalization.** In April 1991, liberalization prices got under way with the elimination of a wide variety of subsidies and cross-subsidies. By late 1994, most prices were market-determined, with the exception of bread, utilities, urban transport, and some pharmaceuti-

cal products. The price of bread was freed in June 1995.

- **Enterprise privatization.** More than 3,500 small-scale enterprises and 950 medium- and large-scale enterprises have been privatized to date. Small businesses privatized have been mainly retail premises. Among the larger-scale privatizations, a number of large companies were transferred to the majority ownership of their employees in the course of voucher privatization in late 1994.

- **Introduction of new laws.** Laws have been passed to render the legal environment for banks and enterprises more transparent, consistent, and predictable. Laws governing banking practices and bank bankruptcy were passed in mid-1996, with an eye to accelerating the restructuring process. The central bank is now producing accounts according to generally accepted accounting standards, prepared by KPMG. All other banks will have to conform to these standards as of January 1998.

- **Social safety net.** A viable social safety net is being developed through improved targeting. A new pension law was passed in 1995, gradually increasing the retirement age for women and men from 55 and 60, respectively, to 60 and 75, by 2002. The eligible age for child allowances was reduced from 16 to 6 years, effective January 1, 1996. The improved targeting allowed the government to raise average benefits both for pensioners (by about 10 percent, starting January 1, 1996) and for children under 6 (by about 20 percent, starting January 1, 1996). A new employment law that will improve targeting of unemployment benefits is expected to be passed shortly.

- **Liberal trade and exchange policies.** Exchange rate stabilization was one of the early achievements after independence, and foreign exchange was freely available through frequent and well-organized foreign exchange auctions. The surrender requirement was reduced, then eliminated in April 1995. Import tariffs were just 10 percent at the time of stabilization.

### Unbalanced Foreign Trade

Armenia relies heavily on imports of food, raw materials, and energy products. The principal industrial sectors in particular—machine-building, electronics, chemicals, textiles, footwear, mining, building materials, foodstuffs and beverages—are heavily dependent on imports of raw materials and energy that have been severely curtailed by the blockade of trade routes imposed by Azerbaijan and Turkey.

Exports rose by 29 percent year-on-year in 1995, but imports climbed by 68 percent in the same period. Belgium and Germany dominate the country's exports to the EU, which are mostly of cut precious stones. Forty-nine percent of imports are from the CIS, with Georgia, Russia, and Turkmenistan the major source countries.

Growing trade with Iran was boosted in July by a three-way deal with Turkmenistan. Armenia will receive twenty million dollars' worth of Turkmen gas and export an equivalent value of rubber and light bulbs to Iran, which in turn will supply Turkmenistan with unspecified goods and services. Armenia and Iran are also to link their electricity grids: a

55-kilometer-long high voltage transmission line is being erected on both sides of the border, with completion expected at the end of 1996.

Food processing, the service sector, and exports all show considerable potential, but are unlikely to attract investment from international companies seeking a regional base until a rapprochement takes place with Armenia's neighbors, particularly Turkey. Increased political uncertainty following September's disputed presidential election may also discourage foreign investment.

In the short term, selected mined materials, synthetic rubber, mineral water, and jewelry appear the most promising export products, but export growth continues to be hampered by the Turkish blockade and by the conflict in Georgia between Tbilisi and the western province of Abkhazia, which has effectively cut off the Black Sea coastal railway link to Russia and Ukraine.

*Based on news agency reports and the Oxford Analytica East Europe Daily Brief.*

As a result of these financial and structural policies, the monthly inflation rate dropped from about 50 percent in 1993 to 28 percent in 1994 and 2.3 percent in 1995, while economic growth was 5.4 percent in 1994 and reached 6.9 percent in 1995. In the first half of 1996, the economy—with a 4.3 percent year-on-year growth rate—slowed somewhat. According to official statistics, inflation in the first ten months was a mere 1.3 percent, and while wages are increasing in real dollar terms, they remain low compared with other newly independent countries. Unemployment is holding at 9 percent, although this figure does not include those on forced leave.

### Goals and Means

The medium-term program, supported by resources under an IMF enhanced structural adjustment facility (ESAF) arrangement and a World Bank structural adjustment credit for 1996-98, will primarily address the remaining structural distortions in the economy through continued enterprise privatization, financial sector reform, and an overhaul of the legislative framework. The Fund has released the second \$25 million tranche, thus completing the \$50 million disbursement due in the first year of the three-year \$150 million ESAF.

The economic policy aims to achieve the following targets by 1998:

- Output growth of about 6 percent.
- Inflation of less than 10 percent through end-1998.
- Continued revenue improvements and expenditure reductions in public finances, with a consequent reduction in the budget deficit to about 3 percent of GDP.
- Narrowing of the external current account deficit (excluding official transfers) to about 13 percent.

In support of these goals, the authorities intend to:

- Downsize the civil service by reducing

public sector employment to 290,000 by June 1998 from 357,000 in June 1996.

• Strengthen the government's administrative capacity by focusing on three principal areas:

-Tax administration to increase tax revenue collection from state enterprises and the growing private sector.

-Expenditure management through adoption of an integrated treasury system.

-Debt management through improved control and monitoring of domestic and external public debt, including contingent liabilities.

• Accelerate privatization of medium- and large-scale enterprises during 1997 and complete the sale of ten major enterprises through international tender, with the aid of an investment bank. (Strategic enterprises in the mining, arms, and energy sectors will remain in public hands.)

• Continue the enterprise restructuring program aimed at reorganizing and privatizing—or liquidating—the most important financially distressed enterprises. The program will be supported by a new bankruptcy law and a law on collateral. The parliament is expected to pass these laws by early 1997.

• Continue reforms in the banking sector,

which are aimed at improving the legal framework in which banks operate, fostering competition in the banking system, and recapitalizing banks with the minimum possible moral hazard implications.

Armenia's recovery is still fragile and structural reform is not yet complete. During the three-year macroeconomic program, fiscal consolidation—including the creation of a social safety net to provide modest, well-targeted support—and banking sector restructuring are highest on the agenda. These would help to increase national savings and improve resource allocation in the economy. If progress could be achieved toward a permanent peace in the region, and if the trade blockade—imposed on Armenia by Azerbaijan and Turkey as a result of the war over Nagorno-Karabakh—were lifted, the country has every chance to move toward a sustained export-driven economic expansion.

*The authors are economists at the IMF, Paulo Drummond in the Policy Development and Review Department, Balazs Horvath and Nita Thacker in the European II Department.*



From the magazine *Hungarian Economy*

# IFC's Small Enterprise Fund Reaches Out

by Stephanie Miller and Richard Rutherford

In September 1996, the IFC launched an "Extending IFC's Reach" initiative to foster private investment and promote the private sector in sixteen countries, including Albania, Azerbaijan, Bosnia and Herzegovina, Cambodia, FYR Macedonia, Kazakhstan, Laos, Mongolia, Slovakia, and Uzbekistan. The selection for the initiative was carefully considered to ensure broad geographic coverage of countries where the IFC could make a significant difference in overcoming obstacles to private sector development. "We are looking for ways to increase the IFC's impact in poor countries and in countries with the most difficult investment environments"—Executive Vice President Jannik Lindback explained, announcing the three-year pilot program.

Under the program, the IFC created a \$40 million small enterprise fund to support smaller-scale investments in the sixteen countries. The IFC does not normally finance projects of less than \$5 million, owing to the processing time and costs associated with the appraisal process. However, to reach out to small and medium-size enterprises that are expected to become engines of economic growth, the IFC will consider smaller, \$250,000 to \$5 million projects, and will invest about \$100,000 to \$2.5 million, covering about 40 percent of the total cost (compared with 25 percent under the IFC's traditional investment program). "Average investment size is anticipated to be about \$1 million per project," Lindback said. "The small enterprise fund will primarily provide debt financing, but will also have the flexibility to make equity and quasi-equity investments and to offer local currency guarantees." These investments—no matter how small—are expected to be viable economically,

commercially, technically, and environmentally.

The identification and appraisal procedure for these small projects will be simple and fast. They will be approved by the immediate management and not—as is the common practice—by the Board of Directors. To accelerate the program, IFC will assign young investment officers full-time to each country. They will seek out and develop potential investment projects and, together with other IFC representatives, will identify priority sectors, taking account of the country's human, natural, and financial resources, its environment for private investment, and the programs of other development institutions. In each country, IFC staff will draw on the expertise of the World Bank and will seek to complement its work.

Investment officers will work to determine where IFC can make a significant developmental impact through advisory work, technical assistance, investments, and financial intermediary lending, also in the following nine transition countries.

## **Albania**

*GDP per capita: \$690; population: 3.2 million.* Albania is primarily an agriculturally based economy with a small domestic market. Whereas in 1992 the economy declined more than 7 percent, in 1993 economic growth reached almost 10 percent and has been growing steadily since then, with 1995 GDP attaining 77 percent of 1989 levels. The private sector's share in GDP is estimated at 60 percent. But most large businesses and all domestic banks remain state-owned and all are losing money. The legal and credit systems are weak and do not facilitate long-term

commercial lending. This environment has discouraged foreign investment. Investment in infrastructure is badly needed. Despite these barriers, the IFC recently approved its first investment in Albania, \$2 million in a small soap-making company. Through the pilot initiative, IFC investment staff will look for other financing opportunities in small, privately owned businesses with labor-intensive technologies. Possible sectors for investment include textiles, tourism, and construction.

## **Azerbaijan**

*GDP per capita: \$480; population: 7.5 million.* Azerbaijan's 1995 GDP was estimated at only 36 percent of the 1989 level. Although inflation has been sharply reduced, it remains high at 86 percent in 1995 (December-on-December). The private sector's share of GDP is only about 25 percent. As is the case in many small FSU countries, the formal system of central planning in Azerbaijan has been abolished, but the institutions necessary for a market economy are not yet in place. Banking reform and small-scale privatization, however, have been initiated, and steps have been taken to liberalize the price, trade, and foreign exchange regimes. Foreign investment will be attracted mainly to the country's oil and oil-related industries over the short term. For the non-oil industries, opportunities in the small business sector will likely dominate in the initial stages. By catalyzing private investment in small projects and helping capital market development, IFC will contribute toward the medium-term goal of efficient private sector-led growth.

## **Bosnia-Herzegovina**

*GDP per capita: \$500; population (pre-war): 4.4 million.* The country is working to achieve a "sustainable peace," and is simultaneously undertaking a transi-

tion to a market economy. The economic asset base of companies, factories, banks, infrastructure, and housing has been severely depleted by war. GDP in 1995 was estimated at US\$2.2 billion, compared with prewar levels of US\$9-\$10 billion. Tight financial policies have reduced inflation from the extremely high levels of the war years. The country is burdened by large external debt (\$3.2 billion in 1995). The IFC expects to establish a microenterprise bank, and a venture capital fund to provide equity capital to small and medium-size companies.

