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## Overcoming Institutional Barriers and Sociocultural Conflicts in China

By Chi Fulin

China's reform has entered the stage when the government must engage in coordinated reform efforts in the economic, political, and social spheres. The lack of social credibility, the frequency with which instances of corruption have come to light, and the sluggish pace of reform are leading to increased public frustration. Compared with the early stages of reform and economic opening, the current problems are more a result of both institutional barriers and cultural conflicts.

China's feudal legacy poses a direct threat to its transition to a market economy. Currently conflicts exist between rule by individuals versus rule by law, a bureaucrat-oriented culture versus a people-oriented culture, an all-embracing government versus limited government, and government-driven development versus market-driven development. Unless the cultural legacy of feudalism is rooted out, market economic principles could be seriously distorted, or even worse, the outcome could be an inefficient and corrupt market economy.

China's transition to a market economy and institution building should be closely related to sociocultural development. Institutions—which represent a common public understanding of the rules governing their daily activities—require conceptual change. In a traditional planned economy system the government bureaucracy follows a top-down control approach based on the public ownership of all means of production; a rigid hierarchical structure; and a highly integrated structure governing the functioning of the party, the government, and enterprises. Such a highly centralized system played an extremely important role in the early years following the founding of the People's Republic of China; however, after more than two decades of reform and opening, productive forces underwent a tremendous change, and the shift in economic management and the diversification of the ownership structure, as well as of social interest groups, have become irreversible. Thus institutional arrangements and sociocultural

concepts should reflect such changes as the following:

- **The authoritarian nature of society should gradually change into a society based on competence so as to weaken the decisive role of the authorities and strengthen the role of market mechanisms in resource allocation.** In the process of developing a socialist market economy individuals should be able to reap the rewards of their success as they attempt to use their skills and capabilities.
- **The top-down administrative system should gradually change into one based on consultation and cooperation.** To improve efficiency a network-based, horizontal structure should be encouraged.
- **The state-run society should gradually change into a civil society.** Outdated concepts of a planned economy should be abandoned and replaced by approaches based on community self-governance; trade discipline; career building; and independent individuals characterized by self-esteem, self-reliance, and self-empowerment.

China's anticorruption campaign is also related to its sociocultural development. A brief analysis of the spreading corruption in China indicates that the most urgent task is to prevent the abuse of power through democratic principles and the rule of law. Some public agencies have become rent-seeking tools of a few government departments and officials, and there are signs that these practices are becoming institutionalized among entire groups. Such vested interest groups could block



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*Richard Hirschler, Senior Editor*

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further reform efforts. Corruption resulting from loopholes in the system has seriously distorted the operational mechanisms of the market economy, threatened social stability, and lowered people's expectations of reform. It is also one of the important reasons why there is so little public tolerance for the widening income gap. It is noteworthy that some corrupt practices have become generally accepted and are regarded as "normal rules of the game" in a market economy. Such "conceptual corruption" is extremely harmful.

Thus to sum up, new institutions and concepts are needed and the obstacles to reform need to be dismantled if the country is to continue on the road to economic and social progress.

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# China Removes Barriers for Private Firms

**China's Communist Party supports the growth of private business and welcomes entrepreneurs into its ranks. China's booming private sector and foreign investors will be treated on a level playing field with state sector firms, announced Zeng Peiyan, head of the State Development Planning Commission, and Li Rongrong, chief of the State Economic and Trade Commission, at a news conference on November 11 held during the 16th National Congress of the Chinese Communist Party. Private enterprises will be treated the same as state-owned and foreign-invested enterprises in relation to market access, land use, taxation, credit, and foreign trade.**

In 1989 China had 90,000 private firms. Today it has more than 2 million. Private firms currently account for about one-third of China's GDP. The private sector is employing more people and hiring them at a faster rate than any other sector in the economy. While private firms are banned from doing business in a variety of areas, both Li and Zeng said those barriers would soon fall. Already in eastern China, said Zeng, private road repair companies, banks, and trash collection firms, all of which in theory must be owned by the state, operate openly. He added that private businesses would be granted equal

access to bank credit and may even be allowed to issue bonds to raise capital. All economic sectors open to foreign capital will also be open to domestic private businesses, but foreign businesses will now have the right to buy into the state-owned companies listed on China's two stock exchanges. Previously about 65 percent of the shares in those firms were not traded.

### Leveled Playing Field

Areas closed to private businesses in the past would be opened to private capital. This follows private firms' complaints that their access to bank loans is restricted, in part because many banks have no credit mechanism, and in part because many banks are controlled by local governments that favor state-owned firms. Li said that such "policy lending" will stop. "The playing field will be leveled," Zeng pointed out. The officials also said that China had begun an experiment to let farmers amass larger parcels of land. Farmers will be allowed to sell their land use rights to permit economies of scale in agriculture.

Zeng said the country's economy would grow by 8 percent this year, up from 7.3 percent last year, and GDP would hit \$1.2 trillion. Total trade this year should reach \$600 billion, while foreign investment in China surpasses \$50 billion. Chinese officials and economists have predicted that the nation's GDP will quadruple by 2020 to Y35 trillion (\$4.24 trillion). With an estimated per capita GDP surpassing \$3,000 by 2020, China's standard of living should be equivalent to that of a moderately developed economy.

Around 14 million people in urban areas are without work, representing around 7 percent of the entire urban labor force, Minister of Labor and Social Security Zhang Zouji told a press conference also organized on the occasion of the Party Congress. Nevertheless, the number of people employed across the country rose from 650 million in 1990 to 730 million in 2001. The service industry has become a major channel for surplus laborers. Its share of the employment pie increased from 18.5 percent in 1990 to 27.7 percent in 2001, the minister said. The rapid development of individual and private businesses has also contributed significantly to the country's employment efforts, which must take account of the 10 million more people that enter the workforce each year. Statistics indicate that 30 million urban residents found jobs in the private sector from 1990 to 2001. Substantial progress has been made in re-employment, with 17 million of the total of 26 million

workers laid off from state-owned enterprises having found new jobs from the beginning of 1998 to June 2002, said Zhang.

### Rural Labor Surplus

By September 2002 the number of people shielded by unemployment insurance totaled 101 million, an increase of 36 million over 1989. The government plans to sell off state-held shares as part of its efforts to both restructure state-owned enterprises and provide the funds for social welfare. Zhang said that building a comprehensive social welfare system was extremely difficult, especially in rural areas, where traditional forms of social security centered on land use are changing, with proposals being suggested for farmers to make regular pension fund contributions. Some 60 million farmers are currently in such pension fund programs and about 1 million have started to collect pension benefits. Headway has been made in reforming the pension insurance system, and reform of the comprehensive medical insurance system has been initiated, he said.

A truly "well-off" society cannot come into being in China if its farmers are not leading a fairly comfortable life, said Du Qinglin, minister of agriculture, on November 8. "Compared with urban areas, the rural areas are facing more difficulties, especially in raising the income of farmers," he said. Part of the solution would be to speed up the transfer of surplus rural labor to nonagricultural industries and to cities and towns. Du said: "We have realized that to make farmers better off, the rural population has to be reduced." The shift last year of at least 100 million farmers to nonfarming sectors and urban areas had added an average Y1,066 (US\$128) each to their annual incomes. The Engel coefficient—the proportion of food expenditure in consumer expenditure—had dropped from 54 percent in 1988 to 47.7 percent last year for rural people, a key indicator that farmers are increasingly attaining a better standard of living. Du said his ministry intends to further improve agricultural modernization and industrialization and develop township and village enterprises and the rural service sector, all of which can help absorb rural surplus labor.

### Growing Middle Class

The term "well-off" society or a "well-to-do life"—*xiaokang* in Chinese—was used in a modern sense by China's architect of reform, Deng Xiaoping, in 1979 to describe the realization of Chinese-style modernization. It was

later translated into 16 indexes, including per capita income, protein intake, life span, the Engel coefficient, and telecommunications, according to Lu Shuzheng, an economist in Beijing. Most of China's 1.3 billion people remain poor, but a growing number of *xiaokang* live comfortable, even affluent, lives. As costs are low, a family with an annual income below the U.S. poverty threshold of about \$14,000 per year can enjoy middle-class comforts, including stylish clothes, Chinese-made color televisions, DVD players, and cell phones. Economists are forecasting a middle class of more than 400 million people in 10 years time.

However, prosperity in today's China is far from universal. Hu Angang, a researcher with the Chinese Academy of Sciences, says China now has about 20 million urban poor with a per capita monthly income of less than \$18.30 (152 yuan). With surplus farmers and laid-off employees from state-owned enterprises flooding into major cities, the number has shot up by more than one-third in the last three years.

*Based on reports in the Washington Post, USA Today, and the Far Eastern Economic Review and from news agencies.*

## China Is Becoming the World's Manufacturing Powerhouse

China is now the world's fourth largest industrial producer behind the United States, Japan, and Germany. Once viewed as the 1 billion people market, China is becoming the world's factory floor, and its competitiveness is redrawing the global corporate landscape. Beginning in May this year, U.S. imports from China have consistently begun to outstrip those from Japan. And while for decades China has sent mostly low-end products like textiles and toys to the United States, it is now starting to sell more sophisticated goods to American consumers, like computers and DVDs. China's hi-tech exports to the United States are now growing faster than any other exports, up 47 percent in the first seven months of this year from a year earlier. Foreign investment in China continues to soar and could reach a record \$50 billion this year.

China, with its 7 to 8 percent average annual growth, is slowly regaining its historical prominence in world output. By some estimates, in 1820 China's economy accounted for 36 percent of global GDP (by comparison, in 2001 the United States produced 33 percent). In the last 10 years alone, China rose from the 12th largest economy (based on exchange rate calculations) to the 6th. With continued growth China will be a key source of demand for the global economy. Such a development would be critical if the United States economy were slowed by "balance sheet repair."

### Foreign Sales Records

China's exports totaled \$266.2 billion in 2001—equivalent to 5 percent of the world's total exports—and are on track to surpass that figure this year. (Note that half of this total comes from foreign manufacturers or their joint ventures in China.) China makes more than 50 percent of the world's cameras, 30 percent of its air conditioners and televisions, 25 percent of its washing machines, and nearly 20 percent of its refrigerators. A private Chinese company is among the world's biggest aluminum,

copper, and steel producers. Guangdong Galanz Enterprises now accounts for 40 percent of all microwave ovens sold in Europe and Wenzhou, a city in eastern China, sells 70 percent of the world's metal cigarette lighters. Even Chinese farm produce, once too expensive for the global market, is finding its way onto dining tables in the United States, Europe, and elsewhere in Asia. In June exports of electronic products from China to the United States hit \$1.2 billion, up 12.3 percent from May.

When Philips Electronics began prospecting for opportunities in China in the early 1980s, the Dutch company adopted what seemed an obvious strategy at the time: sell products to a billion Chinese. Instead China became a place where the company made its products—and then shipped them elsewhere. Today Philips operates 23 factories and produces about \$5 billion worth of goods in China each year, nearly two-thirds of which are exported overseas. From General Electric (GE) to Samsung Electronics to Toshiba, as well as thousands of Chinese companies, manufacturers are finding that using China as an export base is often more profitable—and almost always far easier—than selling goods inside the country. GE's sales revenue in China



reached \$1.6 billion last year. GE plans to expand the amount of goods it buys in China to at least \$5 billion over the next three years. More of GE's trademark refrigerators will be made by independent Chinese manufacturers, after which GE will stick its label on the products, and more parts for GE's gas turbine engines, used to generate electricity, will be made in China.

China has also become a huge well-head of supply for large U.S. retailers like Target and Wal-Mart. Wal-Mart has been buying goods in China and stocking its stores with them for more than 20 years, and the supply continues to grow. About \$10 billion in Chinese-made merchandise makes its way to Wal-Mart store shelves every year, either directly from manufacturers in China or from other suppliers that source their goods in the country.

### Exporting Deflation

In China, concern about the evolution of market-based institutions drives high precautionary savings (surpassing the \$1 trillion mark in August), depressing domestic demand. The dysfunctional financial system channels domestic savings through the state-owned commercial banks, resulting in excess levels of credit for state-owned enterprises. This feeds excess capacity—sustaining domestic deflation—and starves the private sector of capital. Thus the most productive segment of the economy focuses on overseas markets to generate funds internally. This over-reliance on the external sector “exports” China's own deflation to the rest of the world.

Since 1996 Chinese export prices have slid 15 percent according to BCA Research, a Montreal market research firm. As U.S. imports from China are rising—televisions and audio equipment rose at a 13 percent annualized rate between 1998 and 2001 to \$6 billion in 2001, tools and metal implements were up by a 23 percent annual rate to more than \$1.5 billion in 2001, and sporting goods rose at 16 percent to \$2 billion—U.S. retail prices in many of these categories are falling. The prices of televisions have fallen, on average, by 9 percent each year since 1998 according to U.S. Labor Department data; tool prices have fallen 1 percent each year, on average; and sports equipment prices have dropped by a 3 percent annual rate. While the flood of cheap Chinese imports has translated into some lost jobs for U.S. workers who compete against Chinese manufacturers, it has been a boon for consumers.

National Presto Industries, a U.S. manufacturer of pressure cookers, pans, and other kitchen equipment, has

felt China's deflationary forces first-hand. Between 1998 and 2001 total U.S. imports of household cooking equipment from China more than doubled to \$640 million. As a result, National Presto has been forced to drop the price of its pans from \$49.99 to \$29.99 in just three years. To keep costs low, the company decided early this year to shut down plants in Mississippi and New Mexico and to expand production in China.

“China's rise as a manufacturing base is going to have the same kind of impact on the world that the industrialization of the U.S. had—perhaps even bigger,” says Andy Xie, an economist with Morgan Stanley in Hong Kong, China. Yet China's impact on global price deflation should not be overstated. Despite its rising domination in many export markets, China is but one force driving prices down around the world. Changes in the global economy like NAFTA and European economic integration, both of which improved the flow of goods, mean that the world faces an ever larger supply of goods, even as demand changes little. Gains in technology have spurred productivity, helping to hold down prices. And now the slowdown in the U.S. economy, by far the world's biggest consumer and its most important economic engine, has added significantly to the global glut of goods. In any case, the falling prices of manufactured goods could be more than offset by rising prices for many services such as education, health care, and housing.

Nearly half of all the goods China sends overseas each year are made by foreign companies such as Motorola and Philips manufacturing in that country. Foreign investment continues to soar and is on track to hit a record \$50 billion this year. Motorola says its total investment in China will reach \$10 billion within four years, up from \$3.7 billion now. Honda Motor is setting up China's first export-focused car factory. Toshiba is building one of the world's biggest laptop computer factories outside Hangzhou, with output next year pegged at 750,000 units and growing to 2.4 million in 2004, the vast majority of that destined for export.

### Unbeatable Labor Costs

China's “capitalism” works like this: a new product is introduced, often by a foreign company, and within months a throng of manufacturers, many of them private Chinese companies, start cranking it out. Raging competition sets in, sending prices sliding, and before long producers look to new markets, increasingly overseas. Driving all this is a combination of forces—foreign investment worth more than \$600 billion over the last two

decades, an appetite for foreign technology, and a nationwide entrepreneurial zeal—that have spawned one of the world's most competitive markets.

Of China's population of 1.3 billion people nearly 700 million live on farms and earn, on average, just \$285 per year, compared with the average U.S. household income of nearly \$40,000 a year. These minuscule wages have slowed China's transition to a consumption-driven economy along the lines of that in the United States; however, they have also resulted in an almost endless supply of low-priced labor that not only allows companies to control costs, but often to cut them dramatically. Competitive labor costs are not limited to low-skilled industries: the labor cost advantage is also extremely strong in sectors that require highly skilled employees, such as the science and technology sectors.

Over the past decade China's pace of growth has doubled that of wages adjusted for inflation. A booming private sector adds to its export clout, absorbing excess workers and keeping costs low. And in the long run the government's control over its currency offers another tool for ensuring that China's exports stay competitive. As the Chinese government relaxes its export rules, a new generation of nimble Chinese companies—particularly private enterprises—is beginning to focus on overseas sales as well. Exports by private Chinese companies increased by nearly 50 percent in the first half of this year.

*Based on reports from Oxford Analytica, the U.K.-based international research group, and from articles by Karby Leggett and Peter Wonacott published in the Far Eastern Economic Review and the Wall Street Journal.*

## Wolfensohn and Putin Praise Russia-World Bank Relations

**During his mid-November visit to Moscow World Bank President James Wolfensohn, along with Russian President Vladimir Putin, expressed satisfaction about current relations between the Bank and Russia, including consultations on the future course of Russia's economy. In connection with Russia's plans for its economy, in an article published in the *Moscow Times* two of the Bank's leading experts on Russia warn about the dangers of ownership concentration, of the small numbers of new firms entering the marketplace, and of the lack of diversification in the economy, while acknowledging the considerable achievements of the past few years.**

"We have been working with the Bank since 1992. During this time the Bank has extended about 50 loans totaling \$12 billion to Russia. This year Russia will repay \$1.2 billion, and next year \$2.2 billion," said Putin, and praised the Bank's new country assistance strategy for 2003-05. [Editor's note: The strategy envisages lending and guarantees of up to \$600 million each fiscal year during the period, underpinned by an extensive program of analytical work in support of the reform agenda.] Putin also praised such joint projects with the Bank as "combating AIDS and tuberculosis . . . and joint work on a future global financial architecture." He remarked: "In the view of the Russian leadership, the role of the World Bank in stabilizing the global economy and creating stable conditions in the financial sphere is important today and it should continue in the future."

Wolfensohn, for his part, said that he thought the World Bank and Russia were now operating "on the same page," and that relations between Russia and the Bank are good. While summing up the results of his visit to Moscow during

a press conference, he pointed out that Russia is an attractive country for foreign investments against the backdrop of a global economic recession. "Russia's investment potential is huge, not only because of large oil reserves, but also because of progress in structural reforms and Russia's lack of many shortcomings that are typical for other developing markets," he noted.

The Bank has approved three loans this year for various reforms: \$120 million for fiscal federalism and for regional finances, \$100 million for tax administration reform, and \$231 million for the Treasury. Another three loans are scheduled for approval before the end of the Bank's current fiscal year on June 30, 2003: \$150 million to fight AIDS and tuberculosis, \$140 million to modernize the customs service, and \$160 million to develop the economy of St. Petersburg.

The news comes as Julian Schweitzer, World Bank country director for Russia, and Christof Ruehl, World Bank chief economist for Russia, wrote in the *Moscow Times* that after the chaos of the 1990s, a reform-minded, stable

government is now in place in Russia. Privatized industry has consolidated itself as well, and now faces incentives powerful enough to lift the economy permanently out of its second-tier status to catch up with the advanced market economies of the OECD. Rapid growth is sustainable, because secure property rights have finally been established. The new owners of industry want market rules and institutions that foster and safeguard market behavior, making this development irreversible; however, three major economic issues remain to be resolved, namely:

- **Competition:** "People of the same trade seldom meet together, even for merriment and diversion," wrote Adam Smith, "but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices." A recent survey by the World Bank and the Center for Economic and Financial Research indicates that throughout Russia, barriers to entry for new businesses are higher where production and employment are concentrated, and plenty of anecdotal evidence suggests that powerful regional interest groups continue to impede competition and the creation of new firms. As the big financial and industrial groups acquire ever more assets in their noncore sectors, whether these groups will become advocates of procompetition policies, keep an arms-length distance from regional governments, and fight barriers to entry for their competitors is not clear, nor is whether the full benefits of their new investments will naturally accrue to consumers. In sum, Russia's powerful conglomerates are unlikely to act differently from monopolies elsewhere in the world.

- **Why powerful interests holding concentrated ownership positions would support those institutions that are vital for the effective functioning of a market economy is not clear.** If they follow their own best interests, the conglomerates might be ill-advised to demand effective antitrust legislation, protection of minority shareholder rights, or independent regulatory bodies that mold secondary capital markets so as to facilitate takeovers. Some compare the situation in Russia today with that in the United States a century ago. The U.S. economy only opened up, became accessible

for new enterprise startups, and experienced the large boost of productivity and growth that moved the country to its current position after the introduction of decisive antitrust legislation. Russian conglomerates are unlikely to be any more supportive of such equal opportunity policies than their American counterparts were a century ago.

- **While a degree of inequality in the distribution of wealth is necessary to ensure effective control of large public companies, too skewed a concentration of ownership may be detrimental.** If a large fraction of society's wealth is concentrated in too few hands, limitations of time and knowledge will undermine the ability of this small group to run a large share of society's productive capacity effectively.



James Wolfensohn and Vladimir Putin in the Kremlin.

recently suggested? The concentration of ownership rights, the small numbers of new firms entering the marketplace, and the lack of diversification in the economy all suggest that despite the considerable achievements of the past few years, much reform work remains to be done. Russia is not on autopilot yet conclude Schweitzer and Ruehl.

In a new report released on November 13 on the EBRD's strategy in Russia, the EBRD warns Russia's government that the country's heavy dependence on its booming oil and gas exports may delay badly needed economic reforms and tempt the authorities to continue subsidizing inefficient industries. Oil and gas account for roughly half of Russia's exports and a fifth of its GDP. "Continued growth of the Russian economy is highly vulnerable to commodity price cycles, which can only be partially offset through fiscal and exchange rate policies," the report cautions. Fueled by an oil export boom, the Russian economy is expected to grow by about 4 percent this year, comfortably outstripping the performance of most European countries.

*Based on reports from the World Bank and news agencies.*

# The Great Divide and Beyond: Financial Architecture in Transition

By Erik Berglof and Patrick Bolton

**A growing and deepening divide has opened up between those transition countries where economic development has taken off and those caught in a vicious cycle of institutional backwardness and macroeconomic instability. This “great divide” is increasingly visible in levels of financial development. The great divide in economic and financial development and the convergence in financial architecture among the successful countries raise fundamental questions about how financial development interacts with economic growth.**

Strikingly, the basic financial architectures of the transition front-runners—primarily the Czech Republic, Hungary, Poland, Slovenia, and the Baltic states—are remarkably similar, in that they are strongly dominated by commercial banks, increasingly foreign owned, that lend primarily to the government. Stock markets are highly volatile and illiquid, and their sustainability is in question as the numbers of listed firms are stagnating, or even falling (see table 1). Enterprises rely primarily on internally generated funds, and the bulk of external long-term finance comes from foreign direct investment.

Financial development does not explain why a small group of countries developed and grew while most transition economies remained mired in economic stagnation. In general, the financial sector has played a small role in restructuring the manufacturing sector in transition economies, and in some cases financial liberalization may have undermined real sector development.

Governments’ ability to take fiscal and monetary responsibility, committing themselves to refrain from excessively bailing out failing banks or loss-making enterprises, and to enforce the rule of law, determined whether economic and financial development took off.

Specific initial conditions and underlying country characteristics facilitate the emergence of fiscally sound governments capable of enforcing the rule of law.

## Emergence of the Great Divide

All banking systems in transition economies have evolved from a single institution, the monobank, which was responsible for both monetary policy and commercial banking. The financial sector’s transition from a planned economy to a market-oriented economy involved transforming the monobank into a decentralized financial system, which started by separating the central bank from commercial banking and by breaking the latter up into

**Table 1. Number of Companies Listed on the Stock Market, Selected Transition Countries, 1994-2000**

Country	1994	1995	1996	1997	1998	1999	2000 <sup>a</sup>
Czech Republic	1,024	1,635	1,588	276	261	164	154
Estonia	0	0	0	22	26	25	23
Hungary	40	42	45	49	55	66	65
Latvia	0	17	34	50	69	70	64
Lithuania	13	357	460	607	60	54	54
Poland	44	65	83	143	198	221	221
Slovenia	25	17	21	26	28	28	34
Bulgaria	16	26	15	15	998	828	842
Romania	4	7	17	76	5,753	5,825	5,578
Russia	72	170	73	208	237	207	218
Slovakia	19	21	816	872	837	845	843
Ukraine	0	96	99	102	113	117	120

a. Through March.

Sources: S. Claessens, S. Djankov, and D. Klingebiel, *Emerging Markets Factbook* (Washington, D.C.: International Finance Corporation, 2000); World Bank, “Stock Markets in Transition Economies,” Financial Sector Discussion Paper no. 5 (Washington, D.C.).



multiple smaller units. Most countries also allowed for the entry of new banks.

After the initial pain of the credit crunch and several banking crises, the eventual outcome in some Central European and Baltic countries was stable monetary and fiscal policy. These countries managed to gradually reorient their productive sectors and integrate them with world trade, thereby jump-starting the growth process early on. In other transition countries, including most of the former Soviet Union republics as well as countries in Southeast Europe, like Bulgaria and Romania, the authorities did not or could not resist the pressures for financial relief. After only a few months of attempted stabilization, central banks provided additional loans to commercial banks and monetized the rapidly increasing stocks of credit. The repeated bailouts of banks and businesses delayed enterprise restructuring, weakened the banks, and increased the banks' appetite for more inflationary credit bailouts. As a result, these countries have experienced a protracted slump. The great divide had opened up.

The differences in financial development are apparent mostly in measures of financial reform and general institutional quality, such as laws on the books and law enforcement indexes. While most transition countries have adopted increasingly sophisticated legal and regulatory frameworks in the financial area (similar to those used in table 2), implementation and enforcement are significantly better in countries on the "right" side of the divide. So what explains these differences in institutional quality?

The transition experience does not reveal a single magic policy formula that guarantees a successful path for financial and economic development. The countries that have failed to bridge the great divide have tried a variety of policies, and several types of dysfunctional financial systems have emerged. Russia and Ukraine have privatized most commercial banks, but many of the them are insolvent and should be closed down. The 1998 financial crisis hit financial institutions and markets in these two countries severely. Corruption, crime, and cronyism undermine enforcement of the legal and regulatory framework and political resistance toward further reforms remains strong. A second group of less successful transition countries, including Bulgaria, Romania, and Slovakia, have only made partial attempts to reform. The largest banks in these countries are still predominantly state owned. In addition, the presence of a large number of insolvent banks undermines competition. While the regulatory environment is improving, enforcement remains weak.

In the more successful CEE countries, financial architecture is converging despite major differences in policies, including procedures for restructuring bad loans; strategies for privatizing enterprises and banks; and approaches to removing barriers to foreign entry in the banking sector, entry of new banks, and stock market development. The approach to cleaning up bank balance sheets has also differed significantly across transition countries. Both the extent to which banks were induced to stop rolling over bad debts to enterprises and the methods used to recapitalize banks varied widely. Some countries, like the Czech Republic, transferred bad debts to specialized "hospital" banks, while others, like Poland, chose to clean up balance sheets within existing institutions.