### **Cambodia and Laos**

*Cambodia GDP per capita: \$260; population (in millions): 10.3. Laos GDP per capita: \$350; population (in millions): 4.8.* Cambodia and Laos are in the midst of a difficult transition to a market economy. In Cambodia, the process has been hindered by the trauma and disruption of past internal strife and the difficulty of rebuilding the country's leadership and technical expertise. Laos, a country is landlocked and relatively isolated, that has had limited exposure to market economy issues. There are significant constraints to foreign investment in these two countries, including uncertain legal environments, limited investor interest, and the absence of a significant indigenous local private sector. Many of the constraints are addressed in the World Bank's current strategy and there are several technical assistance programs that attempt to improve the institutional framework. The IFC is currently pursuing small projects that would support banking and insurance in Laos and tourism in Cambodia. Investment opportunities may be found in the agribusiness, power, and light manufacturing sectors as well.

### **FYR Macedonia**

*GDP per capita: \$840; population: 2.1 million.* FYR Macedonia had been the poorest of the Yugoslav republics and is heavily dependent on the other repub-

lics, especially Serbia. The disintegration of Yugoslavia resulted in the loss of markets and of financial subsidies from the other republics. The economic transition has been accompanied by drastic declines in output, employment, and income. (1995 GDP was roughly half of 1989 levels.) Inflation, however, has been brought under control and medium-term prospects have improved. Although the legal framework for developing the private sector is largely in place, and the private sector's share in GDP is about 40 percent, foreign investment is likely to remain low due to political uncertainties in the region. The IFC is looking for opportunities to finance small-scale projects including in the textile and construction sectors. It will also focus on developing the capital markets and is currently examining a possible equity investment in a bank, an equipment leasing company, and a new joint venture bank.

### **Kazakstan**

*GDP per capita: \$1040; population: 16.7 million.* Kazakstan is the second-largest republic in the FSU, rich in natural resources, with relatively well developed and maintained infrastructure, a highly educated population, and good social indicators for its level of income. Nonetheless, the overall economic environment remains difficult for private business, and foreign direct investment in 1995 amounted to a mere \$284 million, mostly in the oil and mining sectors. Although the legal environment in Kazakstan is evolving in a positive direction, finding and selecting appropriate and reliable local partners is a major problem facing foreign investors in Kazakstan. The IFC has made several investments in the capital markets area and recently approved an investment in oil field development. It has also provided technical advice in gold mining regulation and in the development of banking and leasing legislation.

### **Mongolia**

*GDP per capita: \$320; population: 2.4 million.* Almost 30 percent of Mongolia's population live below the poverty line. Development has been complicated by the country's limited infrastructure, lack of a modern financial sector, and remoteness. Foreign direct investment was only about \$10 million in 1995.

The private sector now accounts for about 60 percent of GNP, up from about 10 percent in 1990. The IFC sees future investment opportunities in oil, gas and mining, the financial sector, and textile and garment (principally wood, cashmere, and leather) projects.

### **Slovakia**

*GDP per capita: \$2,940; population: 5.4 million.* In Slovakia, inflation has been brought under control, and the country's economy is growing at one of the fastest rates in the region, having attained a 1995 GDP equal to 86 percent of the 1989 level. The share of the private sector in GDP is 60 to 65 percent. Since 1993, privatization has moved forward in fits and starts and has been criticized for its lack of transparency and exclusion of foreign investors. Several potential IFC projects in the country were appraised, but did not go through because privatization has been halted. Recently, Board approval was obtained for a US\$15 million IFC loan to Istrobanka, a Slovak commercial bank, for on-lending to Slovak companies.

### **Uzbekistan**

*GDP per capita: \$930; population: 22.9 million.* Uzbekistan is the most populous of the four Central Asian republics. Rich in mineral resources, and a leading cotton producer and exporter, it is nonetheless one of the poorest FSU countries. Recently, the pace of privatization and enterprise restructuring has accelerated. Inflationary pressures continue to be strong. The government still plays a dominant role in the economy. Private

companies have limited access to hard currency. The IFC has made a few investments in Uzbekistan in mining and capital markets, including two projects together with EBRD. The IFC's assis-

tance in the oil and gas sectors, infrastructure, and in shaping the regulatory framework will require intensive cooperation with the government.

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# 1997 Index of Economic Freedom

A Joint Publication of the Heritage Foundation and *The Wall Street Journal*

## *Excerpts from the Executive Summary:*

The idea of producing a "user-friendly" Index of Economic Freedom for policymakers was born at The Heritage Foundation in 1989. The purpose then, as it remains today, was to develop an index that empirically measures the level of economic freedom in countries around the world. To this end, a set of objective economic criteria has been established to grade 150 countries. Although there are many theories about the origins and causes of economic development, the findings of this study are conclusive: Those countries with the most economic freedom have higher rates of economic development than those with less economic freedom.

The Index of Economic Freedom measures how well these countries score on a list of ten economic factors. The higher the score, the more government interference in the economy (hence, the less economic freedom there is). The factors are, trade policy, taxation policy, government intervention in the economy, monetary policy, capital flows and foreign investment, banking policy, wage and price controls, property rights, regulation, and black market. In each of these ten broad categories, the authors used over fifty independent economic criteria to develop an empirical snapshot of the level of economic freedom in each country. The study demonstrates unequivocally that countries with the highest levels of economic freedom also have the highest living standards. Similarly, countries with the lowest levels of economic free-

dom also have the lowest living standards.

Switzerland is the economically freest country in Europe. The economies of the United Kingdom, the Netherlands, the Czech Republic, and Denmark are the next freest. Former Marxist countries continue to make progress toward maximizing economic freedom. The best examples are the Czech Republic and Estonia, which score well on the index. These countries are following the models of Hong Kong and Singapore to promote large economic growth rates by maximizing economic freedom. Despite the enthusiasm of the investment community, Vietnam remains a centrally planned economy with a marginal, albeit growing, free market. China's economic reforms are on track and the economy is growing (though with respect to economic freedom it lags behind).

Introducing the sorts of reforms that would boost a nation's score on the Index of Economic Freedom could well produce massive improvements in the living standards experienced by people in many of the world's poorest and least free economies.

*Kim R. Holmes, Bryan T. Johnson, The Heritage Foundation; Melanie Kirkpatrick, The Wall Street Journal*

## **Ranking Order—Example, the Czech Republic**

The Czech Republic became an independent state in January 1993 after its

separation from Slovakia. Since the breakup of the Warsaw Pact in 1989, it has pursued economic liberalization. It trades mainly with other countries of the former Soviet Union and with the European Union (EU); at least half of its foreign trade is with countries in the EU, especially Germany.

**Trade Policy Score:** 1-stable  
(very low level of protectionism)

The country is one of the most open markets in Europe. The average tariff rate is about 4.5 percent, although tariffs on some products can run as high as 70 percent. There are, however, no other significant barriers to imports.

**Taxation Score:** 3.5+ (high tax rates)  
[income taxation: 2+, (low tax rates)  
corporate taxation: 4- stable (high tax rates)]

Top marginal income tax rate is 40 percent, down from 44 percent in 1995, and the tax on the average income level is 0 percent. The top marginal corporate income tax rate is 39 percent, down from 41 percent in 1995. The Czech Republic also has a 39 percent capital gains tax, a 22 percent value-added tax, and a real estate transfer tax.

**Government Intervention in the Economy Score:** 2-stable (low level of government intervention)

Of all the countries that used to make up the Soviet bloc, the Czech Republic

today has one of the freest economies. The government has been consuming about 21 percent of GDP since the first half of 1996.

**Monetary Policy Score:** 2-stable (low level of inflation)

The country has pursued an anti-inflationary monetary policy since 1992 and, according to the U.S. Department of State, has one of the world's most stable currencies. The rate of inflation was 10

percent in 1992, 18 percent in 1993, 11 percent in 1994, and 9 percent in 1995, for an average of about 12 percent. In 1996, the inflation rate is expected to be about 10 percent.

**Capital Flows and Foreign Investment Score:** 2-stable (low barriers to foreign investment)

With the exception of defense-related industries, all sectors of the Czech economy are open to foreign investment.

The Czech Republic attracts the most foreign investment per capita of any country in Central and Eastern Europe.

**Banking Score:** 1-stable (very low level of restrictions on banking)

Competition in the Czech banking system is increasing and there are few, if any, barriers to opening either a foreign or domestic bank. Banks also are open to foreign participation; a foreign bank may establish a wholly owned bank, buy into

### 1997 Index of Economic Freedom—Country Rankings

| Rank | Country         | Trade policy | Taxation policy | Government intervention | Monetary policy | Foreign investment | Banking policy | Wages/prices | Property rights | Regulation | Black market | Score 1995 | Score 1996 | Score 1997 |
|------|-----------------|--------------|-----------------|-------------------------|-----------------|--------------------|----------------|--------------|-----------------|------------|--------------|------------|------------|------------|
| 1    | Hong Kong       | 1            | 1.5             | 1                       | 2               | 1                  | 1              | 2            | 1               | 1          | 1            | 1.25       | 1.25       | 1.25       |
| 2    | Singapore       | 1            | 3               | 1                       | 1               | 1                  | 2              | 1            | 1               | 1          | 1            | 1.25       | 1.30       | 1.30       |
| 3    | Bahrain         | 2            | 1               | 3                       | 1               | 2                  | 2              | 2            | 1               | 1          | 1            | 1.60       | 1.70       | 1.60       |
| 4    | New Zealand     | 2            | 3.5             | 2                       | 1               | 2                  | 1              | 2            | 1               | 2          | 1            |            | 1.75       | 1.75       |
| 5    | Switzerland     | 2            | 3               | 3                       | 1               | 2                  | 1              | 2            | 1               | 3          | 1            |            | 1.80       | 1.90       |
| 6    | United States   | 2            | 4               | 2                       | 1               | 2                  | 2              | 2            | 1               | 2          | 1            | 1.90       | 1.90       | 1.90       |
| 7    | United Kingdom  | 2            | 4.5             | 2                       | 1               | 2                  | 2              | 2            | 1               | 2          | 1            | 1.95       | 1.95       | 1.95       |
| 8    | Taiwan          | 2            | 2.5             | 2                       | 1               | 3                  | 3              | 2            | 1               | 2          | 1            | 1.95       | 1.95       | 1.95       |
| 9    | Bahamas         | 5            | 1               | 2                       | 1               | 3                  | 2              | 2            | 1               | 1          | 2            | 2.10       | 2.00       | 2.00       |
| 10   | Netherlands     | 2            | 5               | 3                       | 1               | 2                  | 1              | 2            | 1               | 2          | 1            |            | 1.85       | 2.00       |
| 12   | Czech Republic  | 1            | 3.5             | 2                       | 2               | 2                  | 1              | 2            | 2               | 1          | 4            | 2.10       | 2.00       | 2.05       |
| 21   | Germany         | 2            | 5               | 3                       | 1               | 2                  | 2              | 2            | 1               | 3          | 1            | 2.00       | 2.10       | 2.20       |
| 25   | Estonia         | 2            | 3.5             | 2                       | 4               | 1                  | 2              | 2            | 2               | 2          | 3            | 2.25       | 2.35       | 2.35       |
| 64   | Hungary         | 4            | 4               | 3                       | 4               | 2                  | 2              | 2            | 2               | 3          | 3            | 2.80       | 2.90       | 2.90       |
| 69   | Latvia          | 4            | 2.5             | 3                       | 5               | 2                  | 2              | 2            | 3               | 2          | 4            |            | 3.05       | 2.95       |
| 77   | Slovak Republic | 2            | 4.5             | 3                       | 3               | 3                  | 3              | 3            | 3               | 3          | 3            | 2.75       | 2.95       | 3.05       |
| 80   | Lithuania       | 2            | 3               | 3                       | 5               | 2                  | 3              | 3            | 3               | 3          | 4            |            | 3.50       | 3.10       |
| 83   | Slovenia        | 4            | 4               | 3                       | 3               | 3                  | 2              | 3            | 3               | 3          | 3            |            | 3.35       | 3.10       |
| 85   | Poland          | 4            | 3.5             | 3                       | 5               | 2                  | 3              | 3            | 2               | 3          | 3            | 3.25       | 3.05       | 3.15       |
| 93   | Mongolia        | 3            | 4               | 3                       | 5               | 3                  | 3              | 3            | 3               | 3          | 3            | 3.33       | 3.50       | 3.30       |
| 97   | Moldova         | 3            | 3.5             | 3                       | 5               | 3                  | 3              | 3            | 3               | 3          | 4            | 4.10       | 3.45       | 3.35       |
| 98   | Romania         | 2            | 5               | 3                       | 5               | 2                  | 3              | 2            | 4               | 4          | 4            | 3.55       | 3.70       | 3.40       |
| 100  | Armenia         | 2            | 3.5             | 3                       | 5               | 4                  | 3              | 3            | 3               | 4          | 4            |            | 3.75       | 3.45       |
| 106  | Cambodia        | 5            | 2.5             | 4                       | 4               | 3                  | 3              | 3            | 4               | 4          | 3            |            |            | 3.55       |
| 108  | Bulgaria        | 3            | 5               | 3                       | 5               | 3                  | 3              | 3            | 3               | 4          | 4            | 3.50       | 3.50       | 3.60       |
| 115  | Albania         | 3            | 3.5             | 5                       | 5               | 2                  | 4              | 3            | 3               | 3          | 5            | 3.55       | 3.45       | 3.65       |
| 117  | Russia          | 5            | 3.5             | 4                       | 5               | 3                  | 2              | 3            | 3               | 4          | 4            | 3.50       | 3.50       | 3.65       |
| 119  | Croatia         | 3            | 3               | 5                       | 5               | 3                  | 3              | 4            | 4               | 4          | 3            |            | 3.70       | 3.70       |
| 126  | China           | 5            | 4               | 5                       | 3               | 3                  | 3              | 3            | 4               | 4          | 4            | 3.80       | 3.80       | 3.80       |
| 128  | Belarus         | 5            | 4.5             | 3                       | 5               | 4                  | 3              | 3            | 3               | 3          | 5            | 3.65       | 3.55       | 3.85       |
| 129  | Georgia         | 3            | 2.5             | 4                       | 5               | 3                  | 4              | 4            | 4               | 4          | 5            |            | 3.85       | 3.85       |
| 135  | Ukraine         | 4            | 4.5             | 5                       | 5               | 3                  | 4              | 3            | 4               | 4          | 4            | 3.90       | 4.00       | 4.05       |
| 142  | Azerbaijan      | 5            | 4               | 5                       | 5               | 5                  | 4              | 5            | 4               | 4          | 5            |            | 4.70       | 4.60       |
| 146  | Vietnam         | 5            | 5               | 5                       | 5               | 4                  | 4              | 4            | 5               | 5          | 5            | 4.70       | 4.70       | 4.70       |
| 148  | Cuba            | 5            | 5               | 5                       | 5               | 5                  | 5              | 5            | 5               | 5          | 5            | 5.00       | 5.00       | 5.00       |
| 149  | Laos            | 5            | 5               | 5                       | 5               | 5                  | 5              | 5            | 5               | 5          | 5            |            | 5.00       | 5.00       |
| 150  | North Korea     | 5            | 5               | 5                       | 5               | 5                  | 5              | 5            | 5               | 5          | 5            | 5.00       | 5.00       | 5.00       |

Source: Index of Economic Freedom.

an existing bank, or open a branch. Private Czech banks are allowed to sell securities and make some investments.

**Wage and Price Controls** *Score: 2-stable (low level of wage and price controls)*

Most wages and prices are set by the market. Both the prices of many utilities and the rent paid on government-owned housing remain controlled, however. The government maintains minimum wage standards.

**Property Rights** *Score: 2-stable (high level of protection of private property)*

Private property receives a high level of protection and expropriation is highly unlikely. A system of law in which property receives total protection has yet to be created, however.

**Regulation** *Score: 1-stable (very low level of regulation)*

The country imposes few regulations on businesses, and most companies do not need a license to begin operations. The government is planning additional reductions in the level of its regulation of business activity.

**Black Market** *Score: 4- (high level of black market activity)*

Some goods and services are still supplied on the black market. In addition, despite recent legislation to combat piracy of intellectual property, lax enforcement remains a problem. According to the U.S. Department of State, piracy accounts for as much as 35 to 40 percent of all prerecorded video cassettes and 83 percent of all computer software sold in the Czech Republic.

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## Milestones of Transition

### Bulgaria

Bulgaria's parliament on December 12 passed the second "actualization" of the 1996 state budget. The new revision puts the budget deficit at 125.3 billion leva (\$762 million at the average exchange rate for 1996 to date). Expenditures for interest payments on domestic debt were increased by 125.3 billion leva to 356.3 billion leva. Some 308.5 billion leva will go for interest payments on domestic debt, and 47.8 billion for interest on foreign debt. The draft 1997 budget envisages an exchange rate of 350 leva for one dollar and a 40 percent annual inflation rate. In other news, the National Statistical Institute announced that unemployment stood at 12 percent in November, up from 11.3 percent in October. The number of unemployed went up from 425,419 to 460,061. Among the unemployed are 20,382 former employees from sixty-four state-owned firms slated for closure.

Consumer price inflation was 9.7 percent in November, down from 16.7 percent in October, bringing cumulative figure for the first eleven months to 223.6 percent, the National Statistical Institute reported on December 11. The continuing high inflation is blamed on the collapse of the leva, which was fixed by the national bank at 504.30 against the dollar on December 11, compared with 369.42 a week before and 70.47 a year earlier. Since the beginning of the year, electricity prices have risen by 382 percent, transport and communications services by 203 percent, and food prices by 227 percent.

One-third of Bulgarian workers are employed in the gray economy, paying no taxes and evading other pay deductions, a study by the Sofia Institute for Market Economy released in mid-December said. The study blames high taxation, coupled

with inadequate tax and job legislation, for the high incidence of illegal labor, and estimates that due to lost tax revenues, the government has incurred so far in 1996 a loss of approximately \$60 million.

### Czech Republic

Czech Finance Minister Ivan Kocarnik expects the government budget to end 1996 with a maximum deficit of 1.2 billion koruna if urgent savings measures are taken, a government spokesman said. Kocarnik said that without steps to curb spending further, developments through November and estimates for December indicate the budget will end the year with a deficit of 3.2 billion to 5.2 billion koruna. He proposed forcing all government and budget-funded organizations to undertake measures to save immediately and said that the finance ministry would examine all budgets closely. The government has already cut spending by nine billion koruna as revenues failed to keep pace with projections.

The Czech Republic's growing current account and trade deficits are "nearly at the limit of bearable," said Trade Minister Vladimír Dlouhý. The current account deficit has topped \$3 billion—more than 5 percent of GDP—and the trade deficit stood at \$4.2 billion at the end of November. Dlouhý says that it is not yet necessary to alter the exchange rate of the Czech koruna.

### China

The failure of China's nascent legal system to guarantee a farmer's right to the land he works, and the paltry returns many get from their labor, discourage the long-term investment needed to boost production and meet the demands of China's population, which is expanding at the rate of 14 million per year, reports the *New York Times* (12/15, p. A20). As

a result, per capita grain output has plateaued even though each year brings a new record harvest. Despite great strides in agricultural reform since 1979, farming has become unprofitable because of excessive taxation of farmers, who then are reluctant to make long-term investments in the land. Under current policy, the land belongs to local collectives, which have the authority to lease it to farmers in their area. But most farmers are still subject to losing their land in periodic "reallocations" by local officials, with farmers switching plots every three to five years.

Pro-China business leaders and professionals named Tung Chee-hwa to be chief executive of Hong Kong after the territory reverts to Chinese sovereignty in 1997. Tung is a conservative shipping tycoon who advocates stability over democracy. He calls for continuity in economic policy and plans to retain top civil servants. He also backs Hong Kong's low level of taxation, its tradition of small government, and the fixed link between the Hong Kong and U.S. dollars.

China's fixed-asset investment is expected to hit 2.8 trillion yuan in 1997, up 18.5 percent from 1996, the State Economic Information Center reported on November 20. State-owned fixed asset investment will grow 13.9 percent from a year earlier, and will account for 50.5 percent of the 1997 total. Collectively owned (a hybrid of state and private ownership) fixed-asset investment will make up 16.5 percent of the 1997 total, whereas other types of ownership, including that by the private sector, will account for the remainder. Investments in the country's post and telecommunications and transportation industries will maintain a rapid rate of growth in 1997.

The Ministry of Posts and Telecommunications (MPT) installed 13.7 million new telephone lines in the first ten months of 1996, exceeding its full-year goal of 13

million. Of the 13.7 million new telephone subscriptions, about 2.6 million were for mobile phones, the MPT said. By the end of October, China's total public exchange capacity reached 84.7 million lines. In 1995, China had 4.6 telephones for every 100 people. By 2000, MPT hopes to increase telephone density to ten phones for every 100 people.

### Cuba

Cuba has asked Paris Club creditors to refinance its \$10.5 billion in foreign debt, and to help Havana get access to softer credits, according to a report of the National Bank of Cuba.

### Hungary

The State Privatization and Holding Co. (APV Rt.) is planning to offer fourteen major companies for privatization in 1997. These include the national airline Malev, the shipping company MAHART, the film producer and distributor Mafilm, the trucking company Hungarocamion and the truck manufacturer Raba, as well as a further stake in the Hungarian oil and gas company MOL Rt. The government will have largely completed the process of privatization by the end of 1997. After 1997, the APV will permanently hold assets to a total value of HUF 200-300 billion, which will be managed either by a national holding or the state treasury. Of the banks in its portfolio, the Commercial and Credit Bank (Kereskedelmi es Hitelbank), Hungarian Mutual Savings Bank (Magyar Takarekszovetkezeti Bank), Mezobank, and Corvinbank will be offered for sale in 1997. Of the power plants, Bakonyi Eromu, Pecs Eromu and Vertesi Eromu are set for sale. Of the 282 companies the state currently owns stakes in 109 are expected to remain in permanent state ownership.