In an attempt to encourage banks to stop rolling over their bad debts and to deal with the growing problem of payment delays, Hungary adopted a devastatingly effective bankruptcy law. It had an automatic trigger that overnight forced much of Hungary's industry into court-led bankruptcy procedures, but the sheer number of cases paralyzed Hungary's courts. Inevitably, Hungary had to quickly water down its new bankruptcy law and remove the automatic trigger. In a similar attempt the Czech Republic adopted a bankruptcy code just after its mass privatization program, but suspended its application for two years in response to political pressure from many unprofitable state-owned and privatized firms. Once the Czech bankruptcy law came into force it led to a wave of takeovers of smaller, not necessarily less efficient, firms by large, politically connected firms. In a more pragmatic approach, Poland opted for informal workouts outside the courts under a moratorium on bankruptcy, with the government offering to give up the seniority of its tax claims to provide incentives for banks and firms to agree to restructure their bad loans.

Bank privatization accelerated across Central Europe in the second half of the 1990s, but governments often retained strategic stakes. Private ownership did not take a firm hold in the banking sector of most countries until foreign banks were allowed to acquire strategic stakes in the domestic banking sectors. Hungary was the first country to allow widespread foreign penetration in the banking sector, and foreigners now control more than 40 percent of shares in Hungarian banks, accounting for as much as 80 percent of assets.

The Baltic states of Estonia, Latvia, and Lithuania also have high shares of foreign ownership, primarily from banks based in the Scandinavian countries. The shares

of foreign ownership of banks in Poland and the Czech Republic are 52.8 and 50.7 percent, respectively. In the countries on the “wrong” side of the great divide the presence of foreign banks, as well as other foreign direct investment, is much more limited, partly by design and partly by default. Understandably, foreign banks have been reluctant to buy stakes in weak institutions.

In the Baltic states and in Russia the number of registered banks increased dramatically in the early years of transition. Most new entrants, which were small and closely tied to newly privatized enterprises, quickly became insolvent. In Albania, Romania, and Russia devastating episodes of frenzied speculation around a small number of unscrupulous banks that started unsustainable pyramid or Ponzi schemes, which drew in thousands of inexperienced and gullible households, led to severe financial crises and seriously undermined confidence in banking institutions. By contrast, in the CEE countries new bank entry has taken place on a much smaller scale. Foreign-owned banks and banks with stronger capital-asset ratios are growing more rapidly than other banks. On the whole, the growth of bank loans has not kept pace with real sector growth.

Despite these marked differences in policies, the financial systems in the more advanced transition countries have converged and now share the following three key features:

- **Their financial sectors are strongly dominated by banks, which lend primarily to governments and other financial institutions.** Banks provide some working capital finance to the corporate sector, but so far have played a limited role in financing investment, which comes almost exclusively from retained earnings. Most external finance comes through foreign direct investment.
- **Ownership structures in individual firms are concentrated and the turnover of shares is low.** Only stock markets in the Czech Republic, Estonia, Hungary, and Poland have capitalization to GDP ratios comparable with those of other emerging markets (23, 37, 36, and 20 percent, respectively). Most stock exchanges are illiquid with trade concentrated in a small number of firms. The number of listed firms has decreased because of foreign acquisitions, domestic mergers, and delisting. The best firms prefer the quality stamp and liquidity of the international stock markets in Europe and the United States.

**Table 2. Indicators of the Development of the Banking Sector, Selected Transition Countries, Selected Years**

Country	Concentration <sup>a</sup> (%, 1997)	Number of banks (1999)	Asset share of state owned banks (%, 1999)	Bad loans/ total loans (%, 1999)	Loan-deposit rate spread <sup>b</sup> (1999)
Czech Republic	74.9	42	23.2	31.4	4.2
Estonia	84.5	7	7.9	3.1	4.5
Hungary	67.4	39	9.1	2.8	3.4
Latvia	53.1	23	8.5	6.3	9.2
Lithuania	69.7	13	41.9	11.9	8.2
Poland	42.3	77	25.0	14.5	5.8
Slovenia	71.7	31	41.7	10.2	5.1
Bulgaria	86.7	283	663.0	12.9	9.6
Romania	85.0	34	50.3	36.6	—
Russia	53.7	2,376	41.9	13.1	26.0
Slovakia	84.5	25	50.7	40.0	6.7
Ukraine	64.4	161	12.5	3.3	34.3

— Not available.

a. Concentration is defined as the ratio of the assets of the three largest banks to total banking sector assets.

b. The loan rate is defined as the average rate charged by commercial banks on outstanding short-term credits to enterprises and individuals weighted by loan amounts. The weighted average of credits of all maturity is used for the Czech Republic, Lithuania, and Ukraine. For Poland only minimum risk loans are considered. The deposit rate is defined as the average rate offered by commercial banks on short-term deposits weighted by deposit amounts. The weighted average of deposits of all maturity is used for the Czech Republic, Estonia, Lithuania, and Ukraine.

Sources: IMF, *International Financial Statistics* (Washington, D.C., various years); IMF staff country report no. 00/59 (Washington, D.C.); World Bank database on financial development and structure; EBRD, *Transition Report 2000*.

● **Bank spreads—the difference between lending and borrowing rates—have declined significantly in most CEE countries.** Nevertheless, they remain high by developed market economies' standards.

### Why Not Follow a Proven Recipe?

Financial development at any given point in time—as measured by the ratio of bank lending to GDP and/or the ratio of stock market turnover to GDP—is positively correlated with future per capita economic growth. The implied prescription for transition economies is to focus on financial reform as one of the ways to achieve economic growth. Empirical studies have found that financial development is affected by the following:

● **Legal protection of investors.** The theory is that legal origin matters. The Anglo-Saxon (common law) traditions are more investor-friendly than the French, German, or Scandinavian (civil law) traditions, and a clear causal link is apparent between the degree of investor protection, the flow of outside investment to corporations, and financial development. However, in 1913 financial development was significantly higher in France than in the United States, thus at that time the French legal system was apparently not holding back investment flows to corporations. Global financial development peaked before World War I, then declined until well after World War II, before peaking again at the turn of the 21st century. This financial history suggests that other important factors affect financial development besides legal protection.

● **Political power of incumbents.** Insiders, primarily incumbent managers or owners and labor unions, are inherently opposed to financial development, because it would result in greater competition from new entrants. In times of crisis or conflict these insiders gain more political influence and are able to push through legislation that protects their interests and inhibits the growth of financial markets. With greater prosperity, however, these interest groups lose their grip on political power, so that eventually new legislation is passed that fosters the development of financial markets.

● **Insider control.** In most transition countries privatization resulted in a transfer of control to incumbent management, and in some cases to workers. Without effective bonding devices or mechanisms to transfer control to investors, firms have been confined to defensive cost-cutting measures and growth based on internally generated funds.

● **Other factors** have also been involved, such as the confidence in financial markets and institutions; the

extent of social programs, including the pension system; the size of the public sector; and the magnitude of government debt and the resulting trend in long-term interest rates.

Most developing economies have bank-based financial systems and financial markets play a relatively minor role. Financial markets, including stock and bond markets, only begin to play an increasingly important role at more advanced stages of development. The transition experience lends some support to the notion that bank-led finance may be inevitable at certain stages of development, and that efforts to develop stock exchanges in some countries may have been premature; however, the evidence of a link between bank-based development and economic growth is weak.

Why do some countries tend to have fiscally irresponsible governments? What determines whether a government will be able to show fiscal and monetary restraint and not end up on the wrong side of the great divide?

● **Political and economic costs of resisting calls for bailouts.** The Soviet system typically involved production on a very large scale, with in many cases only one firm producing or assembling a particular good. Stalin and later Soviet leaders decided that the various regions should be overspecialized and interdependent, and thus they increased the costs of separation. In addition, the Soviet economy had a disproportionately large military-industrial sector, where the choice of geographic location for a factory was often made for political reasons rather than because of its comparative advantage. The legacy of these arrangements is the many one-factory towns in Russia and the fact that large segments of the population are living in economically nonviable areas. Following the breakup of the former Soviet Union, most newly independent states inherited a highly concentrated, and often also an economically nonviable, industrial base that they had little choice but to keep afloat, at least in the short run.

● **Enterprises' lobbying efforts for more subsidies and bailouts.** In many countries more or less formalized groups of financial and industrial firms have formed—partly because they were previously connected to the same administrative structure—to extract benefits from the government. Several studies in Russia have shown that while such groups were able to relieve the credit constraints of individual member firms, they may also have extracted inefficiently large resource transfers from the state.

- **Ability to raise taxes and other revenues.** Several countries that have crossed the great divide have been able to raise significant revenues by privatizing state assets, limiting tax evasion, and facilitating the enforcement of existing rules and regulations. This ability is closely related to the state's legitimacy combined with the country's experience with democratic government. The political economy is also critical: income distribution will affect the support for fiscal and monetary responsibility and for the enforcement of property rights.
- **Geographical proximity and likelihood of accession to the EU.** If countries are located close to markets with large and rich populations, the potential benefits of trade are greater and restructuring appears more attractive. Most of the growth in CEE has come from new firms or firms with extensive trade links with the West during the communist era. The possibility of joining the EU has also played an important political role in advancing the reform process in much of CEE.

### Chasing a Moving Target

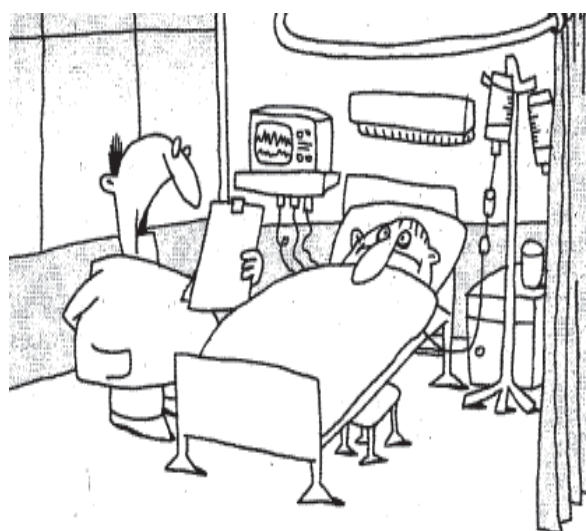
The task of transforming centrally planned economies into well-functioning market economies appeared to be so simple to early reformers that in the early days several plans were proposed to complete transition in less than 500 days. A decade or more into transition it is fair to say that even the front-runners are far from completing their financial transition. Even though the basic financial architecture of a market economy is now in place in the countries on the right side of the great divide, banking and other financial institutions do not yet perform their intended functions of channeling savings to the most productive investments.

Another unexpected development of the past decade is that the financial systems of advanced market economies are themselves evolving rapidly. Reformers only belatedly realized that the transition process partly involves chasing a moving target. As the Berlin Wall was falling, deep shifts were occurring in the financial systems of the industrial market economies, with a greater role for securities and derivatives markets, venture capital financing being followed by initial public offerings, and an acceleration in international financial integration to levels not seen since the end of the 19th century. With the spread of international finance, policies aimed at developing local stock markets in transition economies rapidly became outdated, even counterproductive. Similarly, the greater financial integration of the EU and of the world at large increased the desirability and sustainability of foreign banks in transition economies.

The ongoing globalization of the financial industry raises the issue of whether talking about national financial systems is still meaningful, at least for economies that are small by global standards. The remarkable presence of foreign commercial banks in the transition economies in CEE integrates these national financial sectors into the global strategies of a small number of large financial institutions. To what extent can we talk about domestic financial intermediation when external finance for investment comes mostly from foreign savings? What influence do domestic regulators and regulation in transition economies have on the behavior of institutions with a global reach? These are some of the new questions for financial development posed by the current trends of world financial integration.

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### Cautious Doctor



**"I will be straightforward, we cannot expect miracles. Considering the present state of medical science I have to ask you to give me my fee in advance."**

From the Hungarian daily *Népszabadság*



# Russia Needs a Competitive Banking Sector

**Most large Russian banks that survived the devaluation and banking crisis of August 1998 appear to have returned to profitability. Top-tier Russian banks can now offer clients a broader range of products than just cash management services, but only a fearless few have begun to engage in market-driven deposit taking and corporate and consumer lending. Less than 40 percent of Russian banks' loan portfolios consist of credits extended for a year or more. Bank lending remains tied to the structures of Russia's financial-industrial groups, with intragroup credits accounting for an estimated 43 percent of total credit, and the government or leading domestic companies continue to run the largest banks. The new leadership of the central bank is ready to implement changes.**

Russian banks are not making significant loans to companies, which must finance investment from their own profits. Russia's banks account for only about 3 percent of overall investment and suffer from a shortage of reliable clients. Loans are too expensive for all but the biggest enterprises, and lending represents only 40 percent of bank assets. Russian banks are inefficient and operating expenses are high. Despite much talk about capital flight out of Russia, much of that money never leaves the country: at least \$30 billion in savings—and probably much more—is kept in U.S. dollars “under mattresses.” This tough criticism of Russian banking was delivered by none other than Petr Aven, the head of Alfa Bank, one of Russia's largest commercial banks. The largest retail-commercial bank is Sberbank, majority shares of which are controlled by the central bank. Sberbank, with thousands of branches nationwide, used to be the only savings bank during the Soviet era and still holds 73 percent of all deposits. Alfa Bank comes second as a retail bank, but holds a mere 2 percent of all bank deposits.

The top 10 Russian commercial banks, ranked according to their capital strength as of July 2002 are as follows: 1. Sberbank, 2. Vneshtorg (Foreign Trade) Bank, 3. International Industrial Bank, 4. Alfa Bank, 5. Gazprombank, 6. Globexbank, 7. Rosbank, 8. MDM Bank, 9. Ural-Siberian Bank, and 10. Petrocommerce Bank.

## What Is Wrong with the Banks?

Aven recently spoke at the Carnegie Endowment for International Peace in Washington, D.C. As he pointed out, the money on deposit with banks represents only 7 percent of GDP, which is quite low compared with the Czech Republic and Germany, where the figure is closer to 50 percent. Aven noted that starting in 2004 all Russian banks will have to use Western accounting standards and capital adequacy requirements. Aven urged that strict accounting standards be implemented as soon as possible, federal deposit insurance be extended to

all banks (currently only Sberbank enjoys such a guarantee), the myriad small banks whose only operations are cash transactions be consolidated into more sophisticated financial institutions, and the central bank's bureaucracy be downsized from its current level of 95,000 people. He also warned that without an acceleration of reforms Russia will have difficulty competing for investment with other countries. To date Russia has attracted about \$22.4 billion in cumulative foreign direct investment, which comes to about \$150 per capita, compared with more than \$2,000 per capita for countries like the Czech Republic, Estonia, and Hungary. In addition, since 1994 capital flight has amounted to \$114 billion, or almost \$800 per capita.

The overdue reform of the Russian banking system was discussed during the U.S.-Russia Business Council meeting in Washington in October. Foreign Secretary Colin Powell urged the council's Russian partners to act: “To attract and keep capital invested in Russia, the Russian government must press forward with banking and financial reforms. The banking dialogue between the United States and Russian private and governmental financial sectors has helped put the most important reforms on the Russia agenda. And now it's time to take those reforms and put them in practice.”

Powell was referring to a 10-page report entitled “Joint Banking Strategy” prepared early this year by the Russian-American Business Dialogue, which comprises business organizations and individual experts from the two countries. The document contains 27 recommendations, including rationalizing the state regulatory system, guaranteeing creditors' rights, strengthening antitrust legislation, and revoking the special privileges and subsidies granted to a select few banking and financial institutions at the expense of others. The document proposes that the Russian government should sell its stakes in the banking sector, cut excessive red tape, get rid of Soviet-era accounting practices, and eliminate contradictory legislation.

Almost a year ago, in an article the *Russia Journal*, Christof Rühl, chief economist of the World Bank's Russia Country Office, gave a similar diagnosis of the Russian banking sector: "With combined assets of little more than 12 percent of Deutsche Bank, Russia's banking sector is very small. It is highly concentrated, with very few banks holding the bulk of all deposits and dominating lending and with many banks too small to engage in lending or deposit taking. On top of this top-heavy sector sit the state banks which, as critics point out, enjoy unfair competitive advantages. It is the primary task of financial intermediation to match those who need resources with those who have funds to save."

In Russia, most export revenues and savings are accumulated by a few large companies selling natural resources—primarily oil, gas, and metals—with seven companies controlling most of the export revenues. These companies use about a third of their savings to finance fixed capital investment. About 10 percent is what is officially invested abroad. More than half of the savings go into domestic financial assets, almost entirely into short-term bank deposits at banks owned by the investing enterprises. Thus these savings will not be used for lending to other companies. Only 8 percent of all enterprise investment in the first half of last year went into long-term financial assets that would enable the recipients to on-lend it for the long term. Smaller businesses or would-be entrepreneurs are unable to borrow longer term even though these companies have proved immensely valuable in other countries, where they became the prime driving force of growth.

### Glimmers of Hope

There are some encouraging signs, however: in 2002 Russia's banking sector regained its precrisis levels of capital and assets and substantially exceeded them relative to GDP. In addition, the banks' reliance on funds attracted from households continues to grow.

According to the central bank the banking sector has now more or less made up the ground lost as a result of the financial collapse of August-September 1998 as follows:

- As of April 1 total bank assets were 6.8 percent higher than on July 1, 1998, in real terms. During this time the ratio of bank assets to GDP rose from 30.1 to 35.3 percent.
- Bank capital, which fell to one-quarter of its precrisis level after the collapse, stood 14.7 percent above its July 1998 level at the end of the first quarter of this year (in inflation-adjusted terms) and was equivalent to 5.1 percent of GDP, as opposed to 4.6 percent in July 1998. At 14.6

percent the sector's aggregate capital to assets ratio was still below its July 1998 level of 15.2 percent, but is rising rapidly.

- At 13.5 percent loans outstanding to the real sector were up 47.1 percent in real terms and up five percentage points as a share of GDP.
- As of April 1 corporate deposits were 48.3 percent above their precrisis levels in real terms, while retail deposits were still 3.5 percent below their July 1998 levels. Retail deposits accounted for 73.3 percent of the deposits held by Russian banks. Their recovery has been constrained by two factors: the slower recovery in real disposable incomes and the need to rebuild popular trust in the banking system. Lending to households more than doubled (up 112 percent), while credits to Russian companies rose by 56 percent. However, the growth of retail lending was from a very low base: roughly 93 percent of outstanding bank loans are to corporate borrowers and only around 7 percent are to households.
- Foreign assets now exceed foreign liabilities. Russian banks are now net creditors of the external sector.
- The banks are much larger net creditors of the real sector than they were: their net claims on the nonfinancial private sector at the end of the first quarter stood at 7.6 percent of GDP, up from 4.4 percent in January 1998. They also remain net creditors of the state, albeit to a greatly reduced extent (3.2 percent of GDP compared with 6.7 percent during the precrisis boom in government debt).
- Households are the major sector lending to the banks: the excess of household claims on banks over banks' claims on households now stands at 7.4 percent of GDP. As the importance of the retail sector as a source of funds is set to increase, introducing deposit insurance and other reforms becomes all the more important.

### Reform at the Gates

Responding to the calls for urgent reform, the new management of the central bank under the leadership of President Sergei Ignatiev (Viktor Gerashenko resigned earlier this year) is considering a number of important new measures to complement the introduction of International Accounting Standards and a deposit insurance scheme. These include the following:

- Shifting to a more effective monitoring system instead of depending on formal compliance with regulatory norms to oversee banks' compliance with capital adequacy and disclosure requirements.
- Reducing barriers to competition and market-driven restructuring. This includes simplified central bank approval procedures for opening new branches, engaging in new activities, or undertaking mergers and acquisitions.

The ability of regional and local authorities to interfere in banking markets will be constrained. In addition, simplified procedures for handling small credits will reduce overheads on retail banking and on lending to small and medium businesses.

- Improving creditor protection arrangements and freeing up collateral for lenders more easily and cheaply if loans are not repaid.

- Improving transparency and the circulation of information about banks and their services.

*Based on reports of Oxford Analytica, the UK-based international research group; various news agency reports; and presentation by Petr Aven, president of Alfa Bank, Moscow, at the Carnegie Endowment, in June. URL: <http://www.ceip.org/files/events/events.asp?EventID=493>.*

## World Bank/IMF/EBRD Agenda

### EU Delegates Suggest United IMF Membership

As the *Wall Street Journal* reported on November 7, if the EU were to speak as one legal entity at the IMF, the IMF's headquarters would have to move to Europe, delegates attending the early November Convention on the Future of Europe in Brussels pointed out. "The main advantage of greater economic policy coordination would be a more coherent voice for the euro zone on the world stage," said Andrew Duff, a convention delegate from the United Kingdom. "A further advantage of the creation of a single voice for the union is the headquarters of the IMF would be brought to some place within Europe." Under IMF statutes its headquarters is required to be "located in the territory of the member having the largest" weighted vote. The EU, which currently is represented by its individual member nations, would account for 34 percent of IMF voting rights, compared with 17.2 percent for the United States. "Numerous European cities would clamor for the opportunity to host the IMF," the *Wall Street Journal* quoted Duff as saying.

### Greg K. Ingram Is New Head of the World Bank's Operations Evaluation Department

In mid-October Gregory Ingram was appointed to the post of director-general of the World Bank's Operations Evaluation Department (OED). He succeeded Robert Picciotto, whose retirement was announced previously. Ingram brings 25 years of experience to his new position. He has held various managerial and senior advisory posts in the Bank's Development Economics Vice Presidency, including as administrator of the Research Advisory Staff and director of the Development Research Department. For the past two years he served as director of OED. During that time he increased the transparency of OED's work by promoting consultations with outside stakeholders, using advisory committees of external experts on large reviews, and disclosing more of the studies that underpin OED's evaluations and

methodology. He is credited with fostering the harmonization of evaluation methods by facilitating country and sector reviews carried out cooperatively with bilateral and multilateral donors.

The director-general is directly responsible to the Bank's Executive Directors for evaluating the Bank's programs and activities and appraising the Bank's operations self-evaluation and development risk management systems.

### IFC to Invest \$150 Million in Kazakhstan Oil Field

At the end of October IFC signed several loan agreements with Russia's premier oil company, Lukoil, for a total of \$150 million. IFC will participate in a major multibillion dollar project in Kazakhstan to develop the world-class Karachaganak oil, gas, and condensate field. Even though it is smaller than Kashagan and Tengiz, the other two major deposits, it contains more than 1.2 billion tons of oil and condensate and more than 1.35 trillion cubic meters of gas, making it one of the world's top 20 oil and gas fields in terms of proven reserves. As part of the project, a 635-kilometer connecting pipeline will be built from the oil field to the export pipeline that runs from the Tengiz oilfield to Novorossiisk, a Russian port on the Black Sea. When completed in early 2004 the project will form a key part of Kazakhstan's total oil and gas exports. The project is being jointly developed by British Gas (32.5 percent), the Italian ENI-Agip group (32.5 percent), ChevronTexaco of the United States (20 percent), and Lukoil (15 percent).

### IMF Backs Bulgaria's New Brady Exchange

During his visit to Bulgaria in September Jerald Schiff, head of the IMF's Southeastern Division 1, announced that the IMF was supporting the new Brady exchange prepared by Bulgaria's Ministry of Finance. In March

**Continued on page 36**

# How Do Men and Women Fare in Transition Countries?

## A New World Bank Report

By Pierella Paci

Most countries of CEE and Central Asia began transition with relatively good human development and gender indicators; however, increasing unemployment and crumbling health care, pension, and education systems have contributed to poverty and increased gender inequalities across the region. While women's welfare seems to have declined relative to men's in Central Asia, the burden of transformation has fallen disproportionately on men in Belarus, Russia, and Ukraine. The picture is more mixed in CEE, with no clear gender inequality patterns emerging over the past 10 years. A new World Bank report urges a gender-sensitive approach to inform and shape more effective social and labor policies in the transition countries.

During the last 10 years the transition countries have seen a considerable fall in their GDP and declines in the role of the government and the size of the public sector. They have also experienced different degrees of decentralization, deregulation, and market-oriented transformation. These processes have significantly altered the relative value of time spent in productive and household activities. They have also changed the characteristics of the labor market from an exclusively formal and public one to one that is extremely polarized, with pretransition formal employment in the state sector coexisting with an often highly informal emerging private market. At the same time the burden of child rearing has shifted increasingly away from the state and into the household. These changes are having important consequences for the gender division of labor within the

household and on gender equality in relation to economic opportunities.

### Labor Markets and Gender

Transition has affected the labor market in a number of ways over the last decade, including a sharp increase in unemployment, a decline in public employment, and the growth of a highly unregulated and informal private market for labor. With respect to gender, the concern has been that worsening labor market conditions have had a disproportionately negative effect on women by increasing any pre-existing gender gaps in employment and wages. The findings, however, do not support this claim. No empirical evidence appears to support the notion that the treatment of women in the labor market

### Gender and Equality of Opportunities

The term gender refers to culturally-based expectations of the roles and behavior of males and females. Although gender roles originated in the biological differences between men and women, they vary across countries and can change over time, sometimes rather quickly. For much of recorded history, however, caregiving and household work have been disproportionately allocated to women, while men have specialized in "productive activities." In most societies and economic systems the rewards to the latter far exceed those to the former. In addition, the returns to men's productive activities have historically been higher than those of women's worldwide.

Gender equality should be perceived as equality of opportunities rather than equality of outcomes, as

equality of outcomes across gender reflects a particular view of gender equity or fairness that is still alien to many societies. In addition, equity requires men and women to be free to choose different roles and outcomes, depending on their preferences and their comparative advantages in performing different activities. So equality of outcomes, even on average, is not necessarily equitable or efficient. By contrast, inequality of opportunities and unequal treatment across gender—often referred to as gender discrimination—are both inequitable and inefficient.

Inequality of outcomes may be a fair and efficient consequences of different preferences and biological differences across the sexes, but inequality of opportunities and unequal treatment is gender discrimination.



has systematically deteriorated across the region, although in some countries that has been the case at some time. Indeed, a decade into the transition process, the region still compares well internationally (see the figure on the next page about percentage of women in managerial positions). Other examples include the following:

- **Women's economic activity (participation) rate remains high in the transition economies compared with Western European countries.** Only Bosnia-Herzegovina has the lowest ratio with 55 percent, and fewer than a quarter of the countries in the region had a ratio of less than 80 percent. In recent years, women's activity rates increased relative to men's in nearly two-thirds of the 28 transition countries. In Armenia, for instance, they increased more than 5 percent.

- **While unemployment increased considerably for both men and women, in nearly two-thirds of the countries in the region the increase was sharper for men, and in some countries considerably so.** Indeed, in the last year for which comparable data exist only Armenia experienced considerably higher unemployment rates for women than for men (three times higher). In Azerbaijan and Poland women were 50 and 35 percent, respectively, more likely to be unemployed, while in Estonia, Lithuania, and Hungary men had unemployment rates nearly 20 percent higher than women. Azerbaijan, Croatia, the Czech Republic, the Kyrgyz Republic, Poland, and FR Yugoslavia are the only countries where female unemployment rates are higher than those of men.