ABN-AMRO Bank NV of the Netherlands, Europe's fifth-largest banking

group, beat rival bidder Creditanstalt Bankverein of Austria to buy Hungary's Magyar Hitel Bank (MHB) in a deal that opens the way for the Dutch bank to expand significantly in Hungary. ABN-AMRO will take a nearly 90 percent stake in MHB, one of Hungary's biggest commercial banks, for \$89.2 million. In addition, ABN-AMRO pledged a further \$100 million capital increase in 1997 to help MHB with ambitious plans to modernize its technology and launch electronic consumer banking and life insurance operations.

Foreign capital valued at \$15 billion has been invested in Hungary to date, 60 percent of which was through privatization, and 40 percent through direct investments. Hungary remained the largest recipient of foreign investment in the region. Half of the money was invested in industry, most in telecommunications, followed by the energy sector, financial sector, and trade. Budapest and Pest County attracted 46 percent of all foreign investment, followed by northwest Hungary with 27.5 percent, while only 7.5 percent was invested into northeast Hungary and 6 percent into the southwest. Last year, 98 percent of the country's 200 largest companies were majority foreign-owned. The largest foreign investor has been Germany, followed by Austria and the United States. Most investors see Hungary as a strategic base for expanding their markets in Eastern and Central Europe. (*Sources: Minister of Industry, Trade, and Tourism Szabolcs Fazakas; Bertalan Diczhazi of Privatization Research Institute; and KPMG Auditing, Taxation and Economic Consulting.*)

### Kazakstan

Three-year Kazak euronotes worth \$200 million were launched on December 16 in Amsterdam, Kazak Prime Minister Aleksandr Pavlov announced. The issue made Kazakstan the second CIS mem-

ber, after Russia, to float bonds on world markets. The issue was twice oversubscribed and would help Kazakstan strengthen its position in the international investor community. Proceeds will be used to pay overdue wages and pensions.

### Lithuania

Parliament has approved the government's economic program. Finance Minister Rolandas Matiliauskas said that the government has promised to continue reforms, including pledges to boost the minimum wage and pensions, give tax breaks to companies, cut the VAT, and increase the property tax from 1 percent to 1.5 percent. One of the government's

key aims is eventually to end the peg of the litas to the dollar. The program calls for continued market reforms and for improving the country's ties to the West. It aims for an annual growth rate of 5 to 8 percent and a reduction of inflation from the current 12 percent to 7 percent by 2000. It also calls for the government to continue pressing for membership in the EU, NATO, and the WTO.

The Lithuanian ministries of economy, power engineering, industry and trade, agriculture, as well as forestry will be merged into ministries of European affairs, economy, and agriculture and forestry. The decision to streamline was explained by the need to save budget

outlays, cut ministerial staff by up to 30 percent, and improve administrative efficiency.

### Poland

More than 25 million Poles—or 95 percent of those eligible—have claimed a total of 25.7 million privatization vouchers over the past twelve months. A year ago, only one in ten Poles said they would claim vouchers, and the government expected to distribute about 10 million. Vouchers sold by state banks for 20 zlotys (\$7) are currently selling for some 150 zlotys on the stock exchange. In 1997 the vouchers will be exchanged for shares in each of the fifteen investment funds managing some 500 enterprises. (Each of the fifteen fund-management groups—consortia of Polish and international consultants and financiers—directly oversees around 34 companies and also holds a tiny stake in each of the 500 companies.)

Poland's birthrate has declined from 79 live births per 1,000 women of reproductive age at the beginning of the 1980s to 45 live births per 1,000 women, according to Central Statistical Office data, published on December 12. A drop in the birthrate characterized the period between 1994 and 1996, despite the introduction of a restrictive abortion law in early 1993 (recently amended). In the first quarter of 1996 there were more deaths than live births, the first time this has occurred in postwar Poland. Demographers estimate that by 2020 the total number of children in the country will decline by 1.1 million (compared with 1995). Polish couples frequently cite difficult economic conditions as the reason for having fewer children.

### Romania

Romania's parliament has backed the new reformist government and its economic plan to move the country out of



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prolonged crisis and toward membership in NATO and the EU. The government's program calls for faster privatization, rapid restructuring of industry, tax cuts, increased social benefits, and a crack-down on abuses. There were, however, few specific targets for inflation, the budget deficit, and most other key indicators. Prime Minister Victor Ciorbea has told deputies that he aims at an annual economic growth of 4.5 to 6.0 percent and that he also believes the system for producing wealth has to be fundamentally changed. Ciorbea proposed that the program be implemented in two stages—a six-month emergency plan to raise the living standards of the disadvantaged, followed by a second phase incorporating austerity measures to revive the economy, attract foreign investors, and regain the confidence of international financial institutions, particularly the IMF. Ciorbea said the country was too poor to afford a gray economy that represents 40 percent of GDP, and he pledged "total war" against corruption.

Data recently released by the National Commission of Statistics claim that during the first ten months of 1996 industrial production has increased by 8.7 percent compared with the same period one year ago. Meanwhile, exports have decreased to 93.9 percent over the previous year (\$6.06 billion total), while imports have plummeted to 91.5 percent (\$6.95 billion). The annual rate of inflation has reached 45 percent. Inflation rose 3.4 percent in October compared with September and has increased by 35.5 percent since December 1995. Outgoing Finance Minister Florin Georgescu said the state's hard-currency reserves stand at \$800 million, while the total amount deposited in Romanian banks is \$2.1 billion. The country's foreign debt on September 30 reached \$7 billion.

## Russia

The Duma approved the first reading of Russia's 1997 budget on December 15. To win passage of the measure, the government produced 34.8 trillion rubles in new revenues that allowed it to boost spending by the same amount and to win swing votes with pledges of more regional and farm subsidies. The budget projects 11.8 percent inflation, 2 percent GDP growth, spending of 530 trillion rubles, and revenue of 434 trillion. Industrial subsidies are expected to be down 39 percent, social spending down 38 percent, and regional subsidies down 59 percent compared with 1996. The government claims that the deficit of 96 trillion is equal to 3.5 percent of GDP and thus within the IMF limit. Finance Minister Aleksandr Livshits said the budget will enable the government to undertake critical and far-reaching reform in the armed forces, social services, and the tax system.

Russian Prime Minister Viktor Chernomyrdin yesterday rejected money creation as a way to cover the budget deficit. Chernomyrdin told the Federation Council he plans to suggest to President Boris Yeltsin that social benefits be cut, adding that no other country in the world accommodates a benefits system like Russia's, in which, for example, about 70 percent of passengers use public transportation free of charge. The government has to reduce subsidy costs in order to control financial problems that have led to delays in wage and pension payments, he added. The council passed a resolution rebuking Chernomyrdin, however, saying the government was not capable of tackling the country's problems.

The Russian government plans to cut its official budget target for privatization in 1996 to 2.7 trillion rubles from 12.3 trillion. The government has earned just over 1 trillion rubles from

privatization so far this year. Even the most optimistic government forecast anticipates yields from privatization to be not more than 1.7 trillion rubles by the end of the year.

In the first nine months of this year, only 12 of 411 construction projects envisaged by the 1996 federal investment program were completed, *Finansovye Izvestiya* reported on December 17. At a fifth of the sites, no work was carried out at all. Of the 1.32 trillion rubles (\$240 million) allotted to the program, only 1.01 trillion were released. None of the seventy-seven construction projects in agriculture was finished, and the actual volume of investment in construction in that sector was a mere 57.3 billion rubles, or 20 percent of the expected level.

The State Statistics Committee reported December 14 that Russia's GDP shrank by 6 percent in January-November 1996 from the same period last year. Industrial production was down an annual 5 percent over the same period. (Russia's official statistics do not reflect a substantial gray economy.)

The Russian government is studying the possibility of launching additional eurobond offerings in 1997, following its recent successful launch of a five-year, \$1 billion issue, Central Bank of Russia Deputy Chairman Andrei Kozlov announced in mid-December. He told the annual meeting of the Emerging Markets Traders Association that the new eurobonds could be issued with maturities of between five and ten years. Kozlov said he expected issuance of between \$2 billion and \$5 billion in 1997, adding that the instruments would likely be issued in U.S. dollars. Kozlov also said foreign currency bonds would cover only part of the government's fiscal deficit, and the bulk of the shortfall would continue to

be financed by the domestic treasury market.

Deputy Prime Minister Oleg Davydov expects Russia to join the 125-country World Trade Organization by the end of 1997. Speaking at a meeting of the WTO in Singapore on December 10, Davydov argued that Russia has already abolished all quota restrictions on imports. Russia originally applied to join the WTO's predecessor, GATT, in 1993. Its application has been held up by lack of clarity over industrial subsidies and trade statistics. (Russia's trade turnover in the first ten months of 1996 was up 7.2 percent over the same period last year, with exports of \$71 billion and imports \$38 billion—not including any allowance for individual “shuttle traders.” Trade with CIS countries accounted for 23 percent of the total.)

The total wage debt in Russia equaled 46.6 trillion rubles on November 25, up 3.5 trillion from October 28 the State Statistics Committee report issued December 14. Organizations and enterprises funded directly by the state accounted for 8.58 trillion of the total. Mounting wage arrears are continuing to trigger strikes and other forms of protest. A recent survey shows that only 30 percent of wages in Russia were paid on time and in full in 1996, down from 45 percent in 1995, according to a *Segodnya* report on December 11. Some 31 percent of wages were delayed and 39 percent of workers were not paid at all (compared with 38 percent and 17 percent, respectively, in 1995).

High-ranking officials and managers, white-collar workers, and inhabitants of Moscow, St. Petersburg, and European North were more likely to get paid on time, while manual workers and those living in rural areas, the far east, and Siberia had their salaries de-

layed. The proportion of people who say that price and wage arrear increases may cause social unrest in their regions and those who are willing to take part in protest demonstrations increased from 26 percent and 23 percent, respectively, in 1995 to 40 percent and 26 percent in 1996.

### Slovakia

Slovak Prime Minister Vladimir Meciar, speaking after the EU summit in Dublin, on December 14 said that Slovakia is a democratic country that fulfills the conditions for EU membership. Slovakia has achieved better economic results than any other EU-associated country, he stressed, adding that it faces no social problems and that its legal system is in harmony with the EU's. The only remaining step is “to improve trust in our democratic system,” Meciar emphasized. He said he is not aware of any EU reservations about Slovakia.

### Turkmenistan

State enterprises are to be auctioned in Turkmenistan. Foreign and domestic investors will be offered an equal opportunity to buy 100 state enterprises specializing in sales before the end of the year, *Finansovye Izvestiya* reported on December 17. More than 2,000 enterprises involved in public catering and the retail trade are to be privatized over the next two years.

### Ukraine

Although the hryvnia is slated to become a convertible currency, this must wait until parliament passes the 1997 budget, Ukraine's central bank head Viktor Yushchenko said. The budget must be passed before a central bank proposal—allowing nonresident banks to freely buy hard currency on the Ukraine Interbank Currency Exchange

(UICE) and the interbank market in 1997—can be implemented. Parliament is still reviewing the budget and will probably pass it between January and March 1997, although the constitution stipulates acceptance by January 1. Yushchenko told a news conference that implementing the central bank proposal would bring Ukraine closer to acceptance of the IMF's Article VIII.

The Ukrainian parliament passed a new version of an enterprise privatization law on December 11. According to the law, all Ukrainian citizens can purchase state property, but employees enjoy preferential treatment in acquiring shares in enterprises where they work. The law bans privatization of the property of the armed forces, underground mineral deposits, water resources, radio and TV transmitters and channels, pipelines, distilleries, and weapons-producing enterprises. The law allows Ukrainian citizens, foreigners, and persons without citizenship, along with Ukrainian and foreign corporate bodies, to purchase shares in privatized companies. Armed forces property will be subject to corporatization, with the state retaining 51 percent of the shares.

Up to 42 percent of Ukrainian enterprises, employing one-third of the workforce, are ecologically unsafe, Emergency Situations Minister Valerii Kalchenko said on December 10. Ukrainian railways, where 16 percent of crossings need replacing, are especially dangerous. Ukraine faces problems with destruction of chemical weapons of the former Soviet Union. Kalchenko said that many of 4,000 wagonloads of shells near Kerch in Crimea had exceeded their shelf life.

*We appreciate the contributions from the Open Media Research Institute's Daily Digest.*

## World Bank/IMF Agenda

### Controversial Report Card on World Bank Projects

The annual review of World Bank projects, released on December 13, 1996, conducted by the Bank's independent Operations Evaluation Department (OED), finds that 68 percent of World Bank operations evaluated last year had satisfactory outcomes, compared with 66 percent satisfactory in the previous year. (A completed project is considered satisfactory if it is in line with the Bank's assistance strategy agreed with the borrower country, meets goals of poverty reduction, and uses resources efficiently.) OED evaluated 264 lending operations in 1995 that represent disbursements of about \$22 billion to eighty countries. Most were approved in 1984-91 and completed in 1993-95. Only 46 percent were judged likely to sustain their benefits after the completion of loan disbursements (compared with 44 percent for the 1994 group); a further 32 percent of the group were judged uncertain to sustain their benefits. Fewer than a third had a substantial impact on borrowing countries' institutional development.

The East Asia and Pacific region continued to be the best-performing region (with 94 percent of the projects showing a satisfactory outcome rating), while Africa ranked lowest (with only 49 percent of its operations rated satisfactory). **Out of the 14 projects reviewed in the Europe and Central Asia region, 8 projects (57 percent) were rated satisfactory.** By sector, agriculture and program and policy lending were the largest groups among the operations with high risks and low rewards.

Study recommendations to the Bank's management:

- Opt for advisory and capacity-building services over lending in countries where the policy framework is distorted and

implementation capacity is weak.

- In order to improve the Bank's record in technical assistance, develop strategic alliances with experienced partners to help build client countries' capacity in parallel with, or ahead of, Bank loans and credits.
- Ensure that pilot operations precede full-scale Bank projects where risks are high, domestic capacities are weak, and (or) borrowers' commitment is not assured.
- Strengthen development risk assessment, monitoring, and evaluation throughout the project cycle and use these to shape the Bank's country assistance strategies.

### Johannes Linn on World Bank's Role in Promoting Private Investment

Improving the investment climate and incentives in the transition economies of Europe and Central Asia (ECA), the World Bank has promoted private capital flow and foreign direct investment in the region, Johannes Linn, World Bank Vice President for Europe and Central Asia, emphasized in a speech delivered in Tokyo on November 25. World Bank activities include lending operations to find socially acceptable ways to downsize loss-making state sectors, identification of reforms in social transfers, rehabilitation of basic health services, and assistance in alleviating critical shortages of basic equipment for the emergency medical system. The Bank provides leadership by investing in environmental improvements and promoting regional environmental programs. In the energy field, the Bank could play an important role as a broker for multicountry agreements, providing technical advice and needed financing or guarantees, particularly if foreign direct investment is associated with such agreements, the Vice President added.

### World Bank Goes Ahead with the Bosnia Reconstruction...

The World Bank on December 16 approved credits for three reconstruction projects in Bosnia-Herzegovina.

- The Local Initiatives Project (of \$18 million the Bank provides \$7 million) will be used to create jobs for war widows, demobilized soldiers, displaced persons, and returning refugees by encouraging them to set up their own businesses through microenterprise loans. Italy is contributing an additional \$3.3 million.
  - The Essential Hospital Services Project (\$15 million out of a total cost of \$33.5 million) will be used to rebuild hospitals and purchase medical equipment and supplies. Italy is kicking in \$5.2 million in cofinancing.
  - The Emergency Industrial Re-Start Project (\$10 million out of a total cost of \$50 million) will help Bosnia attract foreign private financing by guaranteeing investors against political risks. Switzerland is contributing \$7.5 million.
- These credits bring the total number of World Bank reconstruction projects for Bosnia to sixteen.

### ...Helps Croatia Reconstruct Coastal Forests...

A \$42 million loan to help finance a Coastal Forest Reconstruction and Protection Project was approved by the World Bank on December 11. The project will restore and protect forest land along the Dalmatian coast, enhancing the landscape and recreation values of the region and contributing to the revival of tourism to its prewar level. It includes the reforestation of 5,000 hectares of the 11,000 hectares of forests destroyed by war and fire damage in Senj, Zadar, Sibenik, Split, and Dubrovnik. Croatia has a large (over 2.4 million hectares) forest resource base, which covers 43.5 percent of the total land area. Since Croatia joined the World

Bank in 1993, Bank commitments total over \$450 million for nine projects.

### **... Improve Transportation Routes and Clear Land Mines**

On November 21, the Bank approved a \$102 million loan to Croatia to help finance an Emergency Transport and Mine Clearing Project. The project will improve the efficiency of regional transport networks (including repair and reconstruction of roads and bridges, railways lines, and the Port of Ploce) and will clear land mines in areas of high economic priority for reconstruction. By rebuilding the transport system, delivery of construction materials to Bosnia and Herzegovina will be accelerated and traditional trade patterns will be reestablished.

### **World Bank Strengthens Hungarian Public Finance Reform...**

To help finance a Public Finance Management Project, the World Bank on December 5 approved a \$7.75 million loan to Hungary. Tools (primarily information technology) and skills will enable speedy access to accurate financial information, which can improve resource planning and public expenditure management and control. In 1996, to ensure budgetary control, the Hungarian government established a treasury and introduced an interim financial management information system. The consolidated government deficit (excluding privatization revenues) is expected to be reduced from a record level of 8.4 percent of GDP in 1994 to 4 percent in 1996. Estimated budget revenues in 1996 dropped to 46 percent from 53 percent in 1994, and budget expenditures declined from 61 percent to 50 percent by 1996. Since Hungary joined the World Bank in 1982, Bank commitments total approximately \$3.7 billion for thirty-four projects.

### **... and Promotes Ukraine's Exports**

The World Bank on November 21 approved a \$70 million loan to Ukraine to help finance an Export Development Project (EDP). The loan will be made to the State Export-Import Bank of Ukraine (EXIM) in order to support its export development program for the newly emerging Ukrainian private and privatized enterprise sector. Within the project, a \$50 million and DM15 million export-oriented credit line will finance short-term imports of inputs used in the production of exports, and medium- and long-term investment projects of export-oriented private and privatized firms. (In 1995, Ukraine's exports of goods and nonfactor services totaled over \$16 billion and imports were in excess of \$17 billion. Since Ukraine joined the World Bank in 1992, Bank commitments total approximately \$1.7 billion for eleven projects.

### **Joseph Stiglitz is the New Vice President and Chief Economist**

As of February 1, 1997, Joseph E. Stiglitz will become Senior Vice President (Development Economics) and Chief Economist of the World Bank. He succeeds Michael Bruno, who recently left the Bank. Mr. Stiglitz, a U.S. national, has been at the U.S. Council of Economic Advisers since 1993 and was appointed chairman of the council in June 1995. As a key member of President Clinton's economic team, he has been particularly involved in areas of microeconomic and international economic policies. Before joining the Clinton administration, he taught economics at Stanford University.

Mr. Stiglitz helped create the economics of information that has received widespread application throughout economics. He also helped pioneer such concepts as the theory of adverse selection and moral hazard, which are now stan-

dard tools of policy analysts and economic theorists. He has focused interest on the economics of technological change and other factors that contribute to long-run improvements in productivity and living standards.

### **Vietnam Secures Continued Donor Support**

Vietnam's government is committed to continuing the economic and public administration reforms, Deputy Prime Minister Phan Van Khai said during the fourth gathering of the Consultative Group for Vietnam that met on December 5 and 6 in Hanoi. International donors pledged \$2.4 billion for 1997 to support structural reforms and the implementation of the new five-year plan. This does not include the financial contribution of the NGO community and the financial resources expected to be transferred under the International Monetary Fund's Extended Structural Adjustment Facility of \$180 million in 1997.

(Vietnam's growth in 1996 is expected to exceed 9 percent, inflation to remain under control, and investment to reach nearly 30 percent of GDP, fueled by strong growth of FDI disbursements of over \$2.3 billion for the year. But the current account deficit is expected to reach \$2.7 billion, or about 12 percent of GDP this year, from \$1.8 billion, or about 10 percent of GDP, in 1995.)

### **IFC Extends Activity in Vietnam**

The IFC will provide a \$15 million loan and \$750,000 in equity investment to the Vietnam International Leasing Company (VILC) to enable small and medium-size companies to procure capital goods. This support "will have a strong impact on Vietnam's financial sector by extending and improving credit delivery and introducing new financial products to the local market to encourage capital formation and investment," IFC noted. IFC will

continue to support Vietnam in the near future with consultation and training in preparation for Vietnam's stock exchange, Vice President Jannik Lindbaek said during a recent visit to Hanoi. IFC is also considering a total of \$500 million worth of projects in sectors including cement production, flour milling, pharmaceuticals and ports. The IFC will soon establish a resident mission in Vietnam. (The IFC has now backed fifteen projects in Vietnam worth \$830 million with \$156 million of its own funds.)