- **The proportion of women among the self-employed is generally comparable to that in the EU countries.** The gender difference is highest in Estonia and lowest in Latvia, Lithuania, and Poland. Among the self-employed worldwide, men are more likely to be employers while women are more often own one-person businesses.

- **Overall the gender gaps in earnings in the region are comparable to, or smaller than, those prevailing in Western Europe, and are shrinking** (see table 1). In all 17 countries for which data are available the ratio is around 70 percent or higher. In five transition countries it is well in excess of 80 percent. The clear outlier is Azerbaijan, where women appear to be paid barely more than half what the average man receives. To the extent that the gender pay gap reflects systematic differences in preferences for productive versus caring activities and job characteristics, it should not be interpreted as gender inequality

- **The degree of labor market segregation (more women are leaving formal employment for informal economic activity) appears to be increasing, reaching the levels of Western Europe.** This is not in itself a disadvantage.

## Social Safety Nets and Gender

Shrinking government budgets and substantial reforms of pension and benefits systems in the last decade, although gender-neutral in principle, may have affected men and

**Table 1. Gender Pay Ratios, Selected Countries and Years** (women's monthly wages as a percentage of men's monthly wages)

Country	Year	Ratio
Azerbaijan	1995	52.6
Bulgaria	1990	74.0
	1992*	78.4
	1997	69.1
Czech Republic	1987	66.1
	1992	73.0
	1992*	72.1
	1996	81.3
Estonia	1992	79.8
	1996	72.6
FR Yugoslavia	1995	89.9
	1996	88.8
	1997	88.4
Hungary	1986	74.3
	1986*	73.1
	1991*	75.1
	1992	80.8
	1997	78.1
Kazakhstan	1996	72.3
Kyrgyz Republic	1995	73.3
	1997	71.5
Latvia	1998	79.9
Lithuania	1997	65.0
	1997	71.0
Poland	1985	73.7
	1986*	71.8
	1992	79.0
	1992*	81.2
	1996	79.0
Romania	1994	78.6
	1997	76.2
Russia	1989	70.9
	1991*	80.3
	1992	68.5
	1994*	67.9
	1996	69.5
Slovakia	1987	66.1
	1992	73.3
	1992*	77.3
	1996	78.2
Slovenia	1987	87.0
	1991	88.6
	1996	85.4
Ukraine	1991*	76.4
	1994*	59.7
	1996	77.7
Uzbekistan	1995	80.5

Source: UNICEF (1999); Brainerd (2000) where asterisked.

**Table 2. Maternity Leave Benefits, Selected Countries, 1998**

Country	Length of leave (days)	Percentage of wages paid
Albania	365	50-80
Armenia	140	—
Azerbaijan	126	—
Belarus	126	100
Bulgaria	120-180	100
Croatia	208	n.a.
Czech Republic	196	67
Estonia	126	n.a.
Georgia	126	100
Hungary	168	100
Latvia	126	100
Lithuania	126	100
Macedonia, FYR	270	n.a.
Poland	112-126	100
Romania	112	50-94
Russian Federation	140	100
Slovakia	196	90
Slovenia	365	100
Tajikistan	140	100
Ukraine	112	100
Uzbekistan	126	100
FR Yugoslavia	393	100

— Not available.

Source: Author.

women differently because of the different roles they play in society and the economy. Some observers have raised concerns that as women are returning to household activities, and as benefits and pension systems increasingly reward productive activities, gender inequalities in economic opportunities and the incidence of poverty will deepen. Again, the findings do not support these concerns. In particular, the analysis suggests the following:

- **The reforms of family benefits and pension systems have reduced, but not eliminated, women's advantages with respect to returns to paid-in contributions** (see table 2). The reduction in contribution coverage that many countries have experienced as a result of the growth of the informal labor market has not

shown a significant gender bias. Where this bias exists, for example, in Croatia, it affects men disproportionately rather than women.

- **The reduction of state support for nurturing and child care has shifted the entire responsibility for these functions back to women.** Coupled with continuing high participation rates, this has increased the dual burden on women and increased demands on their time.

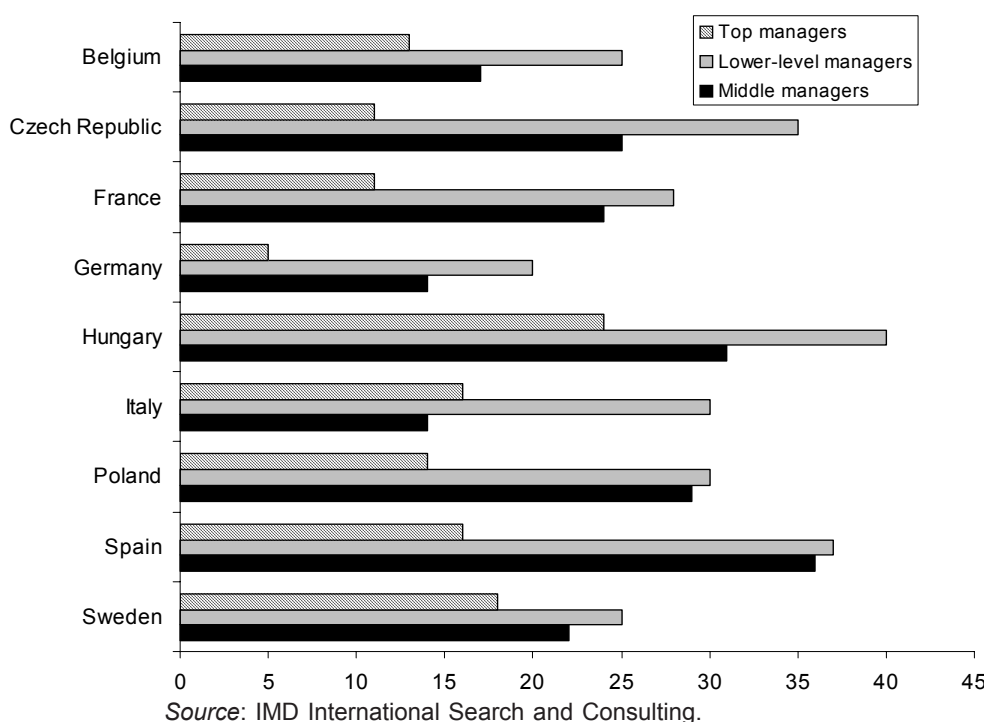
- **No systematic evidence exists that female-headed households are more likely to fall into poverty than others, once differences in individual and household characteristics are taken into account.** Only in Georgia and Tajikistan do female-headed households appear to constitute a distinct vulnerable group with a relatively high risk of being poor or extremely poor. In Kazakhstan, Russia, and Ukraine female-headed households are as likely to fall into poverty as male-headed ones.

### Geographical Variations

The way transition has affected men, women, and gender relations has varied considerably across countries, for instance:

- **Tajikistan is the only country in the region where women's welfare declined relative to men's.** In Tajikistan the average working woman earns just over half what the average man takes home; girls are half as likely to be enrolled in higher education than boys; and only just over half of pregnant women receive any form

**Percentage of Women in Managerial Positions, Selected Countries, 2002**



of prenatal care, resulting in high infant mortality rates.

- **Women are also at a disadvantage in Kazakhstan.** Despite Kazakhstan's higher GDP than its neighbors, like Tajikistan it has disappointing reproductive health indicators, and women receive less than 70 percent of men's wages even though they are often more qualified.

- **In Russia and Ukraine the main concern is the welfare of men, who are at a clear disadvantage with respect to all the indicators considered.** For women the main concern is the increased weight of the double burden they face as main earners and main caregivers in the household. Concerns are also arising because of the increasing disadvantage of women at the bottom end of the earnings distribution.

- **Gender inequalities in enrollment in postbasic education have increased across the region.** Girls are at a high and growing disadvantage in Kosovo, Tajikistan, and Uzbekistan. In many countries boys are at an extremely high and rising disadvantage in admission to secondary education, and especially to higher education.

- **While women the world over outlive men, the gap in male-female life expectancy is considerably higher in the transition countries.** In Belarus, the Baltic states, Kazakhstan, Russia, and Ukraine females outlive males by an average of more than 10 years. Yet often when women do survive to old age they face poverty and hardship because the system of family support and pension benefits that existed under communism has either shrunk drastically or disappeared altogether. In the transition countries the male suicide rate is between 2 and 6 times that of women, compared with 4.2 times in the United States.

- **A considerable increase in human trafficking for purposes of sexual exploitation occurred during the 1990s, especially from Moldova and Ukraine.** In 1997 the U.S. government estimated that such trafficking involved 175,000 women and girls from CEE and the former Soviet Union, representing a quarter of all women

involved in this trade worldwide. Violence against women has increased during the transition. The resurgence of customary and polygamous unions not covered by legal protection in some countries in Central Asia has made women even more vulnerable to violence. Few attempts have been made to adopt new legislation intended to clarify the definition of violence and allow women to be protected by court orders.

## Legal Remedies

Antidiscrimination legislation needs to go beyond the basic statements about equality between men and women found in socialist constitutions. Putting in place some form of equal opportunity legislation is a prerequisite for accession to the EU, and as such is currently under consideration in a number of Eastern European countries. Legal systems—both customary and statutory—need to provide for the recognition, protection, and enforcement of the principle of equal rights to access to resources, such as land and capital. Equality with respect to access to credit is also particularly important in the context of economic transition.

Devising and implementing gender-sensitive policies as part of the region's overall strategy for development and poverty reduction is crucial.

*This article is a shortened version of "Disparities between Men and Women in Transition Countries," published by the World Bank. The author is a senior economist at the World Bank, email: ppaci@worldbank.org. The full report can be downloaded from <http://lnweb18.worldbank.org/ECA/eca.nsf/General/F55E7337BA69423985256BFA0053F091?OpenDocument>. For more information on the World Bank's work on gender issues go to <http://www.worldbank.org/gender>.*

## Gender in the World Bank's Work

In September 2001 the Bank approved a strategy for integrating gender into its operational and policy work that includes the following:

- Preparing periodic country gender assessments that analyze the gender dimensions of development across sectors and identify gender-responsive actions important for poverty reduction, economic growth, human well-being, and development effectiveness to inform the Bank's country assistance strategy
- Developing and implementing priority policy and operational interventions that respond to the assessment

as part of the Bank's country assistance strategy and monitoring the implementation and results of these policy and operational interventions.

In the Eastern Europe and Central Asia region the Bank has completed a gender assessment for Ukraine; has conducted a poverty assessment with a strong gender emphasis in Bulgaria; and has planned others for Albania, Bosnia-Herzegovina, and Poland. A strategy paper on how to engender development in Europe's and Central Asia's transition economies is also under way.

# How the Celtic Tiger Did It: Ireland's Rapid Convergence with the Industrial World

By F. Desmond McCarthy

In tribute to its remarkable economic achievements during the 1990s, some have referred to Ireland as the Celtic Tiger. Between 1995 and 2001 Ireland's growth reached around 10 percent per year. Even though this fell to about 5 percent in 2002, it is still the most dynamic of the EU states. Its productivity increase has consistently been faster than the EU average: Ireland's unit labor costs fell by about 35 percent between 1995 and 2001. In addition, it reduced its 18 percent unemployment rate to near full employment. Ireland now ranks as the third largest world exporter on a per capita basis. There are lessons to be learned here that may be relevant for other countries, especially the transition economies, which also want to converge quickly with the industrial world.

For most of the 20th century, even well into the late 1980s, Ireland's economic record was somewhat dismal. Chronic unemployment led to large emigration flows and dampened entrepreneurial activity. The country's economic situation eventually reached crisis levels because of the spillover effects of the two oil shocks of the 1970s and the high interest rates resulting from the United States' anti-inflationary policies of the early 1980s. By 1987 the fiscal situation clearly needed to be addressed as soon as possible, but the unemployment situation was also serious, emigration resurged, the economy stagnated, and living standards deteriorated. The current budget deficit reached 7.9 percent of GDP in 1986, while the public sector borrowing requirement increased to 14.2 percent of GDP.

In 1987, taking advantage of a broad consensus for change that had emerged among all the major domestic policy actors, the newly elected Prime Minister Charles Haughey pushed through a set of dramatic actions. He introduced large tax cuts, and as GDP growth responded to tax cuts and wage moderation, the budget deficit was slashed and the debt to GDP ratio shrank. A centerpiece of the reform was a social pact, the Program for National Recovery (1987-90), which essentially removed most of the rancor from the macroeconomic debate and resulted in stable labor relations. By 1990 the budget deficit had dropped to 0.6 percent of GDP and the public sector borrowing requirement to 2.8 percent of GDP.

Several other factors also played salient roles in Ireland's spectacular development. These included opening up toward Europe, breaking with British currency, granting massive incentives to foreign direct investment (FDI), engaging in technological development, enhancing industrial organization, and recognizing the role of information.

## EU Advantages

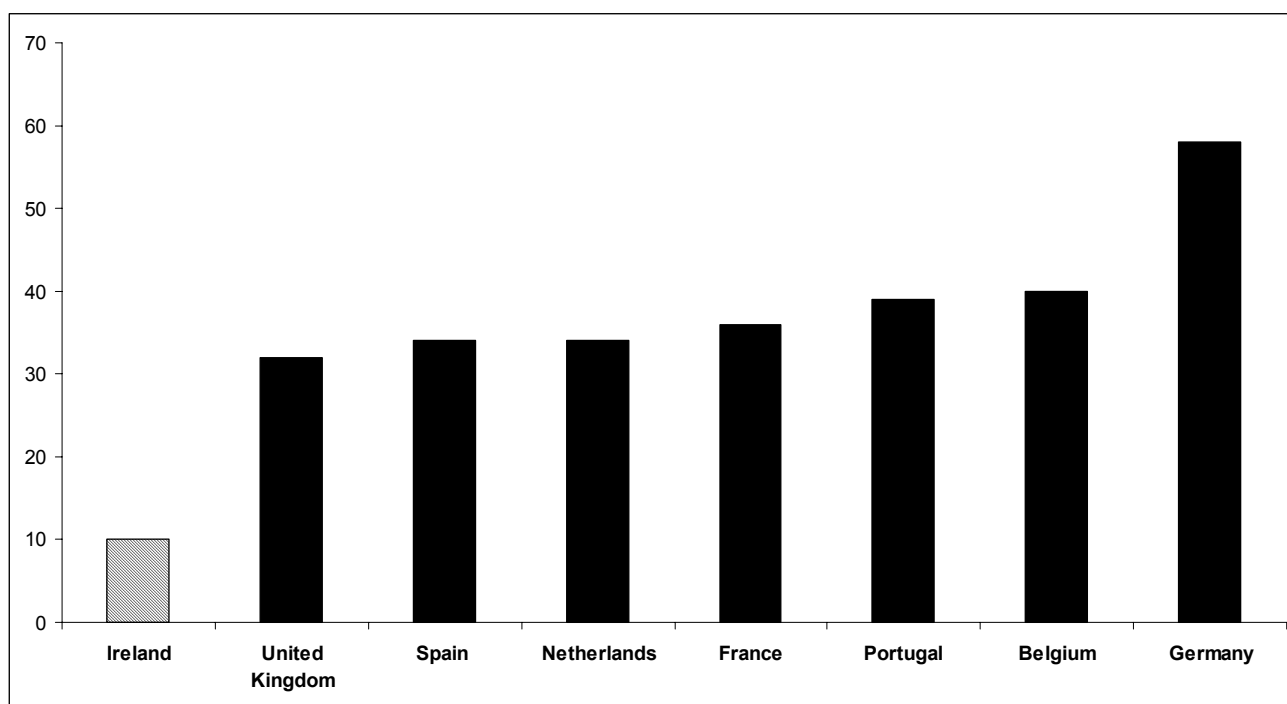
Ireland became a member of the European Community in 1973. This led to a broader free trade regime, and the country reaped significant benefits, especially in the agriculture sector. While previously the United Kingdom and the United States had tended to have a dominant role in Ireland, not only in economic terms, but also in terms of how people framed their view of the world, now the Irish public realized the increasing importance of the European dimension and it led to a new more global outlook. The younger generation in particular began to look to Europe, and education became more cosmopolitan. At a different level policymakers were more aware of the constraints of European Community membership and the associated rewards for prudent action.

Foreign business, in turn, saw the advantages of an English-speaking, well-educated populace with ready access to the large European market and the broad institutional stability provided by the European umbrella. This institutional framework helped foster more transparent and responsible behavior, supported by better monitoring and accountability, especially in the use of public funds. As this virtuous cycle got under way the overall entrepreneurial spirit increased steadily and a more positive "can do" attitude prevailed.

As a net exporter of farm goods Ireland benefited greatly from transfers through the Common Agricultural Policy that amounted to 3 to 6 percent of GNP per year. In 1981 agriculture accounted for about 14.7 percent of employment, or 167,000 people, but by 2001 this figure had fallen to just 9 percent or 117,000 people, and Common Agricultural Policy transfers did provide a cushion during this transition. Much of the



**Figure 1. Corporate Tax Rates for Manufacturing and Qualifying Services, Selected European Countries, 1995 (percent)**



Source: Arthur Anderson data, 1996.

surplus labor was absorbed into other sectors, especially the service sector.

Ireland also received resources from various EU structural funds, including assistance to develop Ireland's poorer regions, to mitigate the social consequences of restructuring, and to help develop the transport infrastructure. While Ireland's EU contributions offset some of these flows, net receipts were equivalent to another 3 percent of GNP. Some benefits of Ireland's EU association have been indirect, for example, the 1993 Maastricht Treaty provided a clear blueprint for Ireland's integration into the Economic and Monetary Union. Ireland adopted the euro in 1999. Substantial support from the EU for physical infrastructure and human capital significantly contributed to the rapid economic development.

### Winning over Multinationals

With the macroeconomic situation stabilized, Ireland's focus turned to growth. The Industrial Development Authority's policy of attracting high-tech foreign firms to Ireland started in the late 1960's. Digital Equipment Corporation came in the early 1970s, followed by Apple Computers. [An English-speaking, well-educated, populace] good labor relations; [and

access to the large European market] were major attractions, along with a low corporate tax rate of 10 percent after 1979 (figure 1). However, even though some foreign firms took advantage of the various enticements in the 1970s and early 1980s, this did not have a strong impact on the economy. Linkages between the foreign firms and the rest of the economy were often weak, and some of the companies gravitated toward other countries when they offered more favorable conditions.

In the late 1980s, however, major changes in industrial structure occurred as multinationals moved away from the mass production model toward greater flexibility and foreign branches of these companies moved away from relatively insulated units toward ones more integrated with the local economy. At the same time companies of the "new" economy were intrinsically more flexible. In particular, new technology reduced transport and communications costs, sharply reducing the geographic disadvantage of being an island economy. The strategy of the Industrial Development Authority was quick to take these new trends into account, and was able to attract a number of flagship companies that were enjoying rapid growth at the global level, such as Intel and Microsoft. At the same time the authority offered a good platform for many of the large chemical and pharmaceutical multinationals.

The Industrial Development Authority provided significant subsidies to foreign investors in the early 1980s, yet FDI growth was slow. By the early 1990s the authority's subsidies were at about half the level of a decade earlier, yet FDI growth was strong. Apparently foreign companies cared more about the tax structure, in particular, the 10 percent corporate tax rate and relatively low labor costs (figure 2), than direct subsidies. Investments by U.S. multinationals in Ireland are getting a 25 percent rate of return, twice what they can expect in Portugal, three times that in Spain, and five times that in the United Kingdom.

In 1998 foreign-owned firms employed 47 percent of the industrial workforce, or 200,000 people out of the total workforce of about 1.7 million, and accounted for 82 percent of industrial output. Some 75 percent of FDI came from the United States. U.S. investments were the largest, both in terms of numbers of companies and numbers employed, dominating in the computer, pharmaceuticals, and electrical machinery sectors. U.S. foreign affiliates now account for 16.5 percent of Ireland's GDP. In 2001 Ireland attracted 10 percent of the EU's FDI. The new companies are building links with domestic suppliers. Employment in "home-grown" industry has

also risen, much of this in the service sector, which is still linked to and dependent on foreign companies.

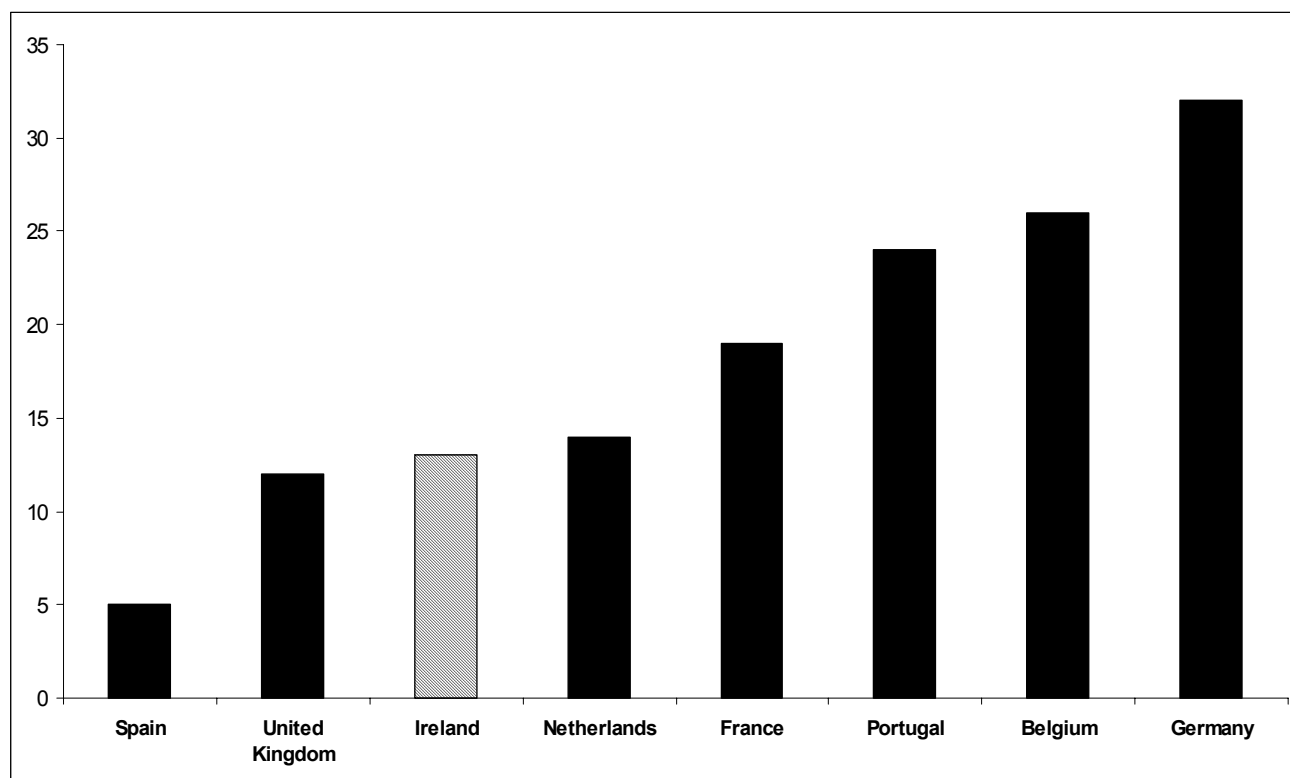
Ireland now ranks as the world's third largest world exporter on a per capita basis behind Singapore and Belgium and Luxembourg. For example, one-third of all personal computers sold in Europe are now made in Ireland. In 2000 Ireland's total trade in goods and services was equivalent to 175 percent of GDP, up from 141 percent in 1995. At the same time the composition and direction of trade moved away from exports of primary goods, mainly agricultural, to manufactures. In 1987 agricultural produce made up 17.5 percent of exports, but this had fallen to 4.8 percent by 2000. During the same period industrial products increased from 80.2 to 92.8 percent of trade. In addition, trade moved away from the United Kingdom, Ireland's traditional dominant trading partner. The share of trade with the EU remained stable at close to 40 percent, while that with NAFTA, which stood at 9 percent in 1987, had doubled by 2000.

### Growing Gap between Rich and Poor

In the late 1980s the weak position of the economy and the increasing role of some forward-thinking union

**Figure 2. Payroll Costs, Selected European Countries, 1995**

(hourly compensation, including additional costs, U.S. dollars)



Source: Swedish Employment Confederation data, 1996.

leaders facilitated a tripartite agreement between unions, employers, and the government. In 1987 the first of a series of tripartite agreements designed to moderate wage increases was signed. A key outcome was to establish a formula for moderate wage increases over the next three years. What the unions wanted in return stimulated economic growth and job creation even more, namely, further tax cuts that resulted in a strong increase in after tax real incomes. In turn, fiscal restraint and wage moderation slashed inflation.

The tripartite agreement was followed by a series of three-year agreements: the Program for Economic and Social Progress, 1990-93; the Program for Competitiveness and Work, 1994-96; the Partnership 2000, 1997-2000; and the Program for Prosperity and Fairness, 2000. Each of these agreements devoted increasing attention to the broader issues of distribution and structural reform. In the early 1990s unemployment and emigration were dominant concerns. As economic gains continued through the 1990s the agreements increasingly emphasized social cohesion, regional development, and poverty.

In a recent speech, David Begg, general secretary of the Irish Trades Union Congress pointed out that Ireland remained the most unequal country in Europe with regard to income, after Portugal. Wage inequality has grown, with the top 10 percent of income earners increasing their earnings from 196 percent of the median wage in 1987 to 232 percent in 1997. The 1998 *Sunday Times* "rich list" established that in 1997 the 25 richest individuals in Ireland had collectively earned 828 million euros. By contrast, the wages of the bottom 25 percent of income earners fell from 73 percent of median earnings to 69 percent the same year. Infrastructure spending has failed to keep pace with social or industrial demands.

As for the poor, in terms of conventional measures of purchasing power and income, the poverty level declined dramatically in the 1990s as average real household incomes rose rapidly and unemployment fell sharply. Social welfare provisions rose in real terms, but not as much as other incomes. In net terms, the number of those on social welfare fell, but their incomes fell further behind the average.

## Lessons to Learn

How long can the Celtic Tiger keep going? The IMF 2002 Staff Report on Ireland warns that "the stellar

performance of the Irish manufacturing sector in recent years was partly interrupted in 2001. The main reasons for fairly limited gains were the global economic slowdown, the bursting of the Internet communications technology bubble, and the rapid increase in Irish wage costs." The IMF also noted that some of the high-tech industries attracted to Ireland in the 1990s were permanently relocating away from the island despite the "astonishing performance of a handful of sectors mostly dominated by multinational companies, whose gains in productivity often result from intangible foreign inputs in production, such as global investment in research, product development and advertising." Irish industrial competitiveness also became vulnerable to fluctuations in the exchange rate between the dollar, the euro, and the pound sterling.