### **Donors Support Kyrgyzstan, Tajikistan, and Kazakstan**

International donors demonstrated support for the 1997 reform efforts in the Kyrgyz Republic, Tajikistan, and Kazakstan with cumulative pledges amounting to \$1.9 billion. On October 30, Kyrgyzstan's donors pledged about \$450 million. On October 31, during the Consultative Group Meeting for Tajikistan, donors pledged \$185 million. On November 1, donors for Kazakstan indicated support totaling approximately \$1.35 billion for 1997.

### **IMF Launches ESAF Evaluation**

The IMF has formally launched an external evaluation of its soft-loan program, the enhanced structural adjustment facility (ESAF), which has been under criticism from nongovernmental organizations (NGOs) for imposing undue social and political costs on recipient nations.

The IMF announced that the external experts will concentrate particularly on the consequences of the ESAF programs. The experts will analyze social policies and the composition of government spending during these programs. They will look at the determinants and influence of differing degrees of national ownership of these programs. Experts will have full access to information, says

the IMF. A report on their findings is expected to be completed by the end of 1997.

### **CEE Financial Sectors Must Be Ready for EU Accession**

The countries of Central and Eastern Europe should press ahead with modernizing their financial sector so as to get ready for EU membership by 2002-03, according to World Bank Division Chief Michel Noel. "Our assessment is that all of these countries are well under way to prepare themselves for EU accession," said. "But there are certain areas which require special attention." Noel spoke at the Central European University in Budapest about the developments in the

## **Conference Diary**

### **Transportation and Distribution in Russia/CIS**

January 30-31, 1997, Washington, D.C., United States

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### **Internationale Kooperation zur Bearbeitung globaler Umweltprobleme: Steuerungsdefizite und innovative Regelungsansätze**

[International Cooperation toward the Solving of Global Environmental Problems: Leadership Deficits and Innovative Approaches to Regulation]  
February 20-22, 1997, Berlin, Germany

Organizer: Deutsche Gesellschaft fuer auswaertige Politik (DGAP), Wissenschaftszentrum Berlin fuer Sozialforschung (WZB), Berlin

financial sectors of the Czech Republic, Hungary, Poland, Slovakia, and Slovenia since their system changes.

### **IMF Board Approves Russia Tranche Release**

The IMF Executive Board on December 13th approved disbursement of a suspended October Extended Fund Facility (EFF) tranche to Russia amounting to about \$336 million. The IMF Board's approval was based on improved revenue performance, efforts to restore fiscal policy to a path consistent with the program's macroeconomic objectives, appropriate conduct of credit policy, and implementation of several structural reform measures.

Topics: Focus will be on environment and the WTO, international policy, and security.

*Information: Studienkreis Internationale Beziehungen, Sekretariat, Prof. Dr. Rolf H. Hasse, Institut fuer Wirtschaftspolitik, Universitaet der Bundeswehr Hamburg, 22039 Hamburg, Germany, tel. 49-40-6541-2771, fax 49-40-6541-2780.*

### **Multifaceted Cooperation of Towns and Regions: Development of Projects and Mechanisms of Their Implementation**

April 21-23, 1997, St. Petersburg, Russia

Organizer: Institute Eurograd.

*Information: Natalia Kostyleva or Natalia Lebedeva, Izmailovsky pr. 14, 198052 St. Petersburg, Russia, tel. 7-812-112-6478, -6604, fax 7-812-112-6506.*

### **International Business in the New Millennium**

May 21-24, 1997, Porto, Portugal

**Organizer:** International Trade and Finance Association.

**Topics:** Subjects for discussion will include commercial policy, countertrade, globalization and competitiveness, immigration and labor, international finance and trade, intraindustry trade, law and economics, LDC trade, protectionism and competitiveness, tax and transfer pricing, trade and employment, trade and the environment, the World Trade Organization.

**Deadline:** Call for papers is by February 3, 1997.

**Information:** Khosrow Fatemi, IT&FA Proceedings Editor, Texas A&M International University, College of Business Administration, 5201 University Boulevard, Laredo, TX 78041-1999, United States, tel. 1-210-326-2565, fax 1-210-326-2564, E-mail: [suenichols@tamui.edu](mailto:suenichols@tamui.edu).

**Human Resources Management: Interaction of the Western and the Eastern European Management Cultures**  
May 22-23, 1997, Jurmala, Latvia

**Organizer:** LBS Exhibitions and Conferences.

**Information:** Latvian Business School, 1 Maza Pils Str., Riga, LV1050, Latvia, tel. 371-721-1186, fax 371-722-4429, E-mail: [lbs@mailbox.riga.lv](mailto:lbs@mailbox.riga.lv).

**Second International Conference on Enterprises in Transition**  
May 22-24, 1997, Split, Croatia

**Organizer:** University of Split, Faculty of Economics.

**Information:** University of Split, Radovanova 13, HR-21000, Split, Croatia, tel. 385-21-341-866, fax 385-21-366-026, E-mail: [eitconf@oliver.efst.hr](mailto:eitconf@oliver.efst.hr).

**First Exhibition and Conference for the Russian Security Industry**  
June 16-20, 1997, Moscow, Russia

**Information:** E. J. Krause & Associates, Bocklinstr. 12, Dusseldorf, Germany, tel. 49-211-685-434, fax 49-211-691-2268.

**20th Century Europe: Inclusions/Exclusions**

August 27-30, 1997, Essex, England

**Organizer:** European Sociological Association.

**Deadline:** Call for papers is by January 15, 1997.

**Information:** Department of Sociology, University of Essex, Wivenhoe Park, Colchester Essex, CO4 3SQ, United Kingdom, fax 44-206-873410, E-mail: [esa97@essex.ac.uk](mailto:esa97@essex.ac.uk).

**Management at a Crossroads: New Interdependencies between Organizations, Labor and Society**

September 10-12, 1997, Groningen, The Netherlands

**Organizer:** Faculty of Management and Organization, Groningen University

**Deadline:** Abstracts are due by February 1, 1997.

**Information:** Groningen University, Faculty of Management and Organization, Dr. E. H. Bax, P.O. Box 800, 9700 AV Groningen, The Netherlands, tel. 31-50-3634288, fax 31-50-3632032, E-mail: [bdk-con@bdk.rug.nl](mailto:bdk-con@bdk.rug.nl).

**Financial Markets under the Pressure of Globalization, Regulation and Monetary Policy**

September 24-26, 1997, Bern, Switzerland

**Information:** Urs Schweizer, Universitat Bonn, Institut fur Gesellschafts und Wirtschaftswissenschaften, Adenaueralle 24, 53113 Bonn, Germany, tel. 49-228-739185.

**Banking and Finance in the Baltics '97**

October 15-17, 1997, Riga, Latvia

**Organizer:** LBS Exhibitions and Conferences.

**Information:** Latvian Business School, 1 Maza Pils str., Riga, LV1050, Latvia, tel. 371-721-1186, fax 371-722-4429, E-mail: [lbs@mailbox.riga.lv](mailto:lbs@mailbox.riga.lv), Internet: <http://www.lvnet.lv/BFB96>.

**29th Convention of the American Association for the Advancement of Slavic Studies**

November 20-23, 1997, Seattle, Washington, United States

**Information:** Wendy Walker, American Association for the Advancement of Slavic Studies, 8 Story Street, Cambridge, MA 02138, United States, tel. 617-495-0677, fax 617-495-0680, E-mail: [aaass@hcs.harvard.edu](mailto:aaass@hcs.harvard.edu).

**First Regional Congress of ICCEES: Russia in the Asia-Pacific Region**

July 7-10, 1998, Melbourne, Australia

**Information:** Stephen Wheatcroft, Department of History, University of Melbourne, Parkville, Vic. 3052, Australia, fax 61-3-934-45590, E-mail: [stephen\\_wheatcroft.soviet@muwaye.unimelb.edu.au](mailto:stephen_wheatcroft.soviet@muwaye.unimelb.edu.au).

**Sixth World Congress of the International Council for Central and East European Studies**

July 29-August 3, 2000, Tampere, Finland

**Information:** Anneli Virtanen, Institute for Russian and East European Studies, Annankatu 44, Fin-00100 Helsinki, Finland, tel. 358-0-2285-4434, fax 358-0-2285-4431.

We appreciate the contributions of the Cooperation Bureau for Economic Research on Eastern Europe

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### Working Papers

Luca Barbone, Domenico Marchetti, Jr., and Stefano Paternostro, **Structural Adjustment, Ownership Transformation, and Size in Polish Industry**, Policy Research Working Paper 1624, July 1996, 25 p.

Significant adjustment took place in Polish manufacturing industries after Poland's 1990 reforms. The productive response of state enterprises was markedly different from that of private firms: Private firms outperformed state enterprises. Size also matters, at least among private firms. Generally, there seem to be increasing returns to scale for private firms, except for very large enterprises, many of which are previously state-owned and may need further restructuring.

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Simon Commander and Andrei Tolstipiatenko, **Restructuring and Taxation in Transition Economies**, Policy Research Working Paper 1625, July 1996, 23 p.

In most transition countries insiders dominated the privatization process. Nevertheless, in Central and Eastern Europe, unemployment sharply rose. In countries of the former Soviet Union, both restructuring and unemployment have remained limited and subsidies to firms have continued to be high. The private sector has expanded, but chiefly in the gray (untaxed) area of the economy. Low taxes in the private sector can drive unemployment up rapidly as the state sector, without fiscal means, is forced to make massive layoffs. But low taxes can also help speed the transition by provoking a more rapid private sector response. Capturing the private sector in the "tax net" early in the transition could lead to its collapse and hence to the failure of restructuring.

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Barry Friedman, Estelle James, Cheikh Kane, and Monika Queisser, **How Can China Provide Income Security for Its Rapidly Aging Population?** Policy Research Working Paper 1674, October 1996, 51 p.

Policymakers face key choices about China's pension system in the light of a rapidly aging population. By 2030, over one-quarter of the world's population over the age of 60 will live in China (22 percent of China's population). This will have far-reaching consequences. Socially, the family will be strained, perhaps more than in other countries, because of China's "one child" family planning policy. Economically, if current systems remain unchanged, rising payroll tax rates—needed to cover sharply increased medical and pension costs—could dampen China's growth in wages and employment, inducing evasion and escape to the

informal sector, and will inevitably mean large intergenerational redistributions.

China is considering a number of reforms to prevent this from happening. Simple design changes—such as reducing the generous benefit rate, moving toward price indexing rather than wage indexing, and raising the retirement age—are necessary but not sufficient conditions for making the pension system sustainable. A multipillar system that includes a modest, mandatory tax-financed basic benefit and a mandatory fully funded defined-contribution (individual account) scheme must go hand in hand with reform of the financial sector and restructured investment procedures that emphasize the right mix of competition, diversification, and regulation. The transition to such a system can be accomplished with a long-term contribution rate of under 18 percent, considerably less than that imposed today in most Chinese cities. Of this total, 1.6 percent would be used to pay off the old pension debt, 7.3 percent would finance the basic benefit, and 8.5 percent would go into the individual accounts. *To order: Selina Khan, Room N8-024, tel. (202) 473-3651, fax (202) 522-1153, E-mail: skhan@worldbank.org.*

Branko Milanovic, **Nations, Conglomerates, and Empires: The Tradeoff between Income and Sovereignty**, Policy Research Working Paper 1675, October 1996, 47 p.

One apparent inconsistency in the breakup of such multinational states as the Soviet Union, Czechoslovakia, and Yugoslavia is that while many new states claimed that they wanted to increase (regain) their sovereignty, they also expressed a strong desire to join the European Union. Why would a country go

through the ordeal of secession in order to quickly get rid of the very sovereignty that justified its secession? Full sovereignty (like the individual's full freedom) is neither attainable nor desirable for most countries—because greater sovereignty is often traded for reduced income. Nations usually have limited economic sovereignty in such areas as their exchange rate policy (determined by IMF rules, or by regional currency systems), trade policy (confined by WTO rules), labor and banking regulations, and accounting practices. There is a tradeoff curve between sovereignty and income. Countries choose a combination of income and sovereignty that allows them to maximize welfare:

- Larger countries (measured by their GDP) are able to choose more sovereignty per unit of income, because of their large domestic markets.
- Countries with abundant natural resources or very skilled labor (with high per capita human and natural wealth) tend to be more integrated internationally. For them, economic sovereignty is less important.
- More-democratic countries also tend to be better integrated internationally because the political elite, which often prefers not to be bound by international rules, is less powerful.

Testing these hypotheses on the 1993-94 data for 165 countries, the study finds a statistically strong impact of per capita wealth and democracy on international integration. The effect of country size is weaker. Democracies and relatively poor countries are more willing to join conglomerates (free trade associations). The willingness to join is high for small countries (whose sovereignty might actually increase because of the conglomerate's sovereignty-sharing features) and for very large countries that may expect to play the role of core-states. The key gain for a relatively rich former member of a communist (poor) conglomerate is not economic sovereignty in

itself, but the ability to switch to a rich conglomerate. *To order: Selina Khan, Room N8-024, tel. (202) 473-3651, fax (202) 522-1153, E-mail: skhan@worldbank.org.*

### *World Bank Technical Papers*

Emily S. Andrews and Mansoor Rashid, **The Financing of Pension Systems in Central and Eastern Europe: An Overview of Major Trends and Their Determinants, 1990-1993**, World Bank Technical Paper 339, October 1996, 40 p.

The economic transformation in Central and Eastern Europe increased unemployment and pushed workers into early retirement. At the same time, the insolvency of enterprises and the growth of the informal sector reduced tax compliance and the number of contributors to the system. Contrary to common perception, the resulting increase in the ratio of pensioners to contributors did not translate into an increase in pension costs relative to GDP for all countries in the region. Many countries reduced the generosity of their pension systems (pension benefits/wages) to mitigate or completely overcome increases in system dependency rates, and pension costs remained fairly stable (the Czech Republic and Romania) or even declined (Albania and Croatia) over the first few years of the transition. Countries with high and increasing pension costs (Bulgaria, FYR Macedonia, Poland, and Slovakia) are therefore largely those that have either raised pension payments relative to wages, or have not been able to reduce pension generosity sufficiently to counteract increases in system dependency rates.

Three policy conclusions emerge:

- Reducing the level and rate of growth of pension costs will be the main instrument for reducing pension deficits. Tax compliance is a major problem in countries of the region and improving tax

compliance will reduce pension deficits: Even with full compliance, high tax rates prevailing in the region would remain, distorting labor markets and dampening the prospects for economic growth.

- Reducing the sharp growth in pension costs in Bulgaria, FYR Macedonia, Poland, and Slovakia will require different approaches. Containing the growth of pension benefit expenditures in Poland requires a sharp reduction in pension fund generosity; Poland has already controlled the growth rate in new old age pensioners. An increase in the number of contributors should help contain growth in pension costs in Bulgaria and Slovakia. Replacement rates have declined in both countries and an increase in pensioners has been negligible. In FYR Macedonia, growth in pension costs can be reduced if the number of new pensioners entering the system is sharply restricted and the growth in the replacement rate is curtailed.

- Strategies to reduce pension costs cannot be generalized. Instead, pension reform should focus on the factors putting upward pressure on pension costs in each country. Policies to reduce pension costs need to focus primarily on reducing pension benefits in Croatia, FYR Macedonia, and Poland; restricting eligibility to the pension system in Albania, Bulgaria, Poland, Romania, and Slovakia; monitoring disability benefits in Poland and Romania, and curtailing the entry of new pensioners in Albania, Croatia, and FYR Macedonia.

Jan J. Rutkowski, **Changes in the Wage Structure during Economic Transition in Central and Eastern Europe**, World Bank Technical Paper 340, October 1996, 55 p.

Economic transition is associated with a uniform, substantial decline in real wages, although in some cases this fall has been exaggerated due to underestimation of the consumer price inflation rate. The fall in real wages has been so deep that, in

majority of cases, all deciles of workers experienced wage losses. Low-paid workers, however, have suffered markedly more than high-paid workers. The earnings distribution, compressed under central planning, has widened significantly. The overall rise in earnings inequality has been moderate, and the level of inequality has become comparable to that of OECD countries. In the majority of CEE countries, the Gini coefficient for earnings ranges between 25 and 27.

Wage income has been transferred from the low-paid majority to the relatively well paid minority. Nearly 70 to 80 percent of workers lost wage share, while 20 to 30 percent gained. In a large number of transition economies, the incidence of low pay has become high even by OECD standards. In some countries, low-paid workers (defined as those earning less than two-thirds of the median wage) account for up to one-fifth of all workers. Returns to education have increased substantially in the course of transition, especially for college graduates. Wage differentials by educational attainment have become close to those prevailing in OECD countries.

Ellen Goldstein, Alexander S. Preker, Olusoji Adeyi, and Gnanaraj Chellaraj, **Trends in Health Status, Services, and Finance: The Transition in Central and Eastern Europe**, volume 1, World Bank Technical Paper 341, November 1996, 56 p.

Only a few transition countries have successfully downsized their health sectors or reallocated health spending in line with their diminished financial resources. Although many now spend 7 to 9 percent of their GDP for health services, long-run stagnation in life expectancy points to the ineffectiveness and inefficiency of many existing health services. While this problem can be traced to long-standing misallocation of resources and a lack of financial incentives for efficiency, it has

been exacerbated by the pattern of fiscal adjustment in the health sector during the early phase of the transition.

There has been little to no reduction in public sector health personnel in most countries. Adjustment in the health sector has occurred through erosion of real wages, without recourse to mass layoffs. As in other types of enterprises, retaining workers at low wages without sufficient working capital—in this case for drugs, medical supplies, utilities, and so on—results in low productivity and low morale, that is inefficient and low-quality health services. In the medium term, however, the health systems of the transition countries need massive investment to replace and upgrade equipment and facilities that are often outmoded and (or) near the end of their economic life.

Most countries are moving very slowly with Croatia and Hungary as the front-runners—to introduce new reimbursement mechanisms that provide incentives for efficiency and cost containment, transfer ownership of some assets to the private sector, build management capacity, and provide necessary managerial autonomy. Little action has been taken to limit the scope of basic health insurance coverage and restructure the financial sustainability, efficiency, and effectiveness of health services. Until financial incentives are in place, restructuring and operational reforms are unlikely to take place.

#### *Other World Bank Publications*

Simon Commander, Qimiao Fan, and Mark E. Schaffer, **Enterprise Restructuring and Economic Policy in Russia**, EDI Development Study, 1996, 308 p.

**Vietnam: Fiscal Decentralization and the Delivery of Rural Services**, World Bank Country Study, November 1996.

With a per capita income of \$250 and with 80 percent of the population living in rural areas, improving rural services (such as education, health care, infrastructure development, and social relief) is essential to sustained growth, poverty reduction, and improvements in social welfare. Vietnam has had success in providing such services as basic preventive and public health measures, literacy, and community social programs. Overall, however, the quality and delivery of these services in rural Vietnam is low, with regional disparities caused by lack of funds and leadership.

Greater decentralization increases the flexibility of the local units and enables them to respond efficiently to local needs and provide services at lower cost. A more effective central government could also help to improve the quality and distribution of rural services.

Further improvement could be achieved through opening information flows among provinces, districts, and communes; developing databases to improve targeting of technical assistance and additional resources; and changing the tax and transfer system to increase the flexibility of local and central administrators.

#### **IMF Publications**

*To order: IMF Publication Services, 700-19th Street, N.W., Washington, D.C. 20431, United States, tel. 202-623-7430, fax 202-623-7201.*

#### *IMF Working Papers*

Pierre L. Siklos, **Capital Flows in a Transitional Economy and the Sterilization Dilemma: The Hungarian Case**, Working Paper 96/86, August 1996, 26 p.

Michael J. Artis, **How Accurate Are the IMF's Short-Term Forecasts?** An-

**other Examination of the World Economic Outlook**, Working Paper 96/89, August 1996, 23 p.

Robert Holzmann, **Pension Reform, Financial Market Development, and Economic Growth: Preliminary Evidence from Chile**, Working Paper 96/94, August 1996, 47 p.

Natasha Koliadina, **The Social Safety Net in Albania**, Working Paper 96/96, August 1996, 55 p.

The social safety net system in Albania has played an important role during the initial period of transition, supporting the poorest groups of population with income transfers and administering social security benefits. Social expenditures remain high—more than 11 percent of GDP in 1994—and impose a significant burden on the central budget (7.7 percent of GDP in 1994, and an estimated 6.4 percent in 1995). It is unlikely that the financing demands on the social safety net would diminish in the short and medium term since widespread poverty and high levels of unemployment are likely to persist over the next few years. To contain the cost of the safety net while protecting the truly needy, introduction of social security numbers (or employee registration)—that is, a broadening of the tax base—and improved targeting of assistance will be important.

#### CEPII Publications

*To order: Centre d'Etudes Prospectives et d'Informations Internationales (CEPII), 9, rue Georges Pitard, 75740 Paris Cedex 15, France, tel. 4842-6464, fax 4842-5912.*

Roumen Avramov and Jérôme Sgard, **Bulgaria: From Enterprise Indiscipline to Financial Crisis**, Working Paper 96-10, July 1996, 41 p.

#### Leuven Institute for Central and East European Studies Publications

*To order: Katholieke Universiteit Leuven, Ch. Deberiostraat 34, 3000 Leuven, Belgium, tel. 3216-326-598, fax 3216-326-599.*

Marvin Jackson, **Labor Markets and Income Maintenance: A Survey of Transition**, Working Paper 58/1996, June 1996, 11 p.

Valentijn Bilsen and Jožef Konings, **Job Creation, Job Destruction and Growth of Newly Established Private Firms in Transition Economies: Survey Evidence from Bulgaria, Hungary and Romania**, Working Paper 59/1996, June 1996, 36 p.