The government is currently facing some difficult issues. The slowdown and uncertainty in the global economy are putting some pressure on the government budget. While economic growth is expected to be around 5 percent, there is a significant fall in revenues. This requires hard choices in slashing budget expenditures. The unavoidable cuts should not endanger promised improvements in social provisions, and continuing infrastructure investments should not result in undue foreign borrowing.

Despite Ireland's current difficulties, several aspects of the Irish approach may offer useful ideas for countries that want to converge rapidly with the industrial countries, namely:

- **Entering into a social partnership.** If a country has to impose fiscal retrenchment, this can be effective if all key groups reach agreement on the policy direction and if this is reinforced by ensuring that each group will gain from its support over time.
- **Attracting FDI.** Policy stability, an educated workforce, tax incentives, and administrative capacity are more important than direct subsidies.
- **Providing a supervision and incentive framework.** In Ireland's case the EU plays this role. Irish policymakers were able to engage in "peer discussions" with their colleagues in the EU. Other countries would do well to also seek some form of "umbrella" for this purpose.

*This article is based on the author's paper "Social Policy and Macroeconomics: The Irish Experience," published by the World Bank in 2001. For further information contact the author at [Fmccarthy@worldbank.org](mailto:Fmccarthy@worldbank.org).*

# Central Europe's Ireland? Interview with Hungary's Economy and Transportation Minister about Launching New Investment Promotion Program

Hungary will join the EU in 2004 at the latest, and has to conform its investment policy with EU regulations. So far the country has attracted more than \$27 billion in foreign direct investment (FDI), mostly in greenfield investments. Per capita FDI is \$2,711, the highest in Central Europe. Foreign companies account for 80 percent of Hungary's exports and a third of its GDP and employ 43 percent of the total industrial workforce. More than 45 of the world's top 50 multinational companies are present in Hungary. Thus how these companies will shape their business strategies in the coming years is critically important. Will Hungary adopt the Irish model in its investment policy? *Transition* asked Istvan Csillag, Hungary's new minister of economy and transportation, appointed in May 2002 following the elections that brought down the conservative government and with a thin margin gave a mandate to the Socialist Party and its small liberal partner, the Alliance of the Free Democrats.

**Q: What can Hungary do to keep multinational companies in Hungary and promote even more foreign investment? What can Hungary reproduce from Ireland's experience?**

**A:** FDI played a major role in Hungary's recent economic development, its structural adjustment, and its increased competitiveness. FDI helped us benefit from globalization, get ready for EU accession, and guide the economy on a sustainable growth path. Therefore it is in our best interests to keep foreign companies in Hungary and try to attract new investors. We recognize Ireland's successes in this respect and would like to adapt those elements of its strategy appropriate for Hungary.

In Central Europe, as across the globe, countries are engaged in sharp competition to attract foreign investment capital. Hungary's rivals in this region are the nine other EU accession countries. Yet I am sure that Hungary has a number of comparative advantages, for example, our geographical position in the middle of Europe enables multinationals to operate their Hungarian subsidiaries as Southeast European regional centers. Just in the last few months a number of companies decided to coordinate either regional production, sales, or various services from Hungary.

Another important factor that could induce foreign investors to come to Hungary is the availability of well-qualified labor that is still relatively less expensive than in other countries. No doubt the labor costs of workers

producing lower value added at the final phase of the manufacturing process are less in countries that lie east of Hungary, therefore the Hungarian government is trying to attract investments that are technology intensive. Hungary offers a cost advantage to those seeking well-educated workers and a multilingual white-collar workforce that can produce high-quality products with significant added value.

Another important factor is the openness of the Hungarian economy. Since the late 1980s we have learned important lessons about dealing with multinationals' local subsidiaries. They, for their part, became well versed with the Hungarian environment, including our social, economic, and legal conditions; culture; and traditions. We know full well that in the EU only those economies that are competitive and flexible will succeed. That requires continuing productivity growth. This is why we need more foreign investment, application of state-of-the-art technology, and adaptation of the latest results of research and development (R&D). The new investment promotion program, "Smart Hungary" (see page 32), which will be launched in January 2003, will serve this purpose.

**Q: The Internet notes: "Smart Hungary, the new investment incentive program of the Hungarian Government, has been drafted to make Hungary the most competitive European business location for investments." How will the program achieve this?**



**A:** The package, which complies fully with EU regulations, strives to create an attractive investment environment comparable with the highest European standards. The program will be predictable, transparent, efficient, and well integrated with the country's overall economic policy. The package includes various tax benefits and direct government support to investors, who will experience less red tape, have access to more services, and benefit from simplified administration.

Investors can receive a development tax benefit for five years provided that the investment exceeds 40 million, creates more jobs, and involves Hungarian suppliers. The tax-free investment reserve fund enables the investor to plough profits into this fund and defer tax payments for as long as four years. Taxes are only paid after the money is drawn from the fund. Workforce training and job creation are promoted by decreasing the investor's tax base or granting direct subsidies through tenders. As a new initiative we are subsidizing investors to move to well-prepared sites that will meet their specific needs. The Smart Hungary program also focuses on supporting corporate R&D, innovation, and infrastructure that is directly linked to investments, information technology, and Internet development, as well as strengthening environmental awareness.

**Q: You are emphasizing the EU conforming character of the new investment incentives, but Hungary was offering large investors extremely beneficial tax benefits and production bases in customs-free zones. What will happen to these after 2004?**

**A:** Again, I emphasize that all elements of the Smart Hungary package conform with EU regulations. Primarily they must be granted for a predetermined period, the support should be proportional to the investment volume, and the support should not exceed the support intensity defined by the EU. We have met all these requirements. True, the present subsidy system includes certain features that are not EU compliant and our commitments might extend beyond the date of Hungary's accession, of which the most important is the corporate tax benefit that we have granted for 10 years. Negotiations with the EU about settling this issue are ongoing. Already it seems certain that beneficiaries will

be able to choose between converting this tax benefit to meet the EU's support intensity requirements or requesting retention of the original benefits for a limited period. In any case, the Hungarian government will do what it can to close the negotiations with satisfactory results for both investors and the country.



Minister Istvan Csillag

**Q: What are the major characteristics of your ministry's policy and what are the main policy differences between this government and the preceding one?**

**A:** This government has defined its mission as leading the country into the EU. Our aim is to restore economic dynamism through increased competitiveness to achieve rapid, yet balanced, export- and investment-led economic growth. The ministry's investment policy is based on the following three basic principles:

- Equal access to resources, including access to a high-quality and relatively low-cost workforce and infrastructure networks
- Fair competition, that is, a level playing field for all enterprises where the criterion of success is performance
- Transparency in both the ministry's operations and in the larger economic environment.

We are planning several new projects based on public-private partnerships to promote realization of these three basic principles.

As to the differences in economic policies, the previous government based its economic policy on extended state intervention, and consequently thwarted competition-based market effects. Our current economic philosophy is based on liberal principles and trying to constrain the state's role to the necessary minimum. Accordingly, the government is aiming to create a market-friendly, predictable, transparent economic environment; limit state redistribution; and cut taxes and other contributions. The two governments' different approaches to the securities markets makes the point. As opposed to its predecessors, the present government wants to stimulate capital markets and make use of their intermediary role, whether it relates to privatization or strengthening small and medium enterprises.

# Unilateral Educational Disarmament?

## UNICEF Social Monitor Warns Transition Countries against Hasty Educational Reforms

Recent international surveys confirm that students from Central Europe continue to perform similarly to those in high-achieving Western countries in mathematics and science, and adolescents in the Baltic states and Russia do not fall much behind, but students in some of the poorer countries do not perform well. Transition country schools appear to teach factual knowledge well, but students are relatively weaker than Western European students in applying that knowledge. However, mechanically transplanting failed Western methods, such as rejection of whole-class teaching, would be wrong. Gradual improvements in education should be based on local traditions.

The quality of learning in the transition countries must be judged in comparison with the situation before transition. For years the excellent results achieved by children in international educational Olympiads, especially in mathematics and science, perpetuated the view that the planned system provided high-quality education. Even though the schools did not encourage individuality or the development of children to their full potential, many countries in the region entered the transition with high average academic standards in a number of key subjects.

### Performance in Mathematics and Science

What is the level of learning quality in the transition economies now? The Third International Mathematics and Science Study (TIMSS) has now provided two sets of assessments of achievement—in 1995 and 1999—among eighth grade (14-year-old) students in mathematics and science in a wide range of countries (see figure 1). TIMSS 1999 includes Bulgaria, the Czech Republic, Hungary, Latvia, Lithuania, FYR Macedonia, Moldova, Romania, Russia, Slovakia, and Slovenia. The results for most transition countries are quite encouraging. Two-thirds of students in the nine transition countries for which data are available for both years reach or surpass the median international benchmark in eighth grade mathematics. Moreover, on average, students in the transition countries perform better than those in the United Kingdom and the United States, although not as well as students in Belgium and the Netherlands or those in the most highly developed Asian countries. Between 1995 and 1999 the Czech Republic was the only transition country where students' performance deteriorated significantly, with 14 percent fewer students reaching the median international benchmark in 1999, and Latvia was the only country where students' performance improved significantly: 15 percent more students reached the benchmark in 1999.

### Using Knowledge

The OECD International Adult Literacy Survey has gauged adult literacy in 23 countries for 1994-98, measuring how well adults use information to function in society and the economy. It defines literacy as "the ability to understand and employ printed information in daily activities, at home, at work and in the community—to achieve one's goals, and to develop one's knowledge and potential." The skills measured in the International Adult Literacy Survey cover three domains: prose literacy (being able to understand newspaper and magazine articles and brochures), document literacy (for example, comprehending maps, charts, and application forms), and quantitative literacy (calculating bills and receipts). Of the four transition countries included in the study only the Czech Republic matches the average score for eight EU countries in the case of 16- to 25-year-olds who have completed secondary education. The relative weakness of the performance of the other three transition countries (Hungary, Poland, and Slovenia) should not be exaggerated. The average scores for Poland, the least well performing of the four countries, are only 10 to 12 percent worse than EU averages.

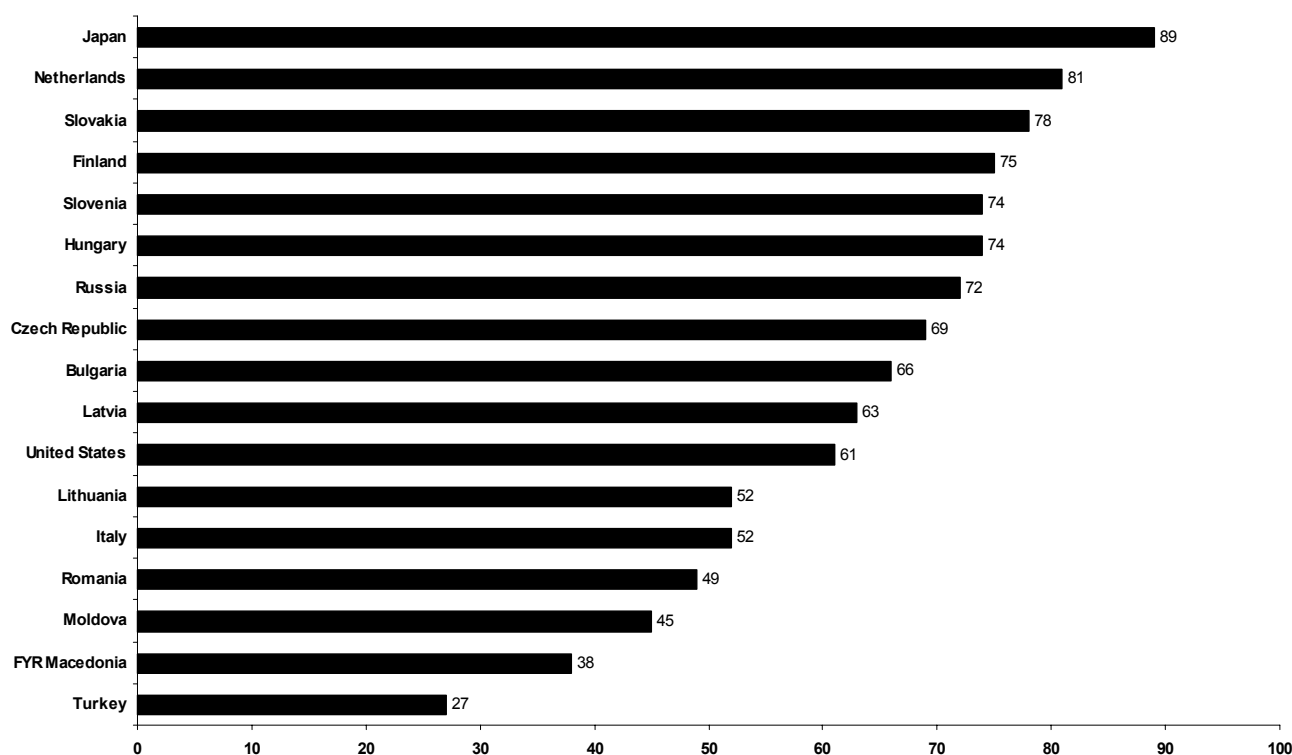
### Meeting Real-Life Challenges

The OECD Program for International Student Assessment (PISA) has set out to determine how 15-year-olds in 32 countries in 2000 were able to use what they had learned in reading, mathematics, and science. PISA looks at their ability to use their knowledge and skills to meet real-life challenges. It examined students in the Czech republic, Hungary, Latvia, Poland, and Russia, and the mean scores for all five transition countries were below those for the EU countries, Japan, and Korea.

The TIMSS assessments in 1995 and 1999 show that most of the countries covered are generally maintaining

**Figure 1. Eighth Grade Mathematics Achievement, Selected Countries, 1999**

(percentage of students above median international benchmark)



a. Latvia refers only to Latvian-speaking schools.

Source: Mullis and others (2000).

academic standards in mathematics and science. However, some of the poorer countries, such as FYR Macedonia and Moldova, are not performing as well. When the tests are broadened to include reading literacy and the use of academic knowledge and skills, a gap opens up between some of the transition countries, such as Latvia and Russia, and the higher average in the advanced industrial countries. What poorer countries such as FYR Macedonia, Moldova, or Romania might score on a PISA-type assessment is unclear, but on the basis of the TIMSS results there may be reason for concern.

### Situation in the Poorest Countries

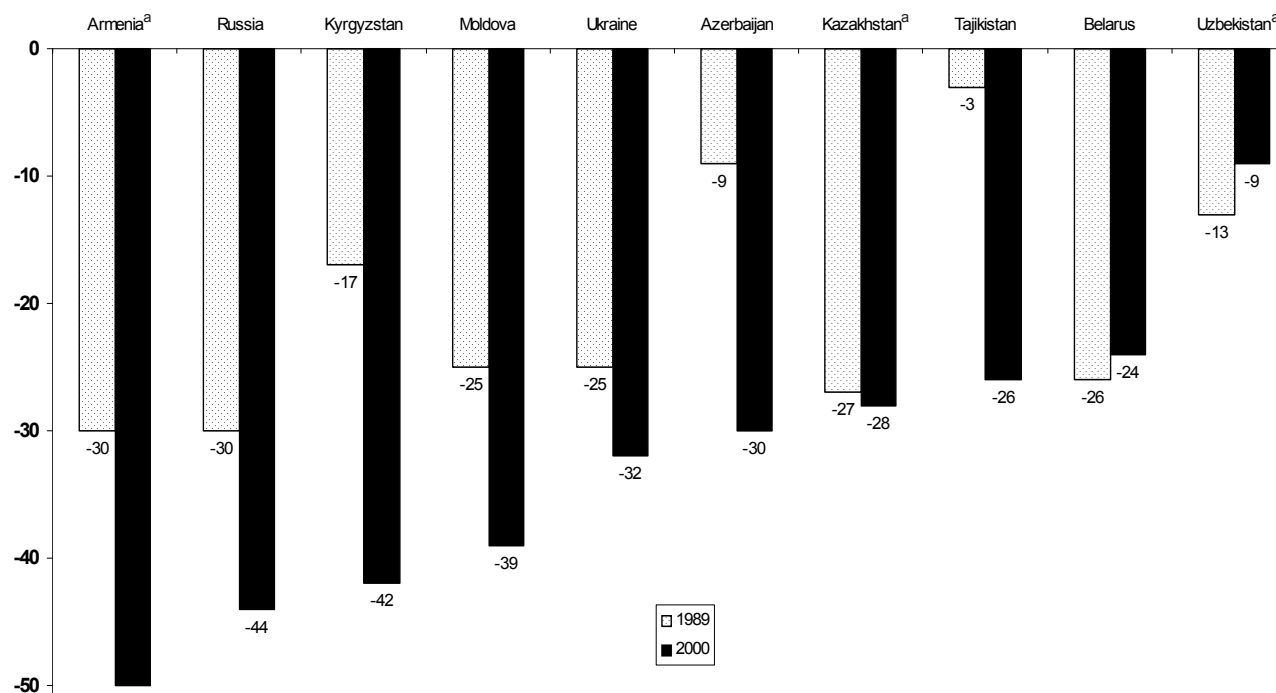
What about the poorest countries in the region, most of which are excluded from the TIMSS, International Adult Literacy Survey, and PISA exercises? In the region's poorest country, Tajikistan, the quality of education (in the widest sense of "self-realization") and the quality of learning have suffered greatly over the past 10 years. Several of the sixth graders interviewed as part of a World Bank study were unable to multiply single-digit numbers. These deficiencies partly reflect a fall in school

attendance because of poverty, but also a deterioration of conditions in schools caused by the outflow of teachers, the destruction of school buildings during the recent civil war, and the lack of textbooks and other materials. The average salary in education in Tajikistan in 2000 was a quarter of the civil service average and less than an eighth of what a sole income earner in a family with four children needs to keep the family above the official poverty line. As a result an exodus of younger qualified teachers has occurred, some to private sector and NGO jobs within Tajikistan—where as drivers or cleaners they can earn as much in a month as they would in a year as teachers—and others to employment in Russia and other CIS countries.

In Uzbekistan too, shrinking real expenditure on education has led to progressive deterioration in school infrastructure. Three-quarters of the rural schools and half of the urban schools do not have functioning toilets. Teacher salaries have dropped to the equivalent of \$6 per month at the market exchange rate.

In Moldova a quarter of the primary and general secondary schools need refurbishment and repair, and several

Figure 2. Wages in Education and Average Earnings, CIS Countries, 1989 and 2000



a. For Armenia, Kazakhstan, and Uzbekistan the second year is 1999.

Source: CIS Stat (2001), *Official Statistics of the Countries of the CIS 2001*, Interstate Statistical Committee of the CIS: Moscow, CD Rom.

are in precarious condition. No money is available for teaching materials, newspapers, or magazines. Most secondary schools have no information technology classes, and only 3 percent of schools have access to the Internet. Skilled teachers are leaving the education system for better paid jobs elsewhere. Extra curricular activities related to technology, travel, nature, and so on have been cut by half since 1992.

### The Role of Family Background

The PISA study shows that in almost every country students from the most advantaged socioeconomic backgrounds consistently perform the best. Transition countries are no exception. However, the PISA study also points out that the relationship between socioeconomic background and performance is far from clear. The type and quality of both the home environment and the schools to which children from different socioeconomic backgrounds go may play a part.

A drift toward elitism that is now being seen in some education systems in the region is likely to exacerbate the inequalities in socioeconomic backgrounds and in schools. A small but rising number of private schools

caters particularly to the children of the affluent. In general, the needs of nonelite and below average students have been inadequately addressed. However, the distribution of school resources in the region is probably still relatively equal by international standards, and in all the transition countries, including Russia, parental wealth seems to have only a modest influence on students' performance.

One reason for this may be the high level of "cultural capital" that most homes in these countries appear to possess: 90 percent of Russian students in the PISA test reported that their homes contained works of classical literature, compared with fewer than 60 percent in EU countries. The proportion of students who reported having visited a theater or an art gallery was higher in the Czech Republic, Hungary, and Latvia than in any advanced industrial country. The PISA tests show that such cultural capital does have a positive impact, particularly on students' literacy performance.

Another factor is the considerable desire among parents in transition countries that their children do well at school. The level of parental involvement in schools—including fund raising and participation in school projects—is higher in most transition countries than in EU countries. Direct



involvement appears to be one way in which parents can compensate for more restricted resources. There is little doubt that it improves the quality of education.

Moreover, parents in transition countries are more likely to help their children with homework than are parents in EU countries. The students themselves spend more time on homework in most transition countries than in advanced industrial countries. Students in most transition countries spend less time receiving formal instruction than do those in the advanced industrial countries, but spend more time, on average, in total learning activities.

### What Needs to Be Changed?

The traditional approach to teaching in the region has been characterized as “factology,” which focuses on building up students’ awareness of facts or ability to solve a known class of problem, but not necessarily on applying a given technique to a new problem or choosing which technique to use to solve a problem. The PISA study shows that, in general, students from transition countries are more likely than students in EU countries to use memorization techniques in learning, for example, repeating items over and over, suggesting that factology is still widely practiced in the region. This may be part of the reason why students in transition countries perform quite well in the TIMSS assessments, which emphasize knowledge, but less well in the PISA assessments, which attempt to measure the application of knowledge.

Responding to information of this kind with a call for a revolutionary change in teaching methods in the transition countries is tempting. Many donor-sponsored attempts at reform point in this direction. However, “progressive” teaching methods (discovery learning, individual “projects,” the rejection of whole-class teaching, and so on), which were widely adopted in several advanced industrial countries in the 1970s and 1980s, are now increasingly being questioned and sometimes set aside in favor of a return to traditional teaching and learning strategies.

Whole-class teaching is by far the most commonly used method in transition countries, and ensuring that it is done well, that is, protecting the active discourse between teacher and pupils and conveying values about the nature and worth of different ways of thinking, knowing, and understanding, may be less risky than trying to transplant new methods that are increasingly being questioned in the countries where they were first employed. There is a danger of throwing out the “baby” of good academic results in mathematics and science with the “bath water”

of old-fashioned teaching methods, particularly in systems that are starved of resources. The gradual and incremental reappraisal of teacher training and retraining and the creation of an environment conducive to better teaching may produce more positive results with less disruption.

The requirements for better teaching and learning include establishing national examination systems that encourage elaboration and discourage excessive reliance on memorization. Such systems should be transparent, rigorous, and fair, allowing children with similar levels of achievement to perform equally well and to be certified as having done so.

### More Resources Required

Creating the conditions for better teaching almost certainly requires more resources. One important problem is the collapse in the purchasing power of teachers’ salaries. Teachers were already underpaid relative to average earnings in 1989, and in most countries the gap between average earnings and teachers’ wages widened during the 1990s (see figure 2). Delays in paying salaries have been common. Other problems include the relative scarcity of young teachers in the region and shortages of materials and equipment. Education expenditure within the region varied widely in 2000, ranging from 6.8 percent of GDP in Latvia to 2 percent in Tajikistan. The need for more resources is particularly great in the Caucasus and Central Asia because of a combination of low public expenditure and large numbers of children.

In summary, all countries in the region should pay more attention to education. Reforms in education systems are urgently needed, but they should be incremental, building on existing foundations, including the strong level of parental support. Public expenditure on education should be increased and should aim at maintaining and improving the quality of learning for all. Students from the poorest families and those who are the weakest academically need high-quality education just as much as other children.

*This article is based on “Quality of Learning in Schools,” one of three analyses of people’s well being in transition countries in Social Monitor 2002, a new annual publication of the United Nations Children’s Fund Innocenti Research Centre’s MONEE Project. Along with in-depth thematic analyses, it replaces the centre’s Regional Monitoring Report series published between 1993 and 2001 and will continue to identify important emerging issues for children and families in the region. To download go to <http://www.unicef-icdc.org/publications/>.*

# Tax Systems in Transition

By Pradeep Mitra and Nicholas Stern

According to the authors, tax revenues in transition countries should be equal to about 22 to 31 percent of GDP, depending on the countries' stage of development. The share of direct taxes in tax revenues, especially of personal income taxes, should be increased. In addition, countries could cut excessively high marginal tax rates, reduce many national taxes, simplify their tax systems, eliminate exemptions, and educate taxpayers' about the reasons for and need to pay taxes.

The purpose of taxation is to raise resources to finance government expenditures on key public goods and to provide basic social services. Taxation and expenditures should ideally be analyzed together. The magnitude of expenditure adjustment during the 1990s was much greater in the CIS countries than in the Central and Eastern European and Baltic (CEEB) countries. Public expenditures as a proportion of GDP reached 45 to 50 percent at the beginning of transition in all the countries, fell during the 1990s, and in 2000 ranged from 29 percent in the CIS countries to more 40 percent in the CEEB countries.

The ratio of government expenditure to GDP in the CIS countries fell to levels comparable to those in countries with similar per capita income levels (in the late 1990s average purchasing power parity-based per capita GDP was \$3,850 in the CIS countries). In contrast, the 40 percent average ratio of government expenditure in the CEEB countries was almost a third higher than in other countries at similar per capita income levels (\$9,350). This does not necessarily imply that public spending in those countries is excessive, considering the larger role

of the state and the need to support public expenditures at higher levels.

Social security and welfare account for more than a third of public expenditures in the high-income OECD and CEEB countries and for roughly a quarter of public expenditures in the CIS countries. Public expenditures on health and education account for a quarter of public expenditures in the high-income OECD and CEEB countries and a little under 22 percent in the CIS countries. They are split roughly evenly between health and education in the OECD and EU accession countries, but in the CIS countries spending on health is about double that on education.

Altogether, expenditures on education, health, and social protection account for nearly 60 percent of public expenditures in the high-income OECD and CEEB countries and nearly half in the CIS countries. Recall, however, that both GDP and the share of public expenditures in GDP are significantly lower in the CIS countries, so that public expenditures on education and health, for example, have each fallen to \$10 per capita or less in

**Table 1. Tax Structure of Industrial and Transition Countries (percentage of GDP)**

Countries	Total revenue and grants		Other revenue and grants	Taxes on income, profits and capital gains of which			Social security and payroll taxes	Domestic taxes on goods and services of which general sales turnover			International trade taxes, of which duties			Wealth and property taxes	Other tax revenues
		Tax revenue		Total	Imports	Exports		Total	Individual	Corporate	Total	duties	duties		
High-income															
OECD	42.9	36.6	6.3	14.4	10.1	2.6	8.9	10.7	6.1	3.1	0.1	0.1	0.0	1.8	0.7
EU <sup>a</sup>	45.2	39.4	5.8	14.3	9.6	2.6	10.8	11.9	6.7	3.7	0.0	0.0	0.0	1.5	0.9
CEEB (early transition)	40.8	35.0	5.8	9.7	5.3	4.3	11.2	11.0	8.4	2.2	2.0	2.0	0.0	0.3	0.8
CEEB (late transition)	37.7	33.0	4.7	7.4	5.2	2.1	10.6	12.4	8.7	3.4	1.3	1.3	0.0	0.4	0.7
CIS (early transition)	29.3	24.4	4.9	8.0	1.7	6.2	6.2	9.0	6.2	2.5	0.7	0.5	0.1	0.2	0.3
CIS (late transition)	25.5	22.2	3.2	5.3	2.0	3.1	4.5	9.7	6.1	2.5	1.2	1.1	0.1	0.8	0.6

CEEB Central and East European and Baltic Countries.