#### WIIW Publications

*To order: The Vienna Institute for Comparative Economic Studies, Oppolzerergasse 6, A-1010 Vienna, Austria, tel. (431) 533-6610, fax (431) 533-6610-50, Internet: <http://www.wsr.ac.at/wiiw.html>.*

Waltraut Urban, Leon Podkaminer, and others, **Kräftiges Wachstum in Ost-Mitteuropa, Weiterhin Rezession in der GUS**, Research Report 163, May 1996, pp. 355-72.

Leon Podkaminer, **Slower Growth in Central and Eastern Europe, Delayed Stabilization in Russia and Ukraine**, Research Report 228, July 1996, 46 p.

Leon Podkaminer and others, **Country Reports: Bulgaria, Croatia, Czech Republic, Hungary, FYR Macedonia, Poland, Romania, Russia, Slovakia, Slovenia, Ukraine, FR Yugoslavia, and China**, Research Report 229, July 1996, 88 p.

#### Centre for the Study of Public Policy (CSPP) Publications

*To order: CSPP, University of Strathclyde, Livingstone Tower, 26 Richmond Street, Glasgow G1 1XH, Scotland, tel. (44141) 552-4400, fax (44141) 552-4711.*

Stephen White, Richard Rose, and Ian McAllister, **How Russia Votes**, ISBN 1-56643-037-2, 1996.

#### Other Publications

**Effective Communications between the Public Service and the Media**, SIGMA Paper 9, France, 1996, 55 p.  
*To order: Head of Publications Service, SIGMA-OECD, 2, rue André-Pascal, 75775 Paris Cedex 16, France, tel. (331) 4524-7900, fax (331) 4524-1300, E-mail: [sigma.info@oecd.org](mailto:sigma.info@oecd.org), Internet: <http://www.oecd.org/puma/sigmaweb>.*

John S. Earle and Richard Rose, **Ownership Transformation, Economic Behavior, and Political Attitudes in Russia**, Stanford University, Center for International Security and Arms Control, August 1996. *To order: Institute for International Studies, tel. (415) 723-0710, fax (415) 723-0089, E-mail: [earle@Leland.stanford.edu](mailto:earle@Leland.stanford.edu).*

Gyorgy Eger and Josef Langer (eds.), **Border, Region and Ethnicity in Central Europe**, Klagenfurt, 1996.  
*To order: Norea Publisher, Linsengasse 59, A-9020 Klagenfurt, Austria, fax 43-463-55265-10; E-mail: [josef.langer@uni-klu.ac.at](mailto:josef.langer@uni-klu.ac.at) or Josef Langer, Universitaet Klagenfurt, Universitaetstrasse 67, A-9020 Klagenfurt, 43-463-2700-471, fax 43-463-2700-467, E-mail: [josef.langer@uni-klu.ac.at](mailto:josef.langer@uni-klu.ac.at).*

John Fingleton, Eleanor Fox, Damien Neven, and Paul Seabright, **Competition Policy and the Transformation of**

**Central Europe, Centre for Economic Policy Research, United Kingdom, 1996.**

This book examines the implementation of competition policy during the 1990s in the Czech and Slovak Republics, Hungary, and Poland. It looks at the economic predicament of countries in transition, considering how far this has required the state actively to regulate the competitive process. It considers the extent to which initial economic and political conditions have constrained the state's involvement in such activity. It then analyzes the statutes of the countries and the structure of the institutions established to implement competition policy. A discussion of the case law and the experience of policy in practice is used to suggest lessons for the task of competition policy, both in these countries and in others undergoing the transition from central planning.

*To order: CEPR, 25-28 Old Burlington Street, London W1X 1LB, United Kingdom, tel. (44171) 878-2900, fax (44171) 878-2999.*

Jozef Konings and Stefan Janssens, **How Do Western Companies Respond to the Opening of Central and East European Countries? Survey Evidence from a Small Open Economy-Belgium**, Leuven institute for Central and East European Studies Working Paper 60/1996, October 1996, 24 p.

*To order: Katholieke Universiteit Leuven, Leuven Institute for Central and East European Studies, Ch. Deberiotstraat 34, 3000 Leuven, Belgium.*

Rustam Lalkaka and Jack Bishop, **Business Incubators in Economic Development: An Initial Assessment in Industrializing Countries**, United Nations Development Program, New York, 1996, 190 p. *To order: Bishop Associates, Consultants to Governments and Business, 1258 N. LaSalle Street, Chicago, Illinois 60610, United States, tel.*

*(312) 787-6756, fax (312) 787-3136, E-mail: jetlag@mcs.com.*

Marek Lubinski (ed.), **Poland International Economic Report 1995-1996**, World Economy Research Institute, Poland, 1996, 248 p.

*To order: World Economy Research Institute, Warsaw School of Economics, 24, Rakowiecka Str. 02-554, Warsaw, Poland, tel. (4822) 49-12-51, fax (4822) 48-91-32.*

Roy Prosterman, Tim Hanstad, and Li Ping, **Large-Scale Farming in China: An Appropriate Policy?** Rural Development Institute on Foreign Aid and Development, no. 90, July 1996, 31 p.

China should reexamine efforts to promote larger-scale and capital-intensive farms for several reasons:

- Empirical case for economies of scale in agricultural production is weak.
- Relationship between farm size and productivity per hectare is usually inverse—smaller farms are generally more productive than larger farms.
- In developed countries with large farms, such as the United States, size and capital intensity are not the cause of high agricultural productivity. Rather, large and capital-intensive farms are the effect of a dynamic, market-driven resource allocation process set in motion by the country's unique factor endowment.
- While many of the larger-scale farming efforts aim to achieve large-scale collective farms, the literature clearly demonstrates that family farms are generally more efficient and superior.
- Field observations of pilot large-scale farming experiments in China raise serious concerns.

The authors recommend:

- Use voluntary land market measures to facilitate the transition to larger farming.
- Emphasize principles of voluntariness, respect for existing land rights, and equal access when direct government inter-

vention is used to promote large-scale farming.

- Provide long-term, transferable land rights to large-scale farmers.
- Conduct rigorous studies on the relative productivity of large-scale farms.
- Eliminate preferential subsidies to large-scale farmers.
- Allow large-scale farmers to choose the mode of farm organization. *To order: RDI, 1100 NE Campus Parkway, Seattle, Washington 98105, United States, tel. (206) 528-5880, fax (206) 528-5881, E-mail: rdi@u.washington.edu.*

**Regional Problems and Policies in the Czech Republic and the Slovak Republic**, Centre for Cooperation with the Economies in Transition, OECD, 1996, 191 p.

*To order: OECD, Head of Publications, OECD, 2, rue Andre-Pascal, 75775 Paris Cedex 16, France.*

**The Rebirth of Democracy: 12 Constitutions of Central and Eastern Europe**, Council of Europe, October 1996, 445 p.

The second edition of this book groups together the constitutions of twelve central and eastern European states (Bulgaria, Croatia, Czech Republic, Estonia, FYR Macedonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Slovenia). This new edition includes recent amendments to the constitutions, clearly marked to provide a comparison with the original text. Also included are chronologies describing the recent history of each country that has led to the forming of these constitutions. *To order: Mrs. S. Lobey, Council of Europe Publishing, BookWorld Publications (a BWP-Media-group Company), P.O. Box 11089, 1516 Seagull Drive, Suite 309, Palm Harbor, Florida 34685, United States, tel./fax (3173) 612-3115, or tel./fax (813) 787-953; E-mail information: info@bwp-mediagroup.com, (for Sales): sales@bwp-mediagroup.*

com; WWW-site: <http://www.bwp-media-group.com/bookworld/homepage.htm>.

Robert Skidelsky (ed.), **Russia's Stormy Path to Reform**, The Social Market Foundation, 1995, 145 p. *To order: The Social Market Foundation, 20, Queen Anne's Gate, London SW1H9AA, United Kingdom, tel. (0171) 222-7060, fax (0171) 222-0310.*

**Structural Change and Foreign Investment in the Russian Far East Gold Mining Industry**, Russian Far East Update, Seattle, Washington, June 1996, 16 p. *To order: Russian Far East Update, P.O. Box 22126, Seattle, Washington 98122, United States, tel. (206) 447-2668, fax (206) 628-0979, E-mail: rfeupdate@russianfareast.com.*

Ernesto Talvi, **Exchange Rate-based Stabilization with Endogenous Fiscal Response**, Inter-American Development Bank Working Paper 324, Washington, D.C., 1996, 29 p. *To order: Inter-American Development Bank, 1300 New York Avenue, N.W., Washington, D.C. 20577, United States.*

Markku Tykkylainen, **Local and Regional Development during the 1990s Transition in Eastern Europe**, University of Joensuu, Finland, June 1995, 169 p. *To order: Ashgate Distribution Services, Gower House, Croft Road, Aldershop, Hants, GU113HR, England, tel. (01252) 331-551, fax (01252) 344-405.*

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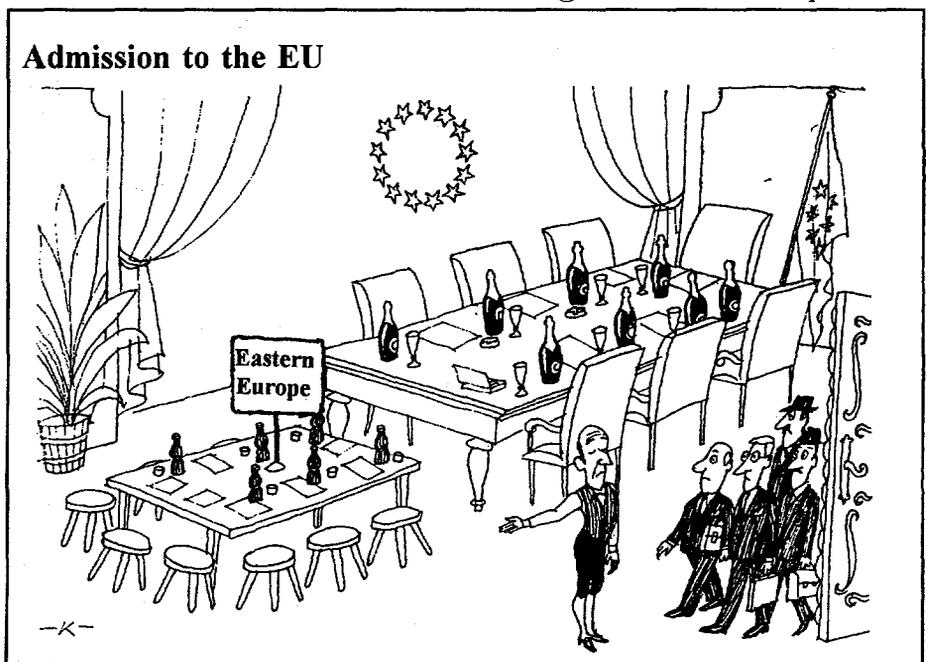
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