VAT Value added tax.

a. Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, United Kingdom.

the poorest CIS countries such as the Kyrgyz Republic and Tajikistan.

## New Characteristics

How did tax systems, whose primary role is to raise resources to finance these public expenditures, evolve during the 1990s?

- The share of tax revenues to GDP fell from 24 to 22 percent in the CIS countries and from 35 to 33 percent in the CEEB countries, paralleling the reduction in public expenditures. In 1999-2000 this left the CEEB countries, and especially the CIS countries, with a lower tax revenue to GDP ratio than the 37 percent prevailing in the high-income OECD countries.
- The share of direct taxes—that is, personal and corporate income taxes plus social security contributions and payroll taxes—to total tax revenues fell from 56 to 43 percent in the CIS countries and from 59 to 54 percent in the CEEB countries. In 1999-2000 this left the transition countries with a share of direct taxes in total tax revenue much lower than the 63 percent obtained in the industrial countries. The decline was primarily due to a sharp fall in the share of the corporate income tax—from 25 to 13 percent in the CIS countries and 13 to 7 percent in the CEEB countries—and reflected the worsening performance of publicly-owned enterprises. While the share of individual income taxes to total tax revenues in both groups of transition countries increased, the ratio of social security contributions and payroll taxes

to total tax revenues fell in the CIS countries to levels below those in the high-income OECD economies, but remained broadly unchanged in the CEEB countries.

- The share of domestic indirect taxes—that is, value added tax (VAT), sales taxes, turnover taxes, and excise taxes—rose from 37 to 44 percent in the CIS countries and from 32 to 38 percent in the CEEB countries.

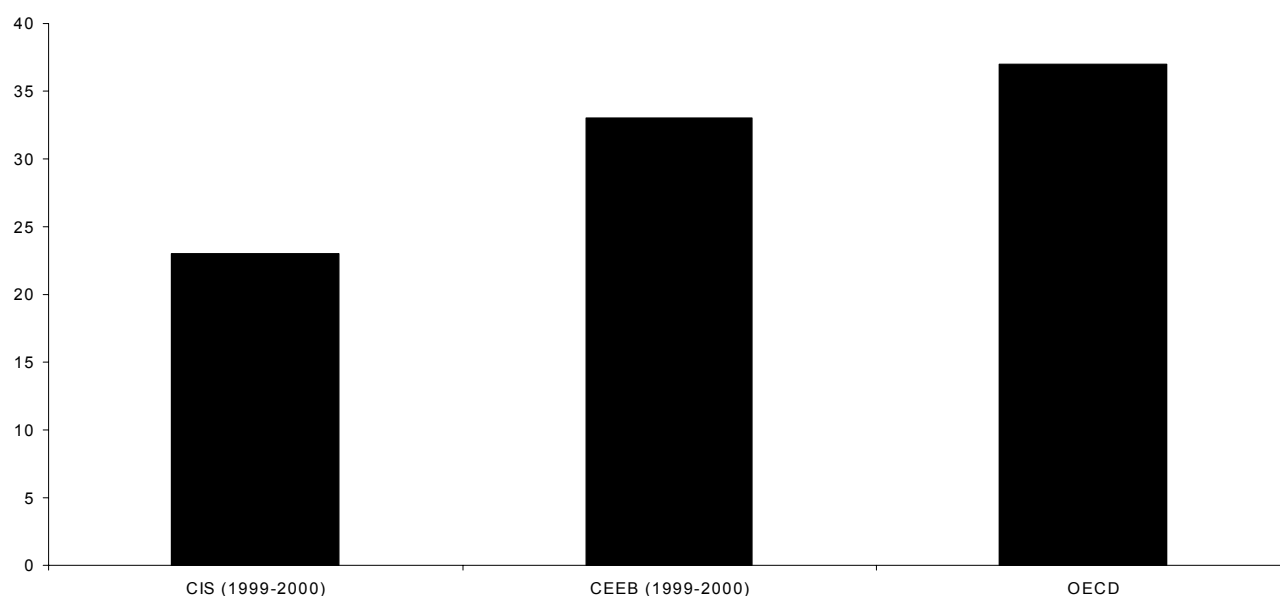
## Taxing Challenges

As a result of tax reform the share of tax revenues to GDP should rise, and within tax revenues the share of direct taxes, especially of personal income taxes, should be increased. At the same time the share of revenue from domestic indirect taxes should be cut and the role of trade taxes should be reduced to negligible levels.

The imposition of market discipline and the creation of an attractive investment climate must go hand in hand. This challenge includes reducing excessively high marginal tax rates. The number of national taxes—profit taxes, VAT and/or sales taxes, income taxes, and social security taxes in the form of payroll taxes, together with turnover taxes to support various special funds—is a rough indicator of the complexity of a tax system. Using this measure Hungary and Poland have the least complex national tax systems while Belarus, Turkmenistan, and Uzbekistan have the most complex.

Tax reform should eliminate tax exemptions. In Georgia, for example, an additional 2 percent of GDP could

**Figure 1. Tax Revenues in High-Income OECD and Transition Economies (percentage of GDP)**



CEEB Central and East European and Baltic Countries

Source: The authors.

be collected from excise taxes on petroleum products and cigarettes. Devising a simplified tax regime for small businesses is also important to relieve their administrative and reporting burden and to minimize contact between tax authorities and taxpayers. However, the use of tax exemptions and tax relief for small businesses is not recommended, as this would allow about 50 percent or more of annual value added—generated by small firms in successful transition economies—to escape the tax net. Thus it could significantly worsen the government's fiscal position without solving the real problems responsible for impeding the development of small firms, such as insecure property rights or inadequate infrastructure.

### **Tax Administration Traps**

While many countries now have modern tax legislation on their books, the development of tax administrations has lagged that of policy. While tax administrations in transition countries share many problems with those in developing countries, the postcommunist legacy has some unique features, namely:

- A culture of mutual mistrust between taxpayers and the tax authorities
- No tradition of voluntary compliance with tax legislation
- No tradition of appeals to the courts against decisions by tax authorities that, by enhancing trust in the fairness of the tax administration, would encourage voluntary compliance
- No tradition of self-assessment, which would shift the burden of appraisal to the private sector and reduce administrative demands on the tax authorities.

This implies that much attention has to be paid not only to strengthening enforcement, but also to developing taxpayer education and services to improve compliance. Thus potential taxpayers should be made aware of the general concept of taxation and why they should pay their taxes; assistance should be provided to taxpayers who wish to comply voluntarily, but is usually available only to large taxpayers in the private sector; and compliance costs should be reduced by simplifying procedures.

While many weaknesses in tax administration may be addressed through technical measures, the development of civil society and the political will to streamline the administration of tax policy are critical. Tax compliance will grow at the same pace as the development of civil society. Political will is required on two fronts. First, hard-

ening budget constraints will force large taxpayers to collect taxes from major tax debtors. Second, to create a level playing field for small enterprises, their tax regime needs to be simplified. Political commitment to implement tax policy effectively should be distinguished from use of the tax administration for political ends, such as selectively enforcing tax discipline on large taxpayers. Politicization of the tax administration should be avoided.

### **Tax Initiatives: A Double-Edged Sword**

In the advanced reforming countries, where few large privatizations remain, a major challenge facing policymakers is to devise an investment climate that can continue to attract inflows of foreign direct investment into greenfield ventures and cross-border acquisitions of private sector assets without undermining the country's fiscal position through the provision of tax incentives. Many countries—such as Bulgaria, the Czech Republic, Estonia, Hungary, Romania, and Slovakia—have offered tax incentives, employment subsidies, and special economic zones to attract foreign investment.

Recent empirical studies in the industrial countries suggest that the location of investment, its modes of financing, and associated tax avoidance respond more strongly to tax changes than was previously thought. Moreover, candidate countries for EU accession—including the Czech Republic, Hungary, Poland, and Slovakia—have successfully engaged in tax competition to attract foreign direct investment within their borders. Caution is, however, warranted here. The tax system, although important, is but one ingredient of an attractive investment climate. Furthermore, the interaction of tax and nontax incentives in relation to investment remains to be adequately explored in empirical work.

Hence if particular regions of a country experience stubbornly high double-digit unemployment as is the case in Central Europe, the solution may lie not in a rush to grant tax holidays, accelerate depreciation, and the like, but instead in directly addressing the sources of the problem, which could include providing relevant educational opportunities to match skills to labor demand, reducing disincentives to labor supply arising from overly generous social expenditures, cutting the cost of labor by lowering payroll taxes, and removing impediments to labor mobility arising from infrastructure bottlenecks. This may still leave a role for tax policy, but governments should avoid the temptation to pick winners and engage in activist industrial policy. That route can lead



to poor choices, subsidized inefficiency, and corrupt seeking after government favors.

Based on broad efficiency considerations and consistency with public expenditure shares for countries at comparable income levels, depending on their stage of development, the transition countries should aim for a tax revenue to GDP ratio in the range of 22 to 31 percent, broken down as follows: value added tax of 6 to 7 percent; excise taxes of 2 to 3 percent; income taxes of 6 to 9 percent; social security contribution plus payroll taxes of 6 to 10 percent; and other taxes, such as on trade and on property, of 2 percent. Tax revenues could be supplemented by nontax sources, which usually account for roughly 2 to 3 percent of GDP.

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## Old Tax Habits Die Hard in Russia

**Reducing the tax burden has been one of the main declared aims of the government in its pursuit of tax reform, along with creating a more transparent and stable tax system. The hope was that this would not only create a more investment-friendly climate, but would also serve to draw shadow activity into the formal sector. The real tax burden on enterprises has declined significantly—by some estimates by as much as 10 to 15 percent—but many problems remain.**

Two years of tax reform have changed Russia's tax landscape. The active phase of tax reform will end on January 1, 2003, with the abolition of the road users' tax. According to the Finance Ministry's estimates, after reaching its peak in 2002 (39.6 percent of GDP), the tax burden will drop to 37.6 percent of GDP in 2003 and to 35.7 percent in 2004. So far the government has implemented the following changes:

- Reduced the profit tax from 35 to 24 percent by revoking the investment preferences that allowed enterprises to pay the tax at an effective rate of 18 percent
- Introduced a flat income tax rate of 13 percent to replace the former three-tier tax scale
- Introduced a single social tax with a maximum rate of 35.6 percent of the wage fund and a regressive scale (it replaces deductions from off-budget funds at an aggregate rate of 39.5 percent) that finances the social security and pension funds
- Reduced the tax rate for road users from 2.5 to 1 percent and will abolish this tax completely as of January 1, 2003
- Abolished the 1.5 percent tax on the maintenance of the housing stock
- Made plans to abolish the sales taxes, which add up to 5 percent of the value of all goods and services, as of January 1, 2004.

Further steps are, however, mired in confusion. While President Putin called for a temporary halt to further measures, Prime Minister Mikhail Kasyanov maintained that lowering taxes is still on the agenda. In early November Deputy Minister for Economic Development Arkady Dvorkovich went so far as to predict a major reduction of the value added tax (VAT) from 20 to 15 percent and of the social tax from 35.6 to 25 percent. He said that property taxes for companies should not be raised and that a simplified taxation system needs to be introduced for small business. Over the next three years taxes should be lowered by the equivalent of 6 percent of GDP.

Earlier, Finance Minister Aleksei Kudrin warned that tax decreases would only become possible after Russia had passed the period of peak external debt repayments in 2003. He was also promoting more modest tax cuts. In his view, the lowering of the social tax to 30 percent and of the VAT to 16 percent should not be done earlier than 2005. He announced that the cancellation of the 5 percent sales tax, which was approved by Parliament a year ago and was due to take effect on January 1, 2004, is "still a question to be discussed." Sales taxes are regional taxes on retail sales. Kudrin said the central government does not yet have enough money to compensate regional governments for the losses they would incur following the abolition of this tax, as the federal

budget will have to save every ruble for external debt repayments next year. Kudrin promised that the tax would be abolished, but said that when this would happen, in 2004 or 2005, was as yet unclear.

A June 2002 survey of Russian managers found that the tax system continues to rank high among the factors impeding the development of their businesses, coming third behind the aging of their capital stock and the difficulty of hiring qualified employees. In 2001 tax revenues as a share of GDP rose by just over one percentage point, helped by improved tax administration and the legalization of activities previously conducted in the informal sector. However, in 2002 the government met its revenue targets for the first six months of the year only because of a significant (29 percent) overfulfillment of the target for the social tax, which goes not to the actual budget, but to the various pension and social insurance funds. Profit tax receipts were down not only as a result of the lower (now 24 percent) nominal rate, which was largely offset by the elimination of various tax breaks, but chiefly because of declining corporate profitability. The profits of medium and large companies in January-May 2002 were down 36.7 percent year-on-year.

Tax accounting has become a major problem for many taxpayers. Companies that have been able to pay less in taxes because of the reforms have had to significantly increase the volume of documentation prepared for the tax authorities, and thus their expenditure on accountants has risen. The number of payment documents companies have to prepare has more than doubled since the introduction of the social tax.

Changes in the arrangements for paying VAT have also created problems for many businesses. Individual small entrepreneurs previously did not pay VAT, but nearly all must now do so. Moreover, from the beginning of next year they will have to pay VAT in advance like large taxpayers do. This will be a serious blow to many small businesses.

Tax collection has not improved: in 2002 uncollected taxes amounted to about Rub13 billion.

To sum up, data on enterprises' tax payments for 2001 and the first half of 2002 point to four general conclusions as follows:

- While nominal tax rates have been cut, especially the profit tax rate, in many respects the tax system remains confused and opaque, especially with respect to tax accounting. In some cases recent reforms have made matters even more complex.
- The social tax has hit small and medium businesses hard, in some respects negating the positive effects of other reforms.
- The so-called turnover taxes, while declining, have not yet been abolished, and in some cases continue to affect business in significant ways.
- As a result of the campaign to close tax loopholes and reduce the number of concessions and tax breaks, the new, simplified profit tax regime has reduced investors' incentives.

*Based on news agency reports and articles of Oxford Analytica, the Oxford, U.K., based international research group.*

## British Business Misses Opportunities in Southeast Europe

By James Ker-Lindsay

**In a recent speech Peter Hain, the United Kingdom's minister for Europe, noted that British companies are not seizing the opportunity to invest in Central and Eastern Europe, and as a result they are losing millions of pounds of potential revenue each year to businesses in other EU member countries. This lack of British involvement is particularly acute in Southeast Europe.**

The simple fact is that compared with the size of investments other EU countries have made in the region, British businesses have not made the inroads that they should have. This is not to say that British investment in the area has been nonexistent, but in comparison with the size of their relative economies, the United Kingdom

has been far less active in the region than Belgium, France, Germany, Greece, Italy, and the Netherlands.

Two reasons can help explain this comparative lack of interest. The first reason is a belief in the United Kingdom that political instability and corruption make any

investment in the region too risky. However, while both political instability and corruption persist and do pose certain difficulties, the extent of the problem is excessively exaggerated in the minds of senior executives in U.K. companies. For some reason they tend to view the business environment of Southeast Europe today as comparable to the Russian market of the early and mid-1990s.

In terms of political stability, the situation in the region is improving with each passing day. While the potential for another flare up of fighting in Kosovo and Macedonia certainly exists, the situation is generally calm and stable and becoming more so. At the same time the region is becoming ever more integrated with Western Europe, both economically and politically. Greece is an EU member, Slovenia looks set to join shortly, and Bulgaria and Romania are candidates and a timetable for their actual accession will likely be presented later this year based on their improved performance. [Editor's note: January 2007 is the latest date for the accession of those two countries.] In addition, Greece and Turkey are already members of NATO and Bulgaria and Romania might well be invited to join this November. Furthermore, stabilization and association agreements, the first step toward eventual EU membership, already exist with Croatia and Macedonia and are planned for Albania, Bosnia and Herzegovina, and Serbia and Montenegro.

Thus while political instability is not as severe as U.K. investors might believe, corruption does pose problems. An examination of figures produced by Transparency International covering 91 countries worldwide shows that the extent of perceived corruption in Southeast Europe is fairly high. Slovenia, the "cleanest" country in the region, ranked only 34th on the list in terms of open and transparent procedures, while Greece came in at 42nd, Bulgaria and Croatia tied at 47th, Turkey came in at 54th, Moldova at 63rd, and Romania at 69th.

Another set of figures released by Transparency International ranks 21 countries in terms of their companies' likelihood to pay bribes, with a score of 1 indicating the "cleanest" countries. According to this index British companies, which received a ranking of 8, are less likely to pay bribes than companies from many other EU countries that are doing well in the area, such as Germany, which came in at 9th; Spain, which came in 11th; France, which came in at 12th; or Italy, which came in 17th.

So the answer could be that British companies do not want to go into a region that requires them to deal with corruption; however, this is not a satisfactory answer. Belgian and Dutch companies are ranked equal sixth in

the survey yet have nevertheless managed to gain a significant foothold in Southeast Europe. Overall the region is certainly less risky—both in terms of conflict and corruption—than many parts of the world where British companies not only operate, but flourish. For example, the Middle East is worth approximately \$10 billion per year in investment to British companies.

The second, and more worrying, reason for the lack of wider U.K. involvement in the region is that British companies are showing an uncharacteristic lack of a sense of adventure. Many of those trying to promote greater U.K. interest in the region note that even though they hail from a country that has had global trade dealings for centuries, British firms now appear to have lost the appetite to search for new markets. This perception is confirmed by many U.K. companies that believe that the time, trouble, and expense needed to open up the region are simply not worth it.

Two good counter responses to this argument are available. First, at a time when global growth rates are down, Southeast Europe is expected to record a regionwide GDP growth rate of more than 4 percent, double the expected growth rate of Western Europe. While it still lags behind Western Europe in terms of per capita income, the gap is closing. As a result, and contrary to many people's perceptions, the region is no longer a gray zone of universal poverty.

Second, the United Kingdom is losing out to its EU partners that are taking a more progressive approach. While U.K. firms are pondering the difficulties and choosing to remain aloof, French, German, and Italian companies have been active across the region in a variety of sectors, including banking, telecommunications, and the media.

While Southeast Europe certainly has a long way to go in terms of economic development, the region's prospects are bright in the medium to long term. It is an area that offers good opportunities to those U.K. companies willing and able to put aside past prejudices or sloth and take the time to find out more about the possibilities. Those companies willing to look at the opportunities should note another point Hain made in his speech: companies in the region are ready to do more business with their British counterparts.

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# World Bank/IMF/EBRD Agenda (*continued*)

2002 the Bulgarian government launched an operation to swap part of its foreign debt for new bonds in parallel presentations in Frankfurt, Boston, London, and New York. The government planned to buy back about \$1 billion to \$1.25 billion worth of Brady bonds, or about 25 percent of its total outstanding foreign debt in Brady bonds. Through a series of auctions the holders of the Bradies will be able to exchange them for bonds from the new eurobond issue. The floating interest rates on the Brady bonds were to be replaced by fixed coupon payments to be determined on the last day of the presentations, and were expected to be 8.5 percent fixed coupon payment on the U.S. dollar-denominated eurobonds maturing in 2015, and 8 percent fixed coupon payment on the euro-denominated bonds maturing in 2013. The operation is expected to allow an 8 to 10 percent reduction of the nominal debt stock, or about \$100 million to \$125 million. It will also allow a reduction in the debt service amount by an estimated \$600 million over 10 years. According to the *Financial Times*, Bulgaria is the first East European country to apply this mechanism, which has been used extensively by Latin American countries.

## Developing Highways in China

In mid-September the World Bank approved a \$250 million project for China that will provide a more effective, safe, and efficiently managed highway system in Hubei province. The project will support the construction of the 243.5-kilometer Xiaogan-Xiangfan expressway, as well as the improvement of road accessibility in poor counties. It will also improve transportation links to China's western region. "Twenty-four million people live in Hubei province areas that will directly benefit from this project," said World Bank Lead Transport Specialist and Task Manager for the project Michel Bellier. "It will lower transportation costs, make road travel safer, and make it easier for residents of low-income areas to access markets, schools, and health centers."

## Donor Agencies Launch Joint Web Site to Exchange Country Analytic Information

On October 30, 24 multilateral and bilateral donor agencies launched a joint web site to share information about country analytic work. Effective country analytic work underpins effective donor assistance programs. The

new joint web site will help improve the impact and cost-effectiveness of development. Through the Country Analytic Work Partnership Website (<http://www.countryanalyticwork.net/>) donor agencies will share analysis, good practice, and advice to strengthen policy dialogue, develop and implement country strategies, and carry out sound lending operations. The web site will help donor institutions and their clients use development resources more efficiently, avoid duplication, and build capacity. It will also provide information about development challenges in a particular country or region. Of the 24 participating organizations 8 have started using the web site and posting relevant information, which includes a sample of the World Bank's recent and planned economic and sector work.

## World Bank Launches BioCarbon Fund to Fight Global Warming

In November 2002 the World Bank launched the BioCarbon Fund, a public/private initiative established as a trust fund administered by the World Bank to finance projects that remove greenhouse gases in forests and agro-ecosystems. The target size of the fund is \$100 million. The fund's aim is to achieve cost-effective emission reduction while promoting biodiversity conservation and sustainable development in transition and developing countries.

## Romanian Gold Mine Loan Is Blocked

"World Bank President James Wolfensohn has killed agency participation in a \$250 million project, a Canadian gold-mining investment in Romania that drew fire from environmentalist groups," reported Neil King Jr., in the *Wall Street Journal* on October 11. The International Finance Corporation (IFC), the Bank's private sector lending arm, was negotiating with Toronto-based Gabriel Resources, Ltd. to back a project creating the largest open pit gold mine in Europe. The \$400 million Rosia Montana project would displace more than 2,000 people and tear down nearly 900 homes. Environmentalists also opposed plans to build a 1,000-acre reservoir to collect cyanide tailings left over from the mining process. World Bank Group President Wolfensohn directed IFC to drop loan negotiations. IFC involvement would not have exceeded \$100 million.





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# Crime and Punishment: The Opportunity Cost

By Yuri Andrienko

**While most studies find income inequality as a major factor significantly increasing the crime rate in various countries, the impact of income is ambiguous, as individual income may also include white-washed criminal revenue, and thus the perpetrator must weigh both the opportunity costs of crime and the expected costs of punishment. Less ambiguous is the relationship between quality of life and incidence of violent crime.**

While scientists have debated what, if anything, pre-determines criminal behavior (the recent discovery of a “criminal” gene in the United Kingdom brought about a long-awaited success for biologists, who have insisted on a genetic predisposition toward criminal behavior), economists have tenaciously tested the “rational offender” theory during the three decades since Becker’s seminal paper.

[Editor’s note: the paper, “Crime and Punishment—An Economic Approach,” argues that traditional, sociological views about criminals are incorrect. Many criminals are not sick, deviant, or in some other way abnormal. Rather, most criminals differ merely in the fact that their choices are different from those of the majority of the population. The modern economic theory of crime is thus based on the assumption that rational individuals act to maximize their utility given the possibility of assigning time or resources to different activities.]

Those economists have made some progress: uncertainty about the consequences of committing a crime seems to play a primary role in criminals’ decisionmaking. Although the probability of punishment for a criminal act generally does not exceed a few percentage points in the modern world, researchers agree that it is not severe punishment (a fine or imprisonment), but the deterrence effect of even a small certainty of punishment, that prevents people from committing offenses.

While income inequality significantly increases the crime rate for different types of crime, for example, intentional homicides rates are highest in Latin American countries and in Russia, the countries with the largest Gini indexes, the impact of income is ambiguous. The explanation is that legal income represents

not only criminal revenue, (assuming that it has been “laundered”), but also the opportunity costs of crime and the expected costs of punishment.

The quality of life, which should measure the costs of crime more accurately, better predicts the incidence of violent crimes. Using aggregate panel data for Russian regions we have shown that if life expectancy, the integral measure of quality of life, is longer, different types of crime will decline. This finding is robust after controlling for endogeneity and the set of covariates. The same result was obtained using international country-level panel data for the intentional homicide rate. Thus the economic theory of criminal behavior based on the assumption of a rational offender can help explain many facts pertaining to crime.

Similarly, victims and law enforcement also behave rationally. Individual rationality is immanent to victims, who usually do not report petty crimes to the police given the low probability that such cases will be solved. Victims are more likely to report serious crimes against their persons or property, and in general the reporting rate for such crimes rises with the level of economic development, from a third of all such crimes in the transition countries to half of all such crimes in the industrial countries.

The enhanced availability and quality of micro-level data on household and individual experience with crime in a number of countries has improved the scope of activity for researchers. Such data allow comparisons of the incidence of crimes against people and property in different countries. For example, in Europe one may find that property crimes (such as theft of personal property) are more widespread in the capitals of transition countries, whereas some violent crimes (assaults and

sexual offenses) occur more often in urban areas in Western Europe. Such data could inform the search for policy instruments to reduce crime.

Multivariate analysis of the individual's risk of being a crime victim shows that those most likely to become victims are young, well-educated, employed,

and unmarried women from rich households residing in big cities. Individual or group-oriented programs should be provided to reduce the risks for such vulnerable groups.

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## Regional Political Cycles in Russia

By Ekaterina Zhuravskaya

**Russian governors systematically use their regional budgets to improve their chances of winning elections. Following a successful campaign they feel safe to cut social programs and revoke promised investments, exposing the local economy to serious shocks. Forcing them to be transparent and accountable by increasing voters' awareness could eliminate these harmful cycles.**

Elections are the most common mechanism for disciplining politicians. How well is this mechanism working in Russia's regions? How much do regional governors need to worry about not being re-elected? Few people would argue that Russia's regional elections are fair and transparent, but opinions differ about how exactly those elections are "co-opted." Some observers maintain that incumbent governors do not worry about elections because they control the vote count. Others are convinced that while votes are counted relatively objectively, incumbents have a significant advantage over their opponents because they run the regions before the elections, and therefore control the regional budgets and use them to improve their chances of re-election.

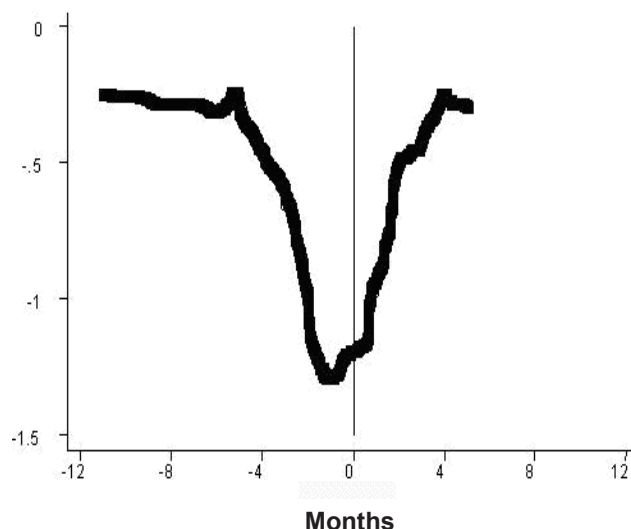
CEFIR examined the relationship between regional budgetary spending and the closeness of regional elections based on a comprehensive review of elections at the regional level since March 1996. The results indicate that incumbent governors apply significant efforts and public funds to win over voters as elections draw closer. This means that the incumbents are worried about re-election, and that the view that incumbents do not need to consider the voters because they control the vote count is incorrect. Thus elections appear to push governors into spending money from regional budgets to improve their constituents' economic conditions. Unfortunately, the situation is not as positive as it might appear to be at first glance.

Often, to ensure victory incumbents only need to serve their constituents' interests for a short time, up to a year, before the elections, even if that negatively affects constituents' economic situation during the first three

years of the incumbents' terms. In practice, to achieve large socioeconomic improvements right before the elections Russian governors intentionally curtail social programs when elections are distant.

The data show that social expenditures rise sharply as elections get closer. The first significant improvements occur as early as nine months before the elections, but the major changes take place in the last month before the elections. Immediately after the elections, however, social expenditures fall dramatically across all areas, and spending levels return to what they were before the election pressure kicked in. Undoubtedly such shocks do not leave the economy unaffected: deep recessions tend to set in after elections. The following are selected results in particular regional budget expenditure items,

**Average Wage Arrears across Regions in the Months before and after Regional Elections in Russia**



adjusted for regional differences, seasonal fluctuations, and federal trends:

- One month before regional elections social expenditures from regional budgets grow, on average, by 32 percent. In the year before the elections the cumulative rise in social expenditures is 135 percent, an increase that is fully reversed during the year following the elections.
- One month before regional elections regional expenditures on education, culture, and health care rise by 13, 11, and 17 percent, respectively. Three months after the elections these expenditures have fallen by 7, 19, and 10 percent, respectively.
- Wage arrears owed from the regional budget accumulate during the first three years of the regional government's term, but start to decrease at an increasing pace nine months before the elections. They fall to a quarter of what they were during the course of the pre-election year, but return to their prior level just four months after the elections (see the figure).

The data show that, controlling for other factors, the larger the increase in social expenditures during the four months before the elections, the better the incumbent governor's chances of re-election. Thus the presence or absence of ideology from the election cycles comes as no surprise: left-wing regional governments exhibit the same pre- and postelection spending patterns as right-wing regional governments.

These political cycles are costly, because they result in relatively long recessions and in inefficiencies in public spending. However, the costs to society caused by distortions in policies and outcomes are only the tip of the iceberg created by the electoral cycles. Governors manipulate voters' opinions using extremely short-term policies, and thus are largely unaccountable in the long run. Thus to date regional elections have not been an effective tool for voters to control elected officials.

So why are incumbent governors able to trick voters using voters' own money? After all, as Abraham Lincoln once said: "You can fool some of the people all of the time, and all of the people some of the time, but you cannot fool all of the people all of the time." The answer seems to lie partly in the immaturity of the Russian democratic tradition, and Russian voters are only now starting to learn from their mistakes. The amplitude of the election cycles during the last round of regional elections in 2000 and 2001 was somewhat smaller than under Yeltsin. Furthermore, some people are more easily fooled than others: the amplitude of the cycles is lower

among more educated voters living in more computerized and urbanized regions.

Therefore even though the direct implications of the data are quite negative, more in-depth evaluation suggests a more optimistic view. First, the presence of the cycles confirms that governors' do feel some electoral pressure, which is good news given the high capture of electoral institutions in the region. Incumbent governors are worried about being punished by the voters, and even though this argument is valid only during the period immediately before elections, we can conclude that governors cannot rely only on controlling the vote count. Second, even if to date incumbent governors have been able to trick voters with short-term improvements, the maturing Russian democracy is learning from its mistakes. Complacency is obviously unwarranted, however, and further moves toward increasing the transparency of regional budgetary expenditures and pre-election campaigns are necessary. Governors' ability to be re-elected must be made dependent on their effectiveness during their entire terms, not just in the month before the elections.

*The author is the academic director of CEFIR in Moscow. For the complete text of this article see <http://www.cefir.org/papers>.*

## Demand for Corporate Governance in Russian Industry

By Sergei Guriev, Olga Lazareva, Andrei Rachinsky, and Sergei Tsoukhlo

**The Russian economy grew by 20 percent during 1999-2001, but as the economy runs out of excess capacity, growth is slowing down. The lack of capital investment is becoming the binding constraint to further growth and industrial restructuring. While exporters of natural resources generate sufficient cash flows to finance internal investment, other industries have to rely on external finance. This is why good corporate governance is crucial for building a sustainable economy.**

Efforts to improve corporate governance have been made since the beginning of Russia's economic reforms, and the country has adopted a sophisticated system of laws and regulations; however, imperfect enforcement has

made these laws irrelevant or, in some cases, even counterproductive.

### Code of Informal Conduct

Recently, the Federal Securities and Markets Commission developed the Code of Corporate Conduct (see [http://www.rid.ru/db.php?db\\_id=516&l=ru](http://www.rid.ru/db.php?db_id=516&l=ru)), which sets out corporate governance norms and procedures intended to protect shareholders and investors. The code is to be adopted on a voluntary basis and to serve as a blueprint for firms developing their own systems of governance. In this sense the code is an informal institution that can partly substitute for the poor enforcement of formal laws. However, if the code is to be implemented effectively, firms need the proper incentives. The main purpose of our research is to study the determinants of Russian firms' demand for good corporate governance.

Our most striking finding is that, contrary to cross-country research, concentrated ownership is positively related to the quality of corporate governance (controlling for size, industry, region, and other characteristics). We believe this result is consistent with the informal, voluntary nature of corporate governance institutions in Russia,

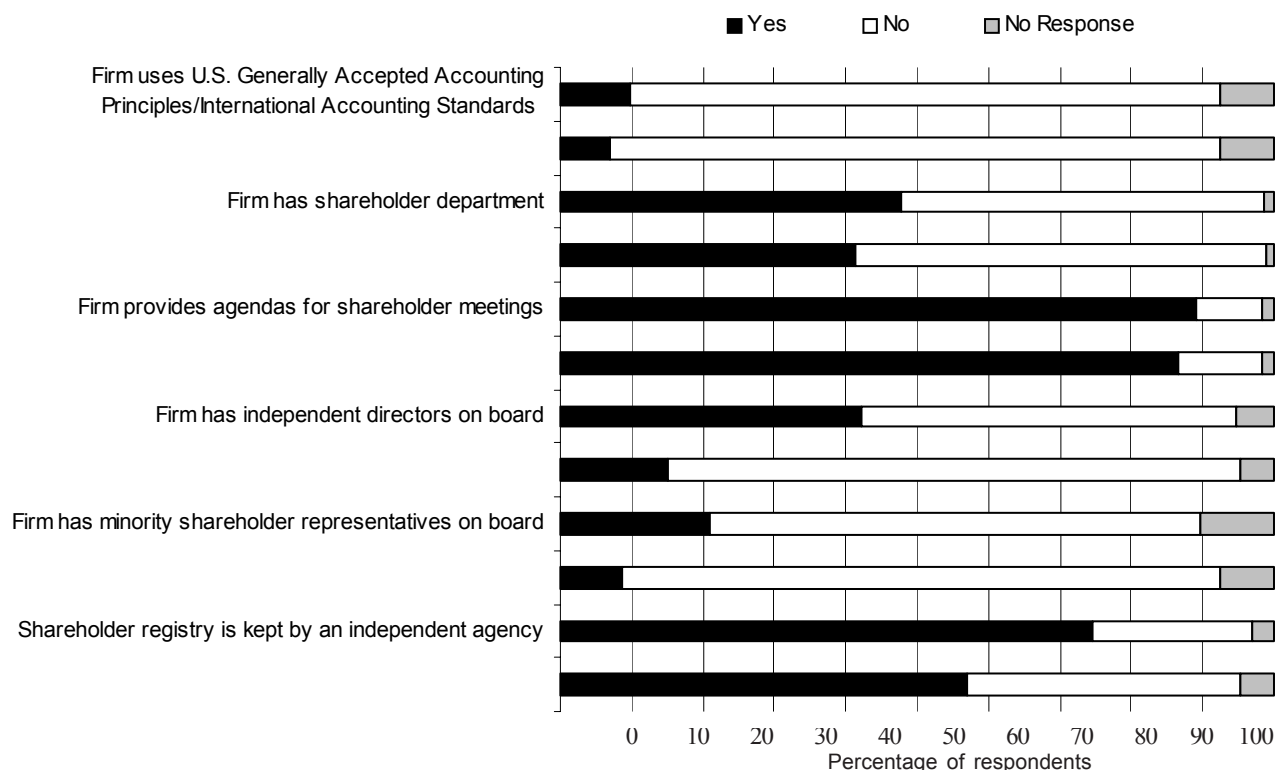
whereas the cross-country studies compare formal institutions, where the better the formal protection given to minority investors, the less concentrated the ownership. As Russia does not, in practice, have such formal institutions, what matters is whether managers or controlling shareholders have incentives to make up for the missing corporate governance mechanisms by voluntarily protecting outsiders.

Our study is based on a survey of the top management of 1,000 large and medium industrial enterprises. The sample was constructed to be representative of Russian industry as a whole, and covered 22 percent of employment in the industrial sector. Most of these firms are not listed on stock exchanges, yet the legacy of privatization is such that most are still formally registered as publicly held corporations. Our survey included questions about firms' ownership structure, sources of investment, barriers to obtaining external finance, current level of corporate governance, and attitude toward the code. We matched the survey data with the firms' official financial accounts.

We investigated the following:

- Determinants of current level of corporate governance

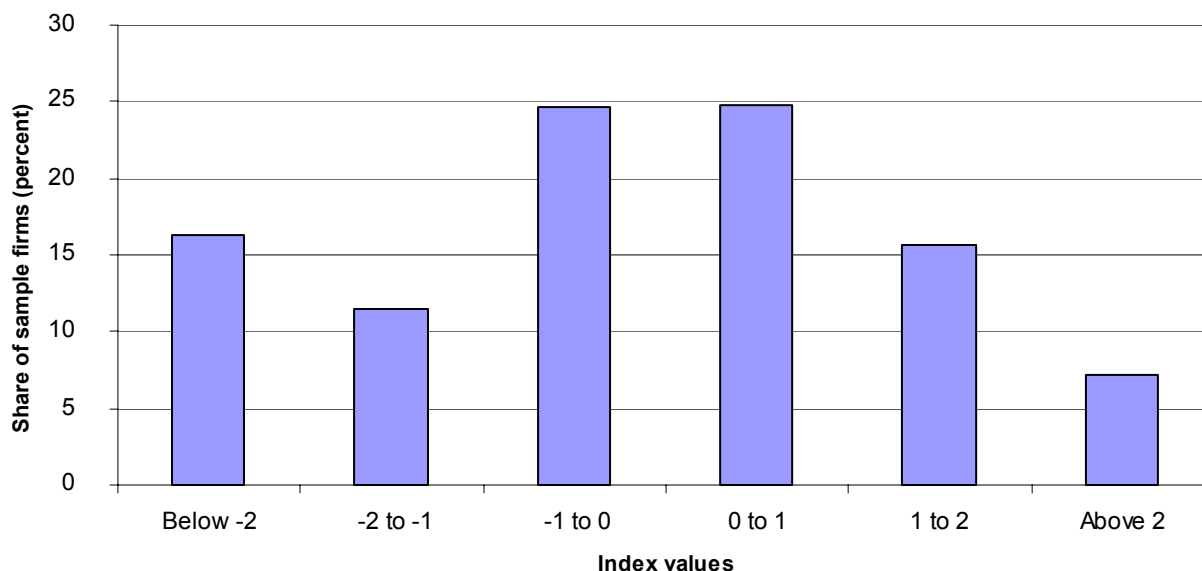
**Figure 1. Corporate Governance Indicators**



*Note:* This figure presents answers for 676 public companies and 186 closely held corporations.



**Figure 2. Corporate Governance Index**



*Note:* Index values of less than  $-2$  correspond to six negative answers. Values above 2 correspond to five or six positive answers. Thus the higher the index value, the better the corporate governance.

- Determinants of capital investment and sources of finance
- Perception of the code and determinants of the demand for corporate governance institutions.

### Index of Corporate Governance

To determine the current level of corporate governance in a firm we used six simple criteria (see figure 1). Based on the answers to these questions we constructed an aggregate index of corporate governance using principal component analysis. As figure 2 shows, the index varies substantially across firms.

What determines the index of corporate governance? To begin with a firm's size has a strong positive effect, which implies the existence of fixed costs of implementing corporate governance mechanisms. The most interesting finding, however, is the effect of ownership structure. Increasing the total share of small shareholders (less than 5 percent each) increases the level of governance. At the same time, the share of management and the share of the single largest outside shareholder also have positive significant effects. Concentration of ownership provides incentives for improving corporate governance. The effect of large blocks is, however, nonlinear. A concentration of more than 50 percent of shares in the hands of managers or outsiders results in a negative effect.

Analysis reveals that the share of the largest outsider has a positive effect up to an ownership position of 78 percent and a negative effect thereafter. That is, when an owner holds a majority stake, corporate governance institutions become less valuable, and consequently less desirable.

We also studied factors determining whether and how firms attract investment. The survey shows that 77.6 percent of firms invested in 2001, most of them using internal sources of finance. Only 20 percent used bank credit and fewer than 1 percent issued new shares to finance capital investment. These figures are consistent with aggregate official statistics. Our main interest is to estimate the effect of corporate governance on investment. We find that controlling for size, industry, ownership structure, and so on, corporate governance does not generally influence investment. However, this may be explained by the complementarities between corporate governance and the ownership structure. Concentrated ownership is a substitute, while ownership by small outsiders' is a complement to corporate governance. The higher the share of small owners, the greater the impact of corporate governance on investment. Hence our failure to find an effect of corporate governance on investment may be explained by the dearth of small shareholders in our sample firms (and in Russian industry as a whole).

We also estimated the determinants of sources of finance. By far the strongest explanatory factor was the stock of liquid assets. Quite predictably, the larger the stock of liquid assets the lower the probability of external investors. The chances of external financing improve the larger the size and share of the single largest outside owner.

Finally, we explored managers' perceptions of and familiarity with the code. Only 33 percent of the managers in our sample knew about the code, and only 4 percent understood the code in detail. We also asked about the acceptability of the code as a whole, and specifically about managers' attitudes toward seven specific norms of the code. Almost half of the sample firms were willing to disclose information about their compliance with the code. Moreover, most managers considered particular norms of the code to be acceptable. The more managers know about the code, the more likely they are to accept it. This suggests that the code plays an important promotional or educational role. Not surprisingly, attitudes toward the code as a whole and toward its particular components are more positive in firms with more dispersed ownership and with higher levels of corporate governance.

### Learning from Results

The results suggest that informal institutions can only be introduced if incentives to adopt them are in place. In the case of corporate governance, these are provided through concentrated ownership by insiders and large shareholders. Hence, there is a positive correlation between ownership concentration and level of investor protection, which is striking given that cross-country studies of formal corporate governance institutions find that higher ownership concentration is associated with lower levels of investor protection.

Our results also emphasize the educational role of the code. As of mid-2002, most Russian managers were unfamiliar with the code, hence more efforts should be devoted to disseminating and promoting it. Furthermore, voluntary corporate governance norms should be supported by informal enforcement mechanisms, such as self-regulating organizations and rating agencies.

A broader conclusion is that firms that want to improve their corporate governance can do so even without the code. This suggests that instead of imposing unified corporate governance rules, policymakers should focus on reducing the transaction costs of switching between

governance systems, in particular, consolidating ownership, going public, and privatizing. Firms that started with similar ownership structures during the time of mass privatization are now arriving at quite different organizational and governance forms. The main challenge for policymakers is to remove barriers on the path that leads firms toward greater investment and growth.

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## Conference Announcement

### CEFIR/Club2015 Second Annual Conference on Russia 2015

November 26, 2002, Moscow, Russia

Hosts: CEFIR, The New Economic School in Moscow, and Club 2015

Four years of economic growth in Russia allow us to refocus the policy debate from current to long-term issues, to think about Russia's development over the next 10 to 20 years, and to look for sources of sustainable growth. The new annual series of Russia 2015 conferences gives policymakers, business people, and academic economists a unique opportunity to discuss long-run development strategies. This second event in the series will bring together Russian and foreign economists from research and educational institutions, economists from international organizations, and government and business representatives to discuss strategic problems of Russian economic development. The main themes the conference will address include developing new incentives for local authorities through economic and political decentralization, increasing factor productivity in individual firms devising long-term strategies for institutional change, and dealing with the consequence of reforms.

*Information: For a provisional program and more details about the conference go to CEFIR's web site: <http://www.cefir.org>.*



Local Government  
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Open Society Institute

# The Link between Research and Policy: Communicating Findings Effectively

By Raymond J. Struyk

*Research cannot be used unless it is available to those who might best use it, at the time they need it, in a format they can use and with findings that are comprehensible and adaptable to local circumstances.* Darren Saywell and Andrew Cotton, *Spreading the Word: Practical Guidelines for Research Dissemination* (1999).

Effectively communicating results to the right audiences is just as important to a think tank's success as producing high-quality research and policy analysis. Conducting fine policy analysis is pointless if it just ends up gathering dust on the analyst's shelf. A cottage industry has grown up around analyzing the link between research and policy development, and the outpouring of advice on how to communicate research results effectively never stops. The sheer volume of writing attests to the difficulty that most researchers and think tanks have in getting the results of their work used.

This discussion deliberately employs the term communication rather than dissemination. Dissemination indicates a process for distributing a product after it has been developed. Here communication denotes a process that starts at the initiation of a research project by identifying policy clients for the results and defining products to meet the needs of the various audiences identified, and then updates this plan as needed as the research project evolves.

## Just-in-Time Policy Recommendations

When an issue is prominently on a nation's agenda and under active consideration, this presents windows of opportunity for the effective use of research findings in the policy process (see the table). The most prominent public policy issues are the purview of senior government officials and the legislature. Within the legislature, its leaders constitute the key players. Members of the government and legislative leaders are assisted by their staffs and by such intermediaries as advocacy NGOs, think tanks, individual experts, and knowledgeable lobbyists.

## A Seven-Step Communications Strategy

Developing and implementing a communications strategy for think tanks is a seven-step process.

### Step 1: Identify the Target Audience

In identifying the target audience, be clear about the ultimate target. Targeting intermediaries who can carry the message to the ultimate decisionmaker is fine, but be aware of the distinctive roles of both parties. Three reasons why the intended audience may not receive the intended message are

- **Selective attention.** Key people in the policy community—policymakers, their staff, researchers at think tanks, advocates at NGOs—receive a huge volume of memos, reports, newspapers, magazines, and other documents, plus many phone calls and emails. Even a well-crafted message may drown in this maelstrom.
- **Selective distortion.** Recipients will hear what fits into their belief system. As a result they often add meanings to the message that are not there (amplification) and do not notice other components that are there (leveling). Thus the communicator must strive for simplicity, clarity, interest, and repetition to get the main points across.
- **Selective retention.** People retain only a small fraction of the messages that reach them in their long-term memory. Effectiveness in delivering the message is critical for retention. Messages that are received positively

are much more likely to be recalled later than those that make a negative first impression. The exception is that an effective negative message that causes the recipient to rehearse counterarguments is also likely to be remembered.

#### *Step 2: Determine the Objective for Each Audience*

The think tank may want to put an idea or result in the person's mind (cognitive stage), change his or her attitude toward an issue (affective stage), or get the person to undertake an action (behavioral stage). The marketing literature contains four main response hierarchy models that treat these three results as sequential events, that is, a person's natural thought process leads through a standard series of responses: cognitive --> affective --> behavioral.

If the research result is the identification of a new potentially prominent policy issue, for example, underservicing of rural infants' health care needs, one target audience is the broad population with an interest in improving the conditions identified. However, you need to use the mass media to reach this audience. Thus, in effect, two audiences are involved: the ultimate audience (the population) and the proximate audience (the mass media). To attract the attention of reporters and editors express results in vivid, but accurate, language; in a highly understandable way; and in a concise document

that contains hard figures and, if possible, human interest vignettes from the project's field work. You could hold a briefing for interested members of the press to follow up on a press release that is embargoed until the day after the briefing.

By contrast, for a second-tier policy issue that is likely to receive attention in the midterm, the objective may be to get those concerned with the issue—NGOs, staff of the policy elite—to take note of the good work contained in the report so that they will refer to it when the issue surfaces later.

#### *Step 3: Select the Communication Channels*

How to communicate with the target audiences is certainly a critical question in developing a communications strategy for policy research results. The marketing community groups platforms under four headings, namely:

- **Promotion:** producing exhibits for conferences and professional association meetings
- **Public relations:** developing press kits and holding press conferences; making speeches at conferences; participating in seminars; publishing research reports, annual reports, and books; writing short policy "memos" and newspaper articles
- **Personal selling:** meeting with policymakers and with intermediaries, organizing roundtables with policymakers

### **Types of Policy Issues from a Communications Perspective**

Opportunity	Target Audience
Prominent policy questions under current discussion	Key members of the government and the legislature and their staffs, influential intermediaries <sup>a</sup>
Policy question that is likely to be prominent and to be taken up in the midterm	Administration and legislative branch staff and intermediaries
Second-tier policy matters under active discussion, for example, those addressing improved administration of a program	Key program administrators, interest groups, intermediaries
Second-tier policy matters likely to receive attention in the midterm	Key program administrators, interest groups, intermediaries
Identification of a new potentially prominent policy issue	Senior members of government and legislators with responsibility for the area, relevant advocacy NGOs, intermediaries, the public

a. Intermediaries include relevant advocacy NGOs, think tanks, and consulting firms working in the area; donor organizations; and individual experts and lobbyists.

- **Direct marketing:** mailing documents, posting results on the web, and emailing announcements.

For a “hot button” issue—a nationally prominent issue currently being addressed by the government or parliament—the team developing the strategy might decide on a combination of the following: personal selling, that is, having the think tank’s most senior people meet with policymakers and with intermediaries, such as NGOs and staff of key policymakers; public relations, that is, preparing short policy memos to support the visits and to distribute to other policymakers and intermediaries and having senior staff make presentations at conferences and professional meetings where the issue is being discussed, plus a press conference might also be appropriate; and direct marketing, that is, producing a research report to complement the memos by providing technical backup and posting it on the institute’s web site.

A quite different mix may be appropriate for a second-tier issue that is not yet on the action agenda of any responsible decisionmaker. In this case the mix could be public relations (publishing a research report, making presentations at professional conferences and seminars, publishing an article based on the research in a professional journal); personal selling (holding meetings at a technical level between think tank staff and intermediaries); and direct marketing (mailing the research report to intermediaries particularly interested in the issue and posting it on the web site).

#### *Step 4: Design the Message*

The communications team should design three separate elements—message content, message format, and message source—as follows:

- **Message content.** Researchers often find that summarizing the heart of their findings in a few simple points is difficult. While oversimplification can do a disservice to the richness of the findings and runs the risk of not fully informing the person receiving the information, communication will fail if the points are not clear and straightforward. How streamlined the message must be depends on the target audience, the message format, and the platform or vehicle picked (policy memo, television appearance, scholarly journal, and so on).
- **Message format.** Once you have identified the content to be delivered and the platforms to be employed, then the key issue is how the message should look or sound. The layout, including color, font size, and heading, helps to define the urgency of the message being conveyed and how the organization wants to be perceived.

A more muted palate, high-quality paper, and moderate font size and language in the headings send a completely different message from brassy colors, cheap paper, and headings that are clarion calls to action. Message format affects how a document—and the message it conveys—is received. For that reason think tanks need to consider presentation issues carefully.

- **Message source.** A credible message is based on how the recipient perceives three aspects of it: expertise, trustworthiness, and likability. Qualities such as candor, humor, and naturalness make a source more likable. The tone of written documents serves something of the same role. Of course, for in-person communications, the staff member’s skills as a presenter are also extremely important. For written products the institution’s credibility is often paramount for implicit claims of expertise and trustworthiness.

#### *Step 5: Establish the Communications Budget*

In practice think tanks usually have two separate sources of resources for implementing a communications strategy. The first is the line in the project budget for report writing and dissemination activities. Often think tanks do not exploit these resources for executing the common strategy to the degree they might. For example, if the strategy calls for a policy memo to be distributed, then the executive summary of the report to the client could be given more attention than usual and written and formatted so that with small adjustments it could be used to communicate with a wider audience. Similarly, if funds for publishing the report are available, it can be organized and formatted from the beginning with the specific communications targets in mind.

Beyond the project resources are those of the institution, both money and in-house staff resources. Some staff resources are charged to overhead accounts and can be allocated to a communications task without additional funds, although their opportunity cost certainly should be recognized. If the think tank has a public relations person, how much time could that person devote to marketing these results, for instance, lining up interviews with newspaper columnists and doing the layout for a policy memo? How much time is the president prepared to spend telephoning and seeing senior policymakers? A comprehensive budget should list both dollars and in-kind resources.

#### *Step 6: Decide on the Communications Mix*

The mix finally decided upon will depend on the cost of each marketing activity and its perceived effectiveness in realizing the communications objective. Each think



tank should define the cost or “internal price” for each activity. In making these calculations, consider the costs incurred at each step in carrying out an activity. Experience is an important source of information for determining how much staff time various tasks take, the cost of printing documents, and so on. Estimating the effectiveness of each communications platform or activity in reaching the communication campaign’s objectives will be much more difficult. Clearly senior management and the researcher should be consulted closely throughout the development of the communication plan and should agree with the final product.

#### *Step 7: Measure the Communications Results*

Organizations that devote effort to monitoring the effectiveness of their past communications activities will do a much better job of designing new ones. They will have critical information about the effectiveness of various platforms when deciding on the communications mix. Different monitoring approaches are appropriate for different activities. The effectiveness of a press conference can be assessed by the resulting volume of newspaper and television coverage, with due allowance made for what other newsworthy events occur on the same day. Another indicator of success is the number of follow-up radio and television appearances triggered by the press conference.

The effectiveness of mailing out or distributing documents such as policy briefs and reports can be assessed using a questionnaire distributed by mail three or four weeks after the initial distribution. Similar questionnaires could be sent to participants at roundtable events and seminars organized by the think tank. By carefully mining the results of surveys conducted on several reports or policy briefs, the organization can better decide which formats and layouts reach alternative audiences. Whatever the method used to monitor the effectiveness of communications activities, think tanks need such feedback if they are to avoid wasting scarce resources on unproductive activities.

#### **Practices in the Transition Countries**

A detailed survey in 1997 of 37 think tanks in Armenia, Bulgaria, Hungary, and Russia found that their involvement in the policy process was based on personal contacts by their leaders. Only think tank leaders in Bulgaria and Russia reported that structured opportunities, such as participating in a parliamentary working group, figured at all in the advice-giving process. All think tanks in the sample publish books, articles, memos, training manuals, and other publications. Two-thirds allocate 20 percent or less of professional staff effort to writing publications, with the balance going to research and consulting, seminars, and, in some cases, training. Several

#### **Some Characteristics of Transition Country Think Tanks**

- Think tanks are heavily involved in the policy formulation process in most countries in Central and Eastern Europe, Moldova, Russia, and Ukraine, but less so in other CIS countries.
- Western—particularly American—foundations were instrumental in encouraging the creation of a number of think tanks and had a broad influence on the private policy analysis industry. The American think tank model, characterized by strong independence, has generally served as the standard. Nevertheless, some think tanks in the region are aligned with political parties or unions of industrialists along the European model. Some observers have concerns about think tanks’ impartiality.
- Most think tanks are at the first stage of development, although a significant share—perhaps 30 to 35 percent—are in the second stage. Entities in the first stage have a small permanent research staff (one or two persons), a much larger number of part-time consultants, unstable funding, and primitive financial and administrative systems. The second stage is associated with a larger permanent research staff (at least 5 to 10 people), relatively stable funding, more sophisticated operating systems, and greater staff specialization (for example, a public relations officer may be on staff).
- National and local governments in Eastern Europe and the CIS have been poor customers for think tanks. Comparatively more contracting has been done in Hungary and Russia, but the volume is still modest. Local philanthropic support is extremely modest. The current legal and tax environment is broadly adequate, but think tanks generally enjoy no special privileges compared with parallel commercial organizations in the region.
- The donor community has not placed a priority on the institutional development of think tanks, although donors have used think tanks to pursue agendas of particular interest to them. Partly as a consequence of weak donor leadership, administrative practices in many think tanks are weak.

Hungarian and Russian institutes make writing a higher priority, devoting between 21 and 40 percent of staff time to this purpose.

Nearly all think tanks said that educating the public on the issues of the day is a main objective and that they use the mass media in their efforts. Events include press conferences, press releases, work with individual reporters to get stories published, short public service announcements, and appearances on television and radio talk shows. They use press conferences infrequently: only a half-dozen of the think tanks reported holding as many as eight such events a year. Expense aside, holding a press conference usually requires the host institution to have a substantial story to convey, with hard figures and a compelling policy conclusion. This deterrent may be more important than the financial one.

Essentially all the think tanks distribute some publications free of charge, and more than a third distribute all publications free of charge. More than 80 percent of the

think tanks have a targeting strategy for circulation of their free publications. Some of the more academic institutes mainly publish books, while organizations more closely involved in policy practice primarily publish brief policy position papers and newspaper articles. Most think tanks consider that short documents are the best type of publication to reach policymakers given their audience's time constraints and the wide range of information sources competing for that time. In the study year 75 percent of the think tanks produced bulletins and newsletters. About 17 percent of think tanks in the sample, mostly from Hungary, regularly publish an academic journal.

*This article is a shortened version of "Communicating Results," a chapter in the author's volume Managing Think Tanks—Practical Guidance for Maturing Organizations, published in 2002 as part of the LGI Studies Series, Budapest. The author is the director of the Transition Policy Network at the Urban Institute, Washington, D.C.; email: paffairs@ui.urban.org.*



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## Problems with Economic Statistics in Russia

By Sergey Nikolaenko

**The Russian system of economic statistics hampers economic analysis, and hence does not provide sufficiently accurate information for decisionmaking.**

In Russia—unlike in the developed market economies—calculations of GDP are based mainly on the sum of value added produced in the economy and not on aggregate spending. This is because a large share of income and transactions derives from or takes place in the shadow economy, which makes including it in statistics difficult. Russia's production approach to calculating GDP suffers from the fact that the last comprehensive census for input-output tables, which show the structure of production in the economy, took place in the 1980s. More recent input-output tables have been based on extrapolation. As a result, in most cases the presumption is that the share of intermediate production in gross production stays constant, and the dynamics of real GDP (value added) are similar to the dynamics of gross production. This is not the case in

reality as, for example, such calculations ignore the increasing efficiency of production.

The reintroduction of the consumer price index in the former Soviet Union in the 1980s, a concept not used since the 1920s, was an important step toward building a market economy. Even though the weights of the consumer price index are changed every year on the basis of household surveys, it is relatively good at measuring inflation. What it is not so good at is measuring the development of real indicators, such as incomes and expenditures, and in particular, providing reliable monthly observations during times of crisis because of the delays in weighting changes. Nevertheless, official statistics use the consumer price index to calculate real income, and hence give incorrect results. If they instead

used the deflator of retail sales of goods and services (calculated by dividing the index of nominal sales by the index of real sales), this would show that people's real income diminished 10 percent less than official statistics show during the 1998 crisis. This was because of the shift in consumption from imported goods, which suddenly became extremely expensive, to cheaper domestic goods. In addition, real consumption had already reached its precrisis level by the end of 2001, whereas official statistics show this happened during the second quarter of 2002.

Problems arise in connection with the publication of revised statistics stemming from the Soviet tradition that regarded amending figures as correcting mistakes. Preliminary figures receive vast publicity, while later revisions receive little comment. Perhaps an even bigger problem involves methodological changes, as official publications almost totally lack explanations about methodological adjustments and their implications for time series. No simultaneous series containing both old and new data are published. This creates situations where making time comparisons in data series is difficult, reducing their utility in economic decisionmaking.

Consider, for example, the statistics on enterprises' profits. Statistics published by Goskomstat, Russia's Central Statistical Office, in March 2001 show that in January 2001 there was an on-month increase in profits of 40 percent. Taken at face value, such information surely gives one reason to feel optimistic about the economic situation. However, the April issue of the relevant Goskomstat statistical publication contained a footnote explaining that Gazprom, the giant natural gas producer and distributor, had been included in the series since the start of the year. What was, and still is, missing is information about what other enterprises are not included in the sample, what the profit development of the old sample excluding Gazprom was in early 2001, and what the profit development of the new sample was before 2001. Hence the comparability of the series was lost.

The basic reasoning behind the introduction of a flat income tax rate and unified social tax at the start of 2001 and 2002, respectively, was to improve the tax system. The losses to the budget caused by the cut in tax rates were to be compensated for by expanding the tax base by legalizing previously unregistered incomes. However, Goskomstat continues to publish incomplete wage statistics that do not permit assessment of the effects of the tax changes. To make matters worse, the publication of household budget surveys stopped in 2001

because of a change in methodology. When publication of the surveys restarted, they omitted information about taxes paid. Such omissions make evaluation of the effects of the reform difficult and comparison of information on households impossible. Thus two years after the introduction of major tax reforms a reliable basis on which to evaluate their impact on the economy is still lacking. Worse for researchers, perhaps, was the loss of a unique chance to study the sensitivity of the Russian economy to fiscal steering methods.

*The author is a principal analyst at the Bureau of Economic Analysis and a senior economist at the Russian-European Centre for Economic Policy. This article was published in the October issue of the Russian Economy—The Month in Review, and is available on <http://www.bof.fi/bofit/>.*

## Baltic States on Their Way to Joining the EU

By Soili Mäkeläinen-Buhanist

**The historic process launched in Copenhagen in 1993 to overcome the divisions in Europe and enlarge the EU is about to be completed. The accession negotiations of 10 candidate countries are in their final stages.**

On October 24-25 in Brussels, the European Council took an important step toward wrapping up the accession negotiations at the Copenhagen European Council in mid-December. Signing of the Accession Treaty is planned for April 2003. After that both the current member states and the new member states must ratify the treaty before the new members can enter the EU in 2004. The Baltic states, like most candidate countries, will hold a referendum on accession to the EU after signing the treaty.

Estonia started its negotiations in 1998; Latvia and Lithuania began in 2000. Since then each country has made steady progress in transposing and implementing EU regulations. Estonia and Lithuania have provisionally closed 28 of the 31 negotiation chapters and Latvia has closed 27. The Commission's latest progress report notes that the three Baltic states already meet the political criteria of membership and should be able to fulfill the economic criteria and assume the obligations of membership in 2004. The Commission will closely monitor the commitments the candidates undertook during

the negotiations, and six months before the date of accession will produce a report monitoring further progress. Outstanding issues include the following:

- **Agriculture.** None of the Baltics states are satisfied with the agricultural production quotas offered by the EU. They argue that the Russian crisis in 1998 had serious negative consequences for their agricultural trade, and that this should be taken into account in determining EU production quotas. In addition, most candidates argue for direct payments on a par with current EU members from the date of accession rather than direct payments being introduced gradually so that new member states reach the support level in 2013 then applicable to current EU members.
- **Budgetary compensation.** The future member states are worried about delays in receiving payments from structural and cohesion funds during the early postaccession years. The Brussels European Council confirmed that if the forecast cash flow balance with the Community's budget is negative for individual candidate states during 2004-06 compared with 2003, temporary budgetary compensation will be offered.
- **Labor movement.** The future member states consider people's freedom of movement an important issue. Some current members want safeguards on labor movements after enlargement. On the initiative of the EU a reciprocal transitional arrangement was agreed for a maximum of seven years. A number of member states opted for immediate liberalization of their labor markets. Finland will keep its current work permit system in place for two years after the enlargement and review the situation after that time.

In addition, some issues have arisen in connection with individual countries, namely:

- **Estonia may continue oil shale production.** The EU and Estonia have agreed on the most sensitive aspects of energy and taxation policy. In recognition of Estonia's need to restructure its oil shale sector, last July the EU accepted Estonia's request for a transition period to the end of 2008 before it opens its electricity market to competition. However, the EU rejected Estonia's request to maintain its right to engage in tax-free and duty-free sales on ferries and other ships serving EU countries for six-and-half years after accession. The EU found that the regime would distort competition in the internal market.
- **Latvia to focus on administrative capacity and judicial reform.** Apart from agriculture, Latvia has encountered few major problems in its accession

negotiations. Nevertheless, the EU remains concerned about corruption and believes Latvia needs to further develop its administrative and judicial systems.

● **Ignalina, Kaliningrad, dominate Lithuania's talks.**

The major challenge for Lithuania is the closing of the Ignalina nuclear power plant and coping with the economic and social implications. Lithuania has confirmed that Unit 1 will be closed before 2005 and Unit 2 by 2009. The EU has promised to support the shut down of Ignalina. [Editor's note: Concerning transit to and from the Russian enclave of Kaliningrad, the recent EU-Russia Summit agreed that from July 2005, "facilitated transit documents" will be available to Russian citizens: the "Kaliningrad pass," essentially a multiple-entry visa, and a "facilitated rail transit document" for rail passengers that will be issued to all ticket holders at the Russian-Lithuanian border. Russian internal passports remain valid for travel through Lithuania until 2006.]

*The author is a counselor at Finland's Ministry for Foreign Affairs, Unit for EU Enlargement. This article was published in the November issue of Baltic Economies—Bimonthly Review and is available at <http://www.bof.fi/bofit/>.*

## Federal Shareholdings in Russian Companies

### Origin, Forms, and Consequences for Enterprise Performance

By Alexander Muravyev

Russia is famous for the unprecedented scale and speed of its privatization program, which within a couple of years transformed the overwhelming majority of state enterprises into privately-owned companies. By 1995 the public sector in this former command economy had been reduced dramatically and produced less than half of Russia's GDP. In subsequent years the state sector continued to shrink as a result of further, though less dramatic, privatization efforts. However, even after a decade of privatization the public sector remains extremely large. At the federal level alone the state remains the sole owner of more than 9,700 enterprises and maintains ownership stakes in about 4,000 other companies. In addition, the state is the owner of more than 34,000 organizations such as hospitals, universities, and the like. These figures would be even higher if enterprises and organizations belonging to the state at the regional level were included.



In general, the performance of companies in which the state has any ownership stake is significantly worse than those of companies with no state participation. This negative effect of state ownership does not appear to be a consequence of the concentration of initially bad firms in the hands of the state during the privatization process, that is, the selection of better firms for privatization. Therefore state ownership would appear to be detrimental to company performance.

The distortion of the objective functions of firms because of state interference is not as dangerous as the lack of control over the companies and the deficient monitoring of managers in particular. This highlights the importance of improvements in the field of corporate governance. Another important observation is that the golden share (the right to veto) generally has no detrimental impact on company performance. It is therefore a less dangerous instrument for protecting the state's interests through retaining some degree of control over companies than keeping blocks of their shares.

This analysis has several policy implications, namely:

- The government should avoid keeping equity stakes in companies unless it has a good reason for doing so. Thus privatizing most blocks of shares remaining in state ownership is recommended.
- If the government wants to keep an ownership stake in a company, control structures must be improved. State shareholdings in the same company should not be split between different ministries or agencies.
- The issuing of golden shares in important companies is a reasonable alternative to retaining some control over them through equity ownership.

*The author is a visiting researcher at BOFIT and an economist at the Russian-European Centre for Economic Policy. The full text of this article, Discussion Paper 12/2002, can be downloaded at <http://www.bof.fi/bofit/fin/6dp/index.stm>.*

## Too Many To Fail? Interenterprise Arrears in Transition Economies

By Antje Hildebrandt

The use of trade credits is an important form of short-term financing in advanced market economies and is generally considered to be a normal business practice. Some transition economies, however, have experienced a rapid accumulation of trade credits, which has led to interlocking webs of arrears and collective bailouts by their governments. Trade credits can have negative spillover effects on other firms by worsening their financial situation. This interlocking effect is more pronounced in countries with less developed institutions, low financial intermediation, and no overall credible commitment to market economic reforms.

The results of testing for the presence of chains of arrears in two transition economies, Hungary and Romania, suggest that while strong trade linkages had been broken up in Hungary, this was not the case for Romania. Presumably, therefore, trade credits still represent a systemic risk to the Romanian economy. Country experience shows that the problem of arrears is closely linked with the ability to adjust to structural changes, as well as with the credibility of a national stabilization program early in transition and of institutional development in the long run. A decade of transition in Central and

Eastern Europe clearly shows that building market-oriented institutions and changing government perceptions is a complex, time-consuming challenge.

What should a government do in the short run if it faces a large stock and flow of interenterprise arrears and its economy is susceptible to a chain of arrears? There are two extreme positions. The first is to do nothing. The alternative is to implement a general bailout of firms in arrears. Both strategies carry severe consequences. The first strategy is advisable only if firms already apply basic credit mechanisms and no interlocking webs of arrears have yet formed. The negative spillover effects generated by this approach can put viable firms at risk. The second strategy solves the stock problem of arrears in the short term, but gives rise to serious moral hazard problems. Furthermore, a stringent liquidation of firms in arrears is difficult to enforce, because the state lacks information to distinguish between good and bad firms.

In the short run the government should, in principle, signal its commitment to economic reforms by liquidating inefficient firms. In Romania's case, however, such a



commitment would have extended mainly to state-run utility companies, because they were the biggest actors in accumulating enterprise arrears. Rather than setting a good example, the state itself may be reluctant to follow basic market economy principles. For less advanced Central and Eastern European countries to cross the "great divide" and escape the transition trap they should focus on building up market-supporting institutions and work to improve confidence in government policies and competitive markets. The state is

still overcommitted in the Romanian economy, which impedes such market-based adjustments as private sector development.

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## Combining Incompatibles: Fixed Exchange Rate, Liberalization, and Financial Development in Estonia

By Pekka Sutela

Contrary to most experience Estonia—as well as Latvia and Lithuania—has for a number of years been able to combine fixed exchange rates, financial liberalization (prior to proper supervision), and large current account deficits without inviting speculation using large capital flows as vehicles. The standard argument is that this must be because of exceptionally sound fundamentals and policy credibility. Without challenging this argument either generally or in the case of Estonia, Latvia, and Lithuania, this paper offers a supplementary perspective.

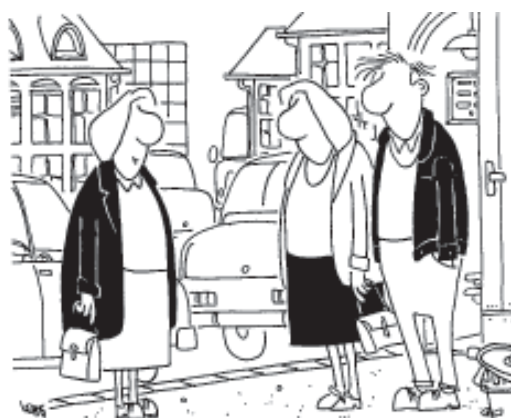
These countries did not aim at developing a full-scale national economy with a complete set of financial and other markets, as they had the possibility of joining an institutionally, culturally, and geographically close set of northwestern European markets. Such a strategy goes further than having the goal of "rejoining Europe" as the external policy anchor. Having well-developed domestic markets can, in some cases, be substituted for by accessing nearby markets, thereby leaving little leeway for potentially unstable capital flows. This option, however, is not open to all, and it also has its downside.

Dependence on a single or very small number of exporters, especially if they are involved in forward processing of cyclically sensitive goods, may pose risks for a small country in terms of sharp fluctuations in export revenue, and therefore potentially in money supply. A less well understood problem is the emergence of a two-tier economy. If domestic savings and financial intermediation are substituted for by access to foreign finance,

such access will not be similarly available to all economic agents. There is a danger that the mostly foreign-owned banks and other financial institutions will concentrate on serving only the upper end of the market. A lack of retail banking, especially in the countryside, and in particular the lack of micro and small-scale finance for start-ups, may hamper both households and the development of a healthy small-scale enterprise sector. Modern technologies such as Internet banking will only partially address these problems.

*The author is the head of BOFIT. Online Paper no 8/2002 can be downloaded from <http://www.bof.fi/bofit/fin/7online/index.stm>.*

### Growing Unemployment



**"It's amazing how fast this little unemployed boy has grown since last year."**

From the Hungarian magazine *Hócipő*

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A NONPARTISAN ECONOMIC AND SOCIAL POLICY RESEARCH ORGANIZATION

# Early Experiment with Performance Management in Albania

By Katharine Mark and Zana Vokopola

**In Albania local governments distribute social assistance benefits to needy families. A survey in the city of Elbasan revealed that many potential recipients of social benefits felt they did not have enough information about social services and believed that the targeting of social benefits was weak. This finding motivated the city authorities to set up a social services information center. This self-sustaining information center was one of the early results of the use of performance management by Albania's local governments.**

Since 1998 Albania has been undergoing both democratization and fiscal decentralization, both of which imply the devolution of authority and decisionmaking powers to local governments. One key benefit of decentralization is that services provided can be more in tune with citizens' needs and preferences. Accordingly, local governments must not only be responsible for delivering services to their citizens, but also for ensuring that they are the right services and that they are effective. In the social sector in particular, needs vary sharply across localities, and using the limited resources available effectively is important. In other words, services must be tailored to address specific needs. However, local governments have little experience in reaching out to citizens or improving service delivery by taking advantage of their greater maneuvering possibilities compared with the central government.

## Action Plan and Survey

This process of improving service delivery can be assisted by performance management, which focuses on the actual results of public programs and on the needs of the customers or citizens served. This system enables local governments to improve services by tracking service outcomes over time, that is, by monitoring the impact of services on citizen's everyday lives and inducing management to make their decisions based on performance. In Elbasan performance management motivated the city's staff to search more proactively for ways to improve services. At the same time, the transparent nature of performance management strengthens the accountability of local governments.

In 1999-2000 a project funded by the U.S. Agency for International Development helped four Albanian local

governments introduce performance management. The project had two interactive components: developing a sector-specific action plan in each local municipality and conducting a multiservice customer survey of about 500 households in each city. The action plan called for each locality to design a performance management system, including developing indicators and plans to improve services based on results. The customer survey provided feedback from the citizenry about services provided by the local government. It also helped citizens focus on the project and was useful in determining baseline values for many of the outcome indicators.

## The Elbasan Experiment

Elbasan chose to focus on social services. The city had several problems. The city council's deliberations on who was entitled to receive social benefits was a slow and laborious process. Verifying information provided by applicants was difficult and time-consuming. Twelve social administrators were located in five different administrative unit offices scattered throughout the city. Each administrator was responsible for about 500 families and claimed that this was too many. The Social Department, for its part, thought that the administrators had "insufficient training."

In 1999 the city was providing monthly social assistance benefits to 5,250 needy families of at most lek 6,500 (\$45) per family. The Social Department believed not only that this was far less than was needed, but that many of those receiving benefits were not entitled to them because their incomes were above the poverty line. The Social Department was also concerned that many needy families were not well informed about the availability of benefits. Many services are provided through a multitude of poorly coordinated NGOs

and local governments, and people simply do not know about them.

A working group was formed by representatives of the city's staff and local NGOs and an outside expert familiar with social issues. The working group's goals were to provide a minimum subsistence level for all families in the city and a healthy and secure environment for the elderly and the disabled. Outcome indicators selected to measure the effectiveness of targeting included the number and percentage of citizens whose incomes fell below the poverty line and the ratio of cash benefits to income paid to households in the lowest income quartile. An additional outcome indicator was designed to measure the proportion of citizens who believed they did not have enough information about social services.

As resources for social services are scarce, targeting benefits to the most needy was especially important. The citizen survey showed that targeting in Elbasan had been weak, with only a third of recipients actually in the lowest-income households—those who earned less than lek 100,000 per year (\$720)—receiving benefits. Benefit recipients were also asked to rate different aspects of the services they received. Respondents were most dissatisfied with the small amount of the benefits. As for the type of service received, benefit recipients were “somewhat dissatisfied” or “very dissatisfied.”

Of those interviewed 32 percent felt they did not have enough information about available social services. Those who received information from “official” sources like the media or social workers thought they were better informed than the many who obtained their information from family and friends. The major source of information was through the media—probably a result of the city's concerted media outreach. More than half of those interviewed had a family member out of work.

In addition to the citizens, Elbasan's city administration was also lacking consistent and comprehensive information about available social services. Accordingly, the working group decided to establish an information center, and did so within a few months. The center disseminates information to the local government, to clients, to central government institutions, and to NGOs that operate in the social sector. In addition to providing information to potential recipients, the center shares information across agencies to facilitate processing, avoid overlaps, and minimize fraud. As a result of integrating information and publishing recipients' names, in the first month almost 600 families and in the first year a total of 1,500 were removed from the benefit program as they had been falsely claiming to be below the

poverty line. The city then spent money on other families in greater need of assistance. The information center thus helps improve targeting to the poorest households and reduces the amount of time staff spend on processing and verification. Additional training helped the staff develop computer skills and improve proficiency in understanding current laws regulating the social sector and the role of local governments in financing and managing social services.

The working group also created a monthly newsletter that has become a municipality publication produced by the information center. The newsletter regularly provides information about city council decisions, city events, and new services. The working group also started holding regular open meetings with local NGOs and journalists to discuss important issues and ensure dissemination. Encouraged by the success of the information center, the city decided to establish a social services office that provides citizens with information such as how to acquire construction permits or obtain tax advice.

### Crucial Questions

In addition to helping the city better focus its efforts in the social sector, the project also has potential value nationwide, especially during this period of decentralization. Some of the issues that this performance management approach illuminated include the following:

- Do local governments have sufficient discretion to respond to local needs?
- Could citizens' groups help local governments provide assistance in the social area more effectively by sharing best practices?
- Are social assistance subsidies reaching the right households?
- Are program funds effective in addressing priority problems?
- Are any special difficulties associated with the implementation of programs, for instance, onerous application processes?
- Are central government programs addressing the right set of problems or do serious mismatches exist between programs and needs?

Responses to these questions are crucial if social services are to be effective and if we want to fulfill the promise of decentralization.

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# Improving Social Assistance Administration in Russia

By Raymond Struyk

**A new initiative, first tried in the Russian city of Arzamas, simplifies Russia's excessively complicated social assistance administration. Clients will have less costly and faster access to municipal benefits and services, and the city administration can save costs and improve effectiveness. Next year the results of this pilot program will be disseminated to all local governments across Russia.**

Local governments in Russia now have primary responsibility for administering social assistance programs thanks to a combination of the decentralization of some responsibilities and the transfer of certain administrative functions from state enterprises to municipalities. Local governments' duties have expanded with the introduction of means-testing to many programs, in particular, housing and child allowances. However, administrative practices generally remain weak.

The redesign of some aspects of procedures for running programs at the local level could result in simplifications that both improve the quality of administration and increase efficiency. The proposed changes include

- Adopting identical definitions for "household," "family," "household income," and "family income" across the national government's programs; using the same documentation for income verification; and requiring the same length of time between income recertification.
- Integrating the administration of now independent programs.
- Promoting greater staff specialization, which could increase productivity and lower error rates.

Russian local governments could realize substantial savings in the cost of administering social assistance programs by integrating the client intake and benefit determination functions. Moreover, such integration could make it much easier for citizens to receive benefits by sharply cutting the number of visits clients have to make to the city agency offices managing the programs and other offices to obtain the documents they need to verify their eligibility for benefits.

## Forms and Formalities

A pilot project to improve the efficiency of program administration was introduced in Arzamas, a city of 110,000 people in the *oblast* of Nizhny Novgorod. The project was also designed to ease the burden on clients and

improve their access to benefits. Specifically, the pilot introduced a unified application form for all the major social assistance programs in the city, and regardless of how many programs clients were applying for, required only one office and one set of documents verifying their eligibility for assistance.

Benefit processing was also consolidated. Before the introduction of the one-window system, the administration of nearly all social benefits was split among three separate municipal agencies, each under the authority of a different department or committee. The system also included a network of neighborhood centers, each staffed by one or two municipal social workers. Although these social workers provided emergency assistance to families, most of their responsibilities were not related to benefit provision. They often referred their clients to the main municipal agencies that provided benefits.

Each of the three benefit agencies performed all the functions necessary for administering the benefits they provided, including client intake, eligibility verification, benefit determination, case record management, client database development and maintenance, payment accounting, and appeals hearings.

The old system included a number of disadvantages for clients, including that families applying for multiple benefits were required to visit multiple offices and obtain multiple copies of documents to verify their eligibility. In addition, because of the lack of coordination among the three offices, clients applying for one benefit may not have been advised about other benefits or services available in other agencies for which they might have been eligible.

For the city administration, the major disadvantage of the old system lay in the administrative inefficiency of having three agencies separately administering means-tested benefits. Thus all the eligibility and benefit processing



functions needed to provide these benefits were duplicated in each agency. In addition, the lack of integration made it difficult for social policy planners to monitor outcomes for families as a whole, evaluate the relative importance of different benefits to families, and propose improvements to the benefits package offered by the city.

## Major Changes

The one-window pilot initiative was designed by the local administration of Arzamas with technical assistance from the Urban Institute in Washington, D.C. and the Institute of Urban Economics in Moscow under a program supported by the U.S. Agency for International Development. The one-window system involved two major changes to the administration of social benefits in Arzamas.

First, the functions of eligibility screening and client intake were separated from the agencies that provided the benefits and decentralized. The social workers in each of the 14 neighborhood offices were trained to interview applicants for all social benefits and to collect their application and verification documents. When implementation was complete clients could apply for up to 10 different federal and municipal benefits, including the housing allowance and the child allowance, at a local one-window office. In addition, a new unified application form was created by a joint committee of the three benefit agencies that could be used for all benefits. Thus applicants need to fill out only one application form at a single nearby office regardless of the number of benefits for which they are applying.

The second major reform was the creation of the Department of Social Payments, a single agency for determining eligibility for benefits, processing payments, and carrying out other benefit administration functions. Social workers in the 14 neighborhood centers forward the unified application form with accompanying documents to the Department of Social Payments for processing. Notifications of eligibility are sent from the department to both clients and the neighborhood social workers. Benefits payments are transferred directly to the bank accounts of program recipients or to neighborhood post offices by the department's accountants. Eligibility specialists and accountants in the Department of Social Payments were trained to process all benefits, not just a single benefit or a small number of benefits.

## Benefits for Everybody

The administrative changes introduced as part of the one-window system were intended to benefit both the municipality and the clients who receive benefits. For the clients, the one-window system was expected to reduce the burden of obtaining benefits, particularly for beneficiaries of multiple benefits, and improve access to municipal benefits and services. For the administration, the one-window changes were expected to decrease administrative costs, improve the effectiveness of administration, improve planning, and lower error rates. Both groups saved as follows:

- Savings to the municipal administration:
  - Consolidation of benefit applications into a single unified application resulted in a 40 percent decrease in the number of applications that needed to be processed.
  - Processing time was reduced by 31 percent.
  - Benefit workers' productivity increased by 33 percent.
  - Administrative costs per benefit application decreased by 32 percent.
- Savings to clients:
  - Clients spend less time getting the documents they need to complete applications, for example, for a household applying for both the child allowance and the housing allowance the time was reduced from about 4 hours to 2-½ hours.
  - Clients spend less time traveling from office to office. The average time savings from reduced travel to multiple offices was 1.1 hours, from 2.4 hours to 1.3 hours.

The one-window system is now being implemented in Chelyabinsk, Cherdin, Gorodetz, and Magadan with assistance from the Institute for Urban Economics in Moscow and the Urban Institute in Washington, D.C. In January 2003, when guidance materials on self-implementation are ready, the results described in this article will be disseminated to other local governments in Russia. A number of countries in the region have pilot projects on program integration under way, but to our knowledge this is the first careful evaluation of the benefits of such integration. Our expectation is that similar benefits could result from implementing similar procedures elsewhere.

*Raymond Struyk is a senior fellow at the Urban Institute. This article is based on his paper in the forthcoming volume "Savings from Integrating Administrative Systems for Social Assistance Programs in Russia," by G. J. Gallagher, R. Struyk, and L. Nikonova. He can be reached by email at [rstruyk@ui.urban.org](mailto:rstruyk@ui.urban.org).*



# Not Garbage: Improving Local Waste Management in Transition Economies

By Gretchen Mikeska and Steve Swanson

Although Western standards for solid waste management promote best practices and minimize risks posed to public health and the environment, they can also discourage donor assistance in transition economies, because meeting these standards can require too large an investment. However, if achieving Western standards is considered a long-term rather than an immediate goal of the assistance program, modest investment could result in significant improvements to solid waste management practices.

Municipal solid waste (MSW) management is a problem worldwide. The amount and composition of a country's garbage is an indicator of its prosperity. The industrial countries generate two or three times the volume of waste than developing countries. As incomes grow, the composition of waste changes from primarily wet biomass to a higher proportion of paper and plastic. The disposal of this "more sophisticated" garbage becomes more complex, because it consists of more durable, less biodegradable materials, such as plastics, paints, and household cleaners.

## Modest Goals, Modest Costs

Improving MSW management can be a costly or a modest endeavor, depending on the goals of the municipality. If the goal is to bring the MSW system up to Western standards, this may entail establishing a door-to-door collection system, providing a transfer station for sorting and recycling, and building a state-of-the-art landfill. However, even a modest investment can result in significant improvements. For example, a review of the collection system may result in better placement of collection bins and more trash collected, or improving the road to the dumpsite may mean that more garbage reaches the landfill. The tendency for MSW projects is, however, to think big: build a new landfill, buy a fleet of compaction and/or collection trucks. MSW projects suffer from the additional problem that neglect of past practices lingers. Old dumpsites often pose a risk to public health and/or the environment, and must be cleaned up to avoid the risk of additional exposure. Abandoning existing sites without proper closure may pose a greater risk than their continued operation.

Three principal alternatives are available for funding solid waste services: property tax revenues, flat fees, and variable fee rates. Transition economies typically use flat fees known as user tariffs. Appropriate tariffs are difficult to establish (and collect), because historically residents were not charged for the full cost of MSW

services. In addition, tariffs rarely cover the full cost of collecting and transferring garbage and operating the disposal facility, let alone closing old sites. For example, in Albania tariffs would, on average, need to be increased 400 percent per household to cover the full costs of MSW services, not including closure costs.

The net effect is that MSW projects tend to be costly and residents believe they are not getting much for their investment if a large portion is allocated toward correcting past practices. This reality makes MSW projects politically unattractive to local officials. They are equally unattractive to the donor community, because the investment is large or does not bring the community any closer to meeting Western standards of solid waste management.

## Landfill Standards

While waste-to-energy and municipal waste incinerators are favored in some areas, the overwhelming majority of waste disposal is on land. The EU and the United States have landfill standards that share common elements for landfill design, construction, and operation. The overall goal of these standards is to protect public health and the environment from unreasonable risks caused by landfill operations, but this approach raises the question whether these standards should be performance based or design based. Most countries have adopted design standards instead of performance standards, because design standards are easier to apply as they can be enforced during project design and construction.

Design standards generally specify requirements for liners, collection of leachate (liquids that pass through the landfill), gas control systems, and groundwater monitoring. Well-sited landfills that meet current design standards are less likely to cause surface water and groundwater contamination. The requirement for landfills to be constructed using either a plastic or clay liner and a leachate collection system is the major reason why old

facilities cannot be retrofitted to meet current standards. A properly designed leachate collection system also helps prevent surface water and groundwater contamination.

Donors must recognize that transition countries will not have the funds to construct Western style, state-of-the-art landfills for many years, and most transition communities will use their existing landfills for the foreseeable future. Donors do not need to provide millions of dollars to finance new state-of-the-art landfills to help reduce the risk posed by land disposal if they shift their focus to performance-based assistance for improving the daily operational performance at existing facilities.

Improving MSW practices in transition countries will occur slowly and through a variety of means. Modest

MSW projects can result in significant improvements. Financing these projects through appropriate user tariffs and donor funding will be the quickest road to project implementation; however, this will require that decisionmakers take some risks. Local politicians must be willing to raise tariffs, without regard to political fallout, and the donor community must be willing to provide assistance even if projects do not immediately achieve Western standards of design and operation.

*Gretchen Mikeska and Steve Swanson are both senior research associates at the Urban Institute. Among other sources, this article draws on work undertaken on projects funded by the U.S. Agency for International Development in Central and Eastern Europe. For further information the authors can be reached at gmikeska@ui.urban.org and oyster41@aol.com, respectively.*

### Trash Collection in Topola, Serbia

The municipality of Topola is a typical Serbian community. It has about 26,000 inhabitants, of whom about 6,000 live in the town of Topola. Some 60 to 70 percent of Topola's solid waste consists of organic material, with the remainder comprising glass, paper, steel, and aluminum. This trash composition is characteristic of Serbia and other transition countries.

Like most locations in transition countries, Topola does not support trash collection from individual homes. Residents must take their trash to central collection points located in the town, where the community's solid waste is collected in large, covered steel containers. Each day the Topola Office of Public Works (TOPW), a public company, empties the collection bins located in the town center. In other residential areas the collection bins are only emptied once every 10 days. The limited number of bins and the infrequent collection in all areas but the town center may contribute to illegal dumping.

Each day the TOPW collects approximately 50 cubic meters of solid waste (18 metric tons or approximately 3 kilograms of solid waste per person per day) from the collection points and transports the waste to the dumpsite.

The municipality recently received a grant that it could use to expand its solid waste management services to include two adjacent villages, which would add 5,000 people to the collection system. A series of projects and actions will be necessary to bring this about, including the following:

- Providing new trucks and collection bins
- Bringing villages into the collection system by placing containers at strategic locations
- Building transfer stations that will separate materials
- Cleaning up illegal dumps
- Improving the management of the landfill by covering waste daily
- Expanding recycling by providing collection containers for glass, plastic, and paper and developing an ongoing public awareness and education program in schools and in the community
- Planning and designing a new landfill and developing a closure plan for the existing dumpsite.

The cost of these projects is beyond the budget of the local community, even if it were to use innovative, low-cost approaches. A locally constructed landfill would amount to some \$1 million. A landfill designed to EU standards would probably cost \$2 million to \$4 million, could last for 25 to 35 years, and would serve about 30,000 to 50,000 inhabitants. On a per capita basis, the cost of a new lower-tech landfill and operating and collection costs for the town of Topola would be about \$86 per person per year. If all 26,000 inhabitants of the municipality were included, for about \$10 per person per year the operating practices of the current landfill could be improved. In a country where water bills are less than \$20 per family per year, this is a significant cost; however, and the cost for an average family of four would be equivalent to more than one month's income.

# Conference Diary

## For the Record

### The 2002 Ninth Annual CIS and Eastern Europe Business Forum Focusing on Success in the CIS and Eastern Europe

November 2-3, Tucson, Arizona, United States

Organizer: University of Arizona, Department of Russian and Slavic Languages.

*Information: Senior lecturer Roza Simkhovich or department head George Gutsche, University of Arizona, Department of Russian and Slavic Languages, 520-626-4007 or 520-298-6599. Last minute program changes can be found on the conference web site: go to <http://russian.arizona.edu> and follow the link to Business Forum 2002. You may also e-mail Roza Simkhovich at [roza@dakotacom.net](mailto:roza@dakotacom.net).*

## Forthcoming

### EuroMarket Forum 2002—Private Sector Development and Investment in Emerging Markets

December 15-17, 2002, Brussels, Belgium

This event is an interactive business forum combining discussions and workshops aimed at strengthening emerging markets' private sectors, promoting trade and investment, and attracting foreign investment to the region.

*Information: <http://www.emrc.be/>.*

### The State of Economics and of Transition—Honoring 10 Years of the New Economic School (NES)

December 19-21, Hotel Renaissance, Moscow, Russia

Organizers: NES, in cooperation with CEFIR, EERC, SITE, and WDI. The keynote speech titled "Globalization and Challenges," will be delivered by Stanley Fischer. Conference papers include "WTO Membership and Productivity" by David Tarr, "Job Creation and Job Destruction in Transition: What Do We Know, What Should We Know?" by Hartmut Lehman, and "Financial Development, Fiscal Responsibility and Rule of Law" by Erik Berglof and Patrick Bolton. Participants in the Postcrisis Russia roundtable include Yegor Gaidar, Barry W. Ickes, Andrei Illarionov, and Pekka Sutela.

### Nordic Forum for Security Policy—Murmansk and New Possibilities in the Barents Region

January 24-25, 2003, Murmansk, Russia

Organizers: The Nordic Forum for Security Policy in cooperation with the Murmansk State Pedagogical Institute and with the support of regional authorities. The Finnish Committee for European Security coordinates the work of the forum.

Topics: These include "Need, Hopes, and Suggestions for Better Border Cooperation," "Murmansk Presents Itself," "Northern Sea Security in the 21<sup>st</sup> Century," "Environmental Safety and Cooperation," "Economic Integration in the European North," "Active Civil Society—A Must for Democracy," "Education and the E-Dimension," "Russia and Northern Europe—A Partnership," and "Overview of Present and Future Perspectives."

The conference will be held at the Murmansk Philharmonic Hall (ul. Vorovskogo 18) and the Hotel Polyarnie Zori (ul. Knipovicha 17). The opening session will start at 9 A.M. on Friday, January 24. The theme sessions and working groups will end at 3 P.M. on Saturday, January 25. Following the closing of the conference an excursion will be organized to the surroundings of the city of Murmansk.

Conference languages: The conference will be interpreted into English and Russian.

*Information: Meri Kulmala, email: [stete@stete.org](mailto:stete@stete.org), tel.: 358 9 260 131; Pieni Roobertinkatu, 5 B 12, 00130 Helsinki, Finland, tel.: 358-9-2600 130, fax: 358-9-2600 122, email: [laura.paivio@stete.org](mailto:laura.paivio@stete.org), URL: <http://www.stete.org>.*

### The New Economic Formation in Asia and the Flow of Foreign Direct Investment

February 13-14, 2003, Hanoi, Vietnam

Organizers: These include the French-Vietnamese Management Training Center, Hanoi, and the Emerging Economies and Enterprises Research Center, Paris.

This colloquium will focus on recent economic developments in South Asia, including the consequences of the 1997 financial crisis and China's accession to the World Trade Organization and their effect on the flow of foreign direct

investment, with the latter being an important indicator of relations between industrial and developing countries.

Conference languages: French and Vietnamese.

Call for papers: by November 15, 2002.

Information: [vkucharski@escp-eap.net](mailto:vkucharski@escp-eap.net).

**Economic Development and Reconstruction Policies in Southeast Europe: Regional Cooperation, Trade, and Foreign Investment**

April 10-12, 2003, Dubrovnik, Croatia

Organizer: The Inter-University Center, Dubrovnik, an independent international institution for advanced studies and a forum for learning and scholarship cosponsored by some 200 member universities and institutions of higher learning around the world.

The conference is the second in a series that will address the issue of economic development and reconstruction in Southeast Europe (the first, held in April 1992, focused on the role of small and medium enterprises). The conference is designed to bring together academics, policymakers, and practitioners interested in issues relating to economic development and reconstruction policies in Southeast Europe to present research results and policy evaluations (what works and why), and to participate in intensive debate and exchange of views.

Application deadline: November 15, 2002 (for abstracts).

Information: *Maja Vehovec*, tel.: 385-51-338-067, fax: 385-51-322-621, email: [maja.vehovec@ri.tel.hr](mailto:maja.vehovec@ri.tel.hr), URL: <http://www.hr/iuc/docs/konfer/confer.html>.

**Enhancing the Capacities to Govern: Challenges Facing the CEE Countries**

(11th Regional Center of the United Nations Online Network in Public Administration and Finance Annual Conference)

April 10-12, 2003, Bucharest, Romania

This conference will discuss the theory and practice of enhancing capacities in public administration. Papers are invited on the main conference theme or on the themes of the working groups.

Information: *Viera Wallnerova*, project manager, NISPAcee, Hanulova 5/B, 840 02 Bratislava 42 Slovakia

Republic; tel.: 421-2-6428-5558, tel./fax: 421-2-6428 5557, email: [Wallnerova@nisp.sk](mailto:Wallnerova@nisp.sk).

**Fifth International Conference on the Enterprise in Transition**

May 22- 24, 2003, Split, Croatia

Organizer: Faculty of Economics, University of Split.

The conference will have two focus areas: institutions, investment, and integration and new challenges for the enterprise in transition. Prospective authors are invited to submit a short abstract (up to 250 words) in English, including the author's name, affiliation, and contact details, by September 30, 2002. Detailed instructions for authors will be provided to all the authors whose abstracts are accepted for the conference. Papers should be received by January 31, 2003, in order to be included in the review process. Details on conference sessions and presentations, as well as on conference venue, will be sent along with the instructions to authors by October 31, 2002.

Information: *Faculty of Economics, 31 Matice Hrvatske, 21000 Split, Croatia*; tel.: 385-21-430-600 or 430-700, fax: 385-21-430-701, email: [eitconf@efst.hr](mailto:eitconf@efst.hr), URL: <http://www.efst.hr/eitconf>.

**Public Relations—An Instrument for Transformation and Development of Higher Education in Central and Eastern Europe**

May 23-25, 2003, University of Economics, Poznan, Poland

Organizers: Chair of economic journalism and public relations, Poznan University of Economics, Poznan, Poland; and the United Nations Educational, Scientific, and Cultural Organization—CEPES, Bucharest, Romania.

The conference will bring together professionals and academics working in the areas of both higher education and public relations in the European transition economies. Participants will discuss current reforms and development issues as they pertain to higher education and how to forge good working relationships and create strong competition between public universities and newly established private universities. Proposals for papers, based on concluded or ongoing research, case studies, working papers, and/or review papers, must focus, among other things, on

- The image of institutions of higher education—selling a “product” or fulfilling a mission?



- Differences in the public relations strategies of private and state-owned schools of higher education.
- Fund raising, a new phenomenon. Do universities need lobbying?
- Differences in the visual identity of private and state-owned schools.
- Role of alumni associations as multipliers of a positive image.
- Role of ranking in creating positive images of a university.
- University newspapers and editing houses, their role in the school's public relations.

Deadlines for submission: abstracts by February 15, 2003, and complete papers by March 15, 2003.

*Information: Jacek Trêbecki, chair of the Organizing Committee, e-mail: kpr@novci1.ae.poznan.pl.*

### **Promise and Problems: Economic Development and Strategic Planning in Eastern Europe in a Globalization Context**

May 27-28, 2003, Kharkiv, Ukraine

Organizers: The Ministry of Economic Development and European Integration, Kharkiv National University, Kharkiv State Academy of Municipal Economy, University of Texas at Arlington, Institution of Economic-Ecological Studies of the National Academy of Science of Ukraine. Co-organizers: Kharkiv State Regional Administration, and Institute East-West.

The symposium will address critical topics and professionalization issues in economic development and strategic planning. Participants will explore the current international framework as a context for local and regional economic development and strategic planning. They will investigate the following questions:

- How should local and regional economic development authorities respond to the current context of the economic development and strategic planning?
- What institutional restructuring is necessary for effective practice of economic development and strategic planning?
- Given the current framework, what are appropriate public policies and economic development strategies?

Participants will consider the role of academic research in informing economic development theory and

practice. Specifically, they will endeavour to determine

- What new research questions are necessary for public policy research to inform economic development and strategic planning?
- How can the academy better inform public policy for economic development?

Please include the following in your application:

- Full name of presenter (and co-authors)
- Your academic degree, affiliation, and position
- Topic of paper and presentation
- Your key research interests and curriculum vitas (up to three pages)
- Full address, including e-mail.

The paper abstract should be in ".doc" or ".tft" format one to two pages, 1.5 spacing, font Times New Roman, size 12, all margins 1 inch.

*Information: Alexander V. Kovryga, director of the Center for Economic Development Research and Management Capacity Building, Kharkiv State Academy of Municipal Economy, Room 303, Revolutsii Street, 12 Kharkiv 61002, Ukraine; email: Oleksandr\_Kovryga@yahoo.com, tel./fax: 380-572-406734 or Sherman M. Wyman, director of the Center for International Education and Development, School of Urban and Public Affairs, University of Texas at Arlington, Box 19588, Arlington, Texas, 75019; email: wyman@uta.edu, tel.: 817-273-3071, fax: 817-7945008; or Grigoriy V. Zadorozhnyi, Kharkiv National University, 1 Mironositskaiya Street, Kharkiv 61002, Ukraine; tel.: 380-572-457550.*

### **Call for Papers for the International Society of New Institutional Economics (ISNIE), 2003**

September 11-13, 2003, Prague, Czech Republic

ISNIE 2003 will be cosponsored with CERGE-EI, the graduate program and research center created jointly by Charles University and the Academy of Sciences of the Czech Republic.

The conference will be held at historic Charles University and CERGE-EI in the center of Prague's Old Town.

*For further information please consult the ISNIE website at <http://www.isnie.org>.*



# New Books and Working Papers

## World Bank Publications

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Jeni Klugman, ed., **A Sourcebook for Poverty Reduction Strategies** (2 vols.), 2002, vol. 1: 624 pp., vol. 2: 656 pp.

## World Bank Technical Papers

Daniela Gressani and Saumya Mitra, **Structural Reforms in Southeastern Europe since the Kosovo Conflict**, Technical Paper 526, 2002, 40 pp.

Ana Revenga, Dena Ringold, and William Martín Tracy, **Poverty and Ethnicity: A Cross-Country Study of Roma Poverty in Central Europe**, Technical Paper 531, 2002, 56 pp.

## World Bank Working Papers

<http://econ.worldbank.org/>

Klaus Deininger and Songqing Jin, **The Impact of Property Rights on Households' Investment, Risk Coping, and Policy Preferences: Evidence from China**, WPS 2931, November 2002, 35 pp.

Even though it is widely recognized that giving farmers more secure land rights may increase agricultural investment, scholars contend that in the case of China, such a policy might undermine the function of land as a social safety net and, as a consequence, not be sustainable or command broad support. Data from three provinces, one of which had adopted a policy to increase security of tenure in advance of the others, suggest that greater tenure security, especially if combined with transferability of land, had a positive impact on agricultural investment and, within the time frame considered, led neither to an increase in the inequality of land distribution nor a reduction in households' ability to cope with exogenous shocks. Household support for more secure property rights is increased by their access to other insurance mechanisms, suggesting some role of land

as a safety net. At the same time, past exposure to this type of land right has a much larger impact quantitatively, suggesting that a large part of the resistance to changed property rights arrangements disappears as household familiarity with such rights increases.

Klaus Deininger, and Songqing Jin, **Land Rental Markets as an Alternative to Government Reallocation? Equity and Efficiency Considerations in the Chinese Land Tenure System**, WPS 2930, November 2002, 39 pp.

Carsten Fink, Aaditya Mattoo, and Ileana Cristina Neagu, **Assessing the Impact of Communication Costs on International Trade**, WPS 2929, November 2002, 38 pp.

Aart Kraay, **Growth without Governance**, WPS 2928, November 2002, 60 pp.

While good governance is important for economic development, the absence of "virtuous circles" in which higher incomes lead to further improvements in governance are not necessarily leading to further improvements. The book provides a newly updated set of worldwide governance indicators covering 175 countries for 2000-01, and the author uses the results to interpret the relationship between incomes and governance, focusing on the Latin America and Caribbean region within a worldwide empirical context. The author speculates about the potential importance of elite influence and state capture while trying to explain the surprising negative effects of per capita incomes on governance, and presents some evidence on such capture in some Latin American countries. He suggests priorities for actions to improve governance when such pernicious elite influence shapes public policy. The full governance indicators dataset is available on <http://www.worldbank.org/wbi/governance/govdata2001.htm>.

Beata Smarzynska, **Does Foreign Direct Investment Increase the Productivity of Domestic Firms? In Search of Spillovers through Backward Linkages**, WPS 2923, October 2002, 30 pp.

Many countries compete against each other to attract foreign investors by offering ever more generous incentive packages and justifying their actions by pointing to the productivity gains that are expected to accrue to domestic producers from knowledge externalities generated by foreign affiliates. However, little conclusive

evidence indicates that domestic firms benefit from a foreign presence in their sector. But perhaps researchers have been looking for foreign direct investment spillovers in the wrong place. Multinationals have an incentive to prevent information leakage that would enhance the performance of their local competitors in the same industry, but at the same time may want to transfer knowledge to their local suppliers in other sectors.

Spillovers from foreign direct investment may therefore be more likely to take place through backward linkages—that is, through contacts between domestic suppliers of intermediate inputs and their multinational clients—and thus would not have been captured by the earlier literature. Based on a firm-level panel dataset from Lithuania, the estimation results are consistent with the existence of productivity spillovers. They suggest that a 10 percent increase in the foreign presence in downstream sectors is associated with a 0.38 percent rise in output of each domestic firm in the supplying industry.

Bernard Hoekman, Francis Ng, and Marcelo Olarreaga, **Reducing Agricultural Tariffs Versus Domestic Support: What's More Important for Developing Countries?** WPS 2918, October 2002, 40 pp.

Randeep Rathindran, Carsten Fink, and Aaditya Mattoo, **An Assessment of Telecommunications Reform in Developing Countries**, WPS 2909, October 2002, 37 pp.

Paul Collier and Anke Hoeffler, **Aid, Policy, and Growth in Post-Conflict Societies**, WPS 2902, October 2002, 24 pp.

Based on a comprehensive dataset of large civil wars and covering 27 countries that were in their first decade of postconflict economic recovery during the 1990s, the authors find that during the first three postconflict years the absorptive capacity for aid is no greater than normal, but that for the rest of the first decade it is approximately double its normal level. Thus aid should phase in during the decade. Historically, however, aid has not, on average, been higher in postconflict societies and has tended to taper off over the course of the decade. The authors also find that that social policies are distinctively important relative to macroeconomic policies in postconflict societies.

John Luke Gallup, **The Wage Labor Market and Inequality in Vietnam in the 1990s**, WPS 2896, October 2002, 43 pp.

Has the expansion of wage employment in Vietnam exacerbated social inequalities despite its contribution to income growth? If Vietnam sustains its economic development in the future, wage employment will become an ever more important source of household income as family farms and self-employed household enterprises become less prevalent. A new method for consistent decomposition of inequality by income source shows that despite the rapid growth of wages in the 1990s, wage inequality fell modestly. A declining share of agriculture as the economy grows in Vietnam means that income inequality will rise, assuming that within-sector inequality does not change. Avoiding this rising inequality caused by the shrinking share of agriculture will be difficult without giving up economic growth and rapid poverty reduction.

Dong Cao, Genfa Lu, Jinnan Wang, Jun Bi, Yuan Wang, Hua Wang, Hua Wang, and David Wheeler, **Environmental Performance Rating and Disclosure: China's Green-Watch Program**, WPS 2889, September 2002, 28 pp.

Edmundo Murrugarra, Pierella Paci, and Soumya Alva, **The Hidden Costs of Ethnic Conflict: Decomposing Trends in Educational Outcomes of Young Kosovars**, WPS 2880, August 2002, 32 pp.

#### **Other World Bank Publications**

**The Right to Tell: The Role of Mass Media in Economic Development**, November 2002, 336 pp.

Free and independent media empower the poor and spur development. Free and independent media can expose corruption in government and the corporate sector, provide a voice for the people to be heard, and help build public consensus to bring about change. They can also help markets work better by providing reliable economic information. This new book draws together 19 chapters from a wide range of authors, including Nobel Prize winner and former World Bank chief economist Joseph Stiglitz, "Irrational Exuberance" author Robert Shiller, and Nobel Prize winning novelist (and a journalist in his early years) Gabriel García Márquez. Writers from the developing world also describe the challenges the media face in specific countries, including the former Soviet Union. The book describes media performance and regulations across countries and highlights what types of public policies and economic conditions might hinder or enhance the media in supporting economic development in poor countries.

